S. Hrg. 108–368

MUTUAL FUNDS: TRADING PRACTICES AND ABUSES THAT HARM INVESTORS

HEARING

BEFORE THE

FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY SUBCOMMITTEE

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

NOVEMBER 3, 2003

Printed for the use of the Committee on Governmental Affairs

U.S. GOVERNMENT PRINTING OFFICE
91–038 PDF WASHINGTON : 2004

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON GOVERNMENTAL AFFAIRS

SUSAN M. COLLINS, Maine, *Chairman*

TED STEVENS, Alaska	JOSEPH I. LIEBERMAN, Connecticut
GEORGE V. VOINOVICH, Ohio	CARL LEVIN, Michigan
NORM COLEMAN, Minnesota	DANIEL K. AKAKA, Hawaii
ARLEN SPECTER, Pennsylvania	RICHARD J. DURBIN, Illinois
ROBERT F. BENNETT, Utah	THOMAS R. CARPER, Delaware
PETER G. FITZGERALD, Illinois	MARK DAYTON, Minnesota
JOHN E. SUNUNU, New Hampshire	FRANK LAUTENBERG, New Jersey
RICHARD C. SHELBY, Alabama	MARK PRYOR, Arkansas

MICHAEL D. BOPP, *Staff Director and Chief Counsel*
JOYCE A. RECHTSCHAFFEN, *Minority Staff Director and Counsel*
AMY B. NEWHOUSE, *Chief Clerk*

FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY SUBCOMMITTEE

PETER G. FITZGERALD, Illinois, *Chairman*

TED STEVENS, Alaska	DANIEL K. AKAKA, Hawaii
GEORGE V. VOINOVICH, Ohio	CARL LEVIN, Michigan
ARLEN SPECTER, Pennsylvania	THOMAS R. CARPER, Delaware
ROBERT F. BENNETT, Utah	MARK DAYTON, Minnesota
JOHN E. SUNUNU, New Hampshire	FRANK LAUTENBERG, New Jersey
RICHARD C. SHELBY, Alabama	MARK PRYOR, Arkansas

MICHAEL J. RUSSELL, *Staff Director*
RICHARD J. KESSLER, *Minority Staff Director*
TARA E. BAIRD, *Chief Clerk*

CONTENTS

WITNESSES

MONDAY, NOVEMBER 3, 2003

ALPHABETICAL LIST OF WITNESSES

Page

APPENDIX

MUTUAL FUNDS: TRADING PRACTICES AND ABUSES THAT HARM INVESTORS

MONDAY, NOVEMBER 3, 2003

U.S. SENATE,
SUBCOMMITTEE ON FINANCIAL MANAGEMENT,
THE BUDGET, AND INTERNATIONAL SECURITY,
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:32 a.m., in room SD–342, Dirksen Senate Office Building, Senator Peter G. Fitzgerald (Chairman of the Subcommittee) presiding.

Present: Senators Fitzgerald, Collins, and Akaka.

OPENING STATEMENT OF SENATOR FITZGERALD

Senator FITZGERALD. Good morning. I would like to call the Subcommittee hearing to order. I would like to thank our distinguished witnesses for being here today. I would also like to thank the Chairman of the full Committee, Senator Collins, for being present, as well as our Ranking Member, Senator Akaka.

Today, we are conducting an oversight hearing on the mutual fund and investment advisory industry. We are here to investigate the breadth and the extent of the illicit trading practices that have come to light in recent months and to examine the impact that the abusive practices have had on ordinary mutual fund investors.

We are also here to reexamine mutual fund management and governance and specifically to identify statutory and/or regulatory reforms that should be enacted in order to prevent a recurrence of the abuses and to better protect fund shareholders.

Just two decades ago, the mutual fund industry was relatively small, but today it is enormous. In 1980, only a small percentage of Americans invested in mutual funds, and the assets of the industry only totaled about $115 billion. Today, roughly 95 million Americans own shares in mutual funds, and the assets of all of the funds combined are now more than $7 trillion.

Mutual funds have grown in popularity in part because they provide a convenient means of achieving diversification, professional management and liquidity, but the Federal Government has also given the mutual fund industry an enormous boost. In the past two decades, Congress has sanctioned or expanded a variety of tax-sheltered savings vehicles such as 401(k)s, Keoghs, traditional IRAs, Roth IRAs, rollover IRAs, and college savings plans.

One effect of these relatively new investment vehicles is that they have turbo-charged the growth of the mutual fund industry and given it a guaranteed and, at least to a certain extent, a cap-

tive clientele. Millions of Americans now set aside money from their twice-monthly paychecks and have it automatically funneled into their mutual fund accounts.

As John Bogle, who will testify later this morning, has observed, the coming to light of the market timing and late trading scandals is a blessing in disguise. The growth of the mutual fund industry has been so rapid during the past 20 years that the industry has managed to escape the thorough review and oversight that it merits. The current scandal prods both Congress and regulators to catch up with the industry and to reexamine its whole setup. Given that mutual funds are now the repository of such a large share of so many Americans' savings, few issues we confront are as important as protecting the money invested in mutual funds.

Several of the witnesses who are here today will explain the mechanics, the extent, and the scope of market timing, late trading and other abusive practices that harm ordinary fund shareholders. I am confident that the SEC, State Attorneys General and other regulators can curb these abuses in the future, and certainly Congress can pass laws, if necessary, to bolster the authority of the SEC in this regard.

But our current focus on particular types of trading abuses must not prevent us from seeing the big picture. It is time for a wholesale reexamination of how mutual funds are organized and managed. As several of our witnesses will testify today, the governance structure of a typical mutual fund is a study in institutionalized conflict of interest. Until we eliminate the conflicts, many mutual funds will continue to engage in behavior that benefits fund managers at the expense of fund shareholders.

Mutual funds typically have a board of directors, but no staff. The board outsources all investment functions to an outside investment advisory firm which charges the fund management and other fees. Almost always many of the directors of the mutual fund, including the chairmen, are also insiders of the investment advisory firm. Surprisingly, Federal law not only allows this incestuous relationship, it codifies it. The law apparently places faith in the false concept that fund directors can bargain at arm's length with themselves. Because of the incestuous relationship between mutual fund directors and their investment advisers, investment management and other fees charged to most mutual funds are far too high.

As Attorney General Spitzer will testify, in 2002, mutual funds paid advisory fees of more than $50 billion and other management fees of nearly $20 billion, not to mention tens of billions that the funds spend on trading costs.

Also, as Attorney General Spitzer points out in his testimony, in most industries, there are economies of scale. One would think that as mutual fund assets increased, advisory fees decrease, but, in fact, it appears that the reverse is true. It appears that as mutual fund assets have risen, advisory fees have risen even more. Mr. Spitzer, citing Mr. Bogle, will argue that between 1980 and 2000, mutual fund assets grew by 60 times, but the funds, fees and expenses grew by 90 times.

America's mutual fund industry has enabled millions of Americans, who otherwise would have been unable, to invest in debt and equity securities. It has contributed substantially to keeping our

country's capital formation system the best in the world, but its institutionalized conflicts of interest have cost Americans dearly. The recent industry scandals merely highlight that in trying to serve two masters, many fund directors have all too often preferred the investment advisory firms with which they are associated over the mutual fund shareholders whom they should theoretically be trying to protect.

Late trading and market timing abuses cost fund investors a bundle, but management fees, distribution fees, sales charge on purchases, so-called loads, purchase fees, deferred sales charges, so-called deferred loads, account fees and other charges cost investors many times more. Even small differences in these fees can translate into the large differences in returns over time.

The combination of excessive and opaque fees, abusive trading practices, coupled with government policies which channel investors, automatically, into mutual funds has transformed this once sleepy industry into a monster.

The mutual fund industry is now the world's largest skimming operation—a $7-trillion trough from which fund managers, brokers and other insiders are steadily siphoning off an excessive slice of the Nation's household, college and retirement savings. We may only be talking about a skim of a few basis points here and a few basis points there, but when the skim is multiplied by $7 trillion, and then compounded over 10, 20, 30 or more years, pretty soon we are talking about real money. But because no one has to write a check for these fees and costs and because it makes so much sense to have a tax-sheltered retirement or college savings account, relatively few have questioned the industry's practices or fees, let alone its bizarre governance structure. And, unfortunately, too few have listened to industry reformers like John Bogle, who has been sounding the alarm for years, until now, that is, John.

The current scandal gives us the opportunity to rethink the whole mutual fund industry. In my judgment, in addition to the obvious tightening to prevent market timing and late trading we must do at least the following:

No. 1, require that at least 75 percent of the fund's directors, including and especially the chairman, be independent, and tighten the definition of independent directors;

No. 2, clarify the fiduciary duty a fund director owes to fund shareholders and make that duty preempt any possible conflicting duties that a director may owe to any vendor to the fund;

No. 3, require mutual funds to competitively bid out all investment advisory contracts and perhaps other contracts;

No. 4, substantially tighten the fee disclosure requirements for mutual funds;

No. 5, require brokers who steer customers into a particular fund to disclose in writing to the customer the compensation that the broker will receive due to the transaction. I am referring to so-called 12b–1 fees. In Chicago, they call those kickbacks. [Laughter.]

No. 6, finally, we ought to consider facilitating the creation of more mutual funds that are truly mutual, ones where like Vanguard, the funds actually own the firm.

Before I introduce our witnesses, I would like to ask Senator Collins and Senator Akaka if they have opening statements.

We will allow the Chairman to go first, the Chairman of the full Committee.

Chairman COLLINS. Thank you. We are both being so polite here.

Senator FITZGERALD. That is right. Thank you. Senator Collins.

OPENING STATEMENT OF CHAIRMAN COLLINS

Chairman COLLINS. Thank you, Mr. Chairman.

Let me begin by saluting you for your leadership and your hard work in investigating this issue and convening this very important hearing this morning. This hearing is about abusive and, in some cases, possibly illegal practices allowed by some mutual fund companies, but the hearing is about more than that. It is really about people, good, hardworking, middle-income families who are doing their best to plan for their retirement or to save for their children's education by investing their savings in mutual funds that have long been promoted as a haven for small investors.

Of all of the components in the financial industry, the mutual fund sector has perhaps the greatest responsibility to safeguard the interests of small investors. Yet, within the last 2 months, more than a dozen companies have been named in allegations of misusing millions of dollars of their investors' money. These practices benefit a select few at the expense of the vast majority of mutual fund investors.

As one of our witnesses has indicated, there is evidence, troubling evidence, that officials at fund companies profited personally at the expense of their customers by market timing their own funds.

It is equally troubling to me that this is not a new problem. According to the securities administrator in the State of Maine, similar allegations involving these practices arose in the late 1990's, and yet little has been done since then to protect the Nation's 95 million mutual fund investors, 445,000 of whom live in Maine. Surely, they deserve better.

I question why the Securities and Exchange Commission, which has regulatory responsibility for the mutual funds and their broker-dealers, has failed to detect these practices, to oppose appropriate restrictions or to penalize those who appear to be misusing their investors' money. I question why mutual fund companies and their boards of directors would sacrifice the trust of their investors in the $7-trillion industry to benefit a select group of individuals who can afford to play the mutual fund market.

Clearly, much more must be done to protect mutual fund investors, whether it is through legislation, tougher enforcement actions, new and stronger regulations or all three. We have a regulatory system that is supposed to ensure that companies are acting in an ethical and legal manner. Mutual fund companies have boards of directors who are supposed to fulfill their fiduciary obligations toward their investors, and yet these abuses occur over and over again. The system is obviously flawed.

As the Chairman may well remember, I spent 5 years in the State of Maine as commissioner of the department with responsibility for securities regulation. This is an issue that is of great interest to me. We need to know what actions will be most effective

in stopping these abusive practices once and for all, and this hearing is certainly a worthwhile step in that direction.

Thank you, Mr. Chairman.

Senator FITZGERALD. Thank you, Madam Chairman. May I just ask you what office had that responsibility for securities in Maine?

Chairman COLLINS. I was the Commissioner of the Department of Professional and Financial Regulation, and that includes the Securities Division. Our administrator in Maine was the recent chair of the National Association of Securities Administrators and worked very closely with some of our witnesses today.

Senator FITZGERALD. Well, thank you. Senator Akaka.

OPENING STATEMENT OF SENATOR AKAKA

Senator AKAKA. Thank you very much, Mr. Chairman. I want to thank you very much and to tell you that I appreciate your conducting this hearing today.

I also would like to thank Representative Baker for his leadership on the important issue of mutual fund governance.

As the Chairman of the full Committee on Governmental Affairs mentioned, this hearing is about the hard-working people of our country who have placed their—and I want to emphasize this word,—"Trust" in the hands of experts to ensure productive investments for a better future are being properly managed. Because of this, we are taking steps in the direction of improving what many in the mutual fund industry are doing and to, in some cases, because of the letters I have received, restore their trust.

Trust, as we know, is the cornerstone of effectively functioning markets. The abuses involving mutual funds that have been revised include having different sets of rules for large and small investors, ethical misconduct, and individuals enriching themselves illegally at the expense of fund shareholders. I look forward to the examination of these abuses by this Subcommittee.

These revelations are particularly troubling because, as the Chairman mentioned, 95 million individuals have placed a significant portion of their future financial security into mutual funds. Mutual funds provide working-class Americans with an investment vehicle that offers diversification and professional money management.

Mutual funds are an investment vehicle that the average investors rely on for retirement, savings for their children's college education and other financial goals and dreams.

Today's hearing provides us, and this is important, the opportunity to better understand the troubling issues involving mutual funds, such as market timing and late trading which have demonstrated a betrayal of the trust of investors by certain investment companies.

I will be introducing legislation designed to restore public trust in mutual funds. I look forward to working with my colleagues, Chairman of the Full Committee Collins, Chairman of this Subcommittee Fitzgerald, and Representative Baker to address the issues of mutual fund corporate governance. The transgressions that have been brought to light make it clear that the boards of mutual fund companies are not providing sufficient oversight. To be more effective, the boards must be strengthened and made to be

more independent. Investment company boards should be required to have an independent chairman, and independent directors must have a dominant presence on the board.

In addition, shelf-space payments and revenue sharing agreements between mutual fund companies and brokers present conflicts of interest that must be addressed. Brokers must be required to disclose in writing, to those who purchase mutual company shares, the amount of compensation the broker will receive due to the transaction, instead of simply providing a prospectus.

In order to increase the transparency of the actual costs of the fund, brokerage commissions must be counted on as an expense in filings with the SEC and included in the calculation of the expense ratio, so that investors can have a more realistic view of the expenses of their fund.

My legislation will address the need for increased transparency of these financial relationships and transactions in order to ensure that individual investors are able to make fully informed decisions when purchasing mutual fund shares.

I want to thank our witnesses for being with us today. I look forward to working with all of you to restore the shattered trust of investors and bring about significant reform of the mutual fund industry.

Thank you very much, Mr. Chairman.

Senator FITZGERALD. Senator Akaka, thank you very much, and I would like to second Senator Akaka's commendation of Congressman Baker. Congressman Baker is scheduled to be our first witness today, but I am advised that he is now en route to Washington, so we are going to accommodate him on a subsequent panel. He is another one who has been like John the Baptist, a voice crying in the wilderness, and talking about this issue for a long time. Before the current trading abuses came to light, he introduced a very good bill over in the House that would bring much needed reforms to the mutual fund industry.

We will move now to this panel. Our first witness is Stephen M. Cutler, who is the Director of the Division of Enforcement at the U.S. Securities and Exchange Commission. His division investigates possible violations of securities laws, recommends Commission action, and negotiates proposed settlements on behalf of the Commission. Mr. Cutler joined the SEC in 1999 as Deputy Director of Enforcement.

Also joining us from the SEC today is Paul F. Roye, who is the Director of the Division of Investment Management. Mr. Roye oversees the $20-trillion investment management industry and administers the securities laws affecting investment companies, including mutual funds and investment advisers. I would note that Mr. Roye has the same combination of college and law school that I have. He is an alumnus of Dartmouth College and the University of Michigan Law School.

Our third witness is the Hon. William F. Galvin, Secretary of the Commonwealth of Massachusetts. As the State's chief securities regulator, Secretary Galvin has earned a national reputation aggressively protecting investors against fraud and has recovered millions of dollars for victims of securities fraud.

Our fourth witness is the Hon. Eliot L. Spitzer, Attorney General for the State of New York. Mr. Spitzer's inquiry into the trading activities of Canary Capital Partners was the first of many subsequent announcements and actions against players in the mutual fund industry. Additionally, his investigations of conflicts of interest on Wall Street have been a major catalyst for reform in the Nation's financial services industry. Prior to being elected Attorney General, Mr. Spitzer served as an Assistant District Attorney in Manhattan from 1986 to 1992.

Our fifth witness is Mary L. Schapiro. Ms. Schapiro is Vice Chairman and President of Regulation Policy and Oversight at the National Association of Securities Dealers. Prior to assuming her current duties at NASD, Ms. Schapiro was appointed the Chairman of the Commodity Futures Trading Commission in 1994 by President Clinton. Prior to that, she was an SEC Commissioner from 1988 to 1993, when she was appointed Acting Chairman of the SEC.

I would like to thank all of you for your appearances today, and in the interest of the time, your full statements will be included in the Subcommittee's record and we ask that you try to limit your summary remarks to about 5 minutes so that we can leave plenty of time for questions.

Thank you. Mr. Cutler, you may proceed.

TESTIMONY OF STEPHEN M. CUTLER,[1] DIRECTOR, DIVISION OF ENFORCEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. CUTLER. Thank you, Chairman Fitzgerald, Ranking Member Akaka, and Senator Collins and other distinguished Members of the Subcommittee. Good morning. Thank you, Mr. Chairman, for inviting me to testify today on behalf of the SEC concerning abuses relating to the sale and operation of mutual funds.

As each Member of this Subcommittee has mentioned, more than 95 million Americans are invested in mutual funds today. For that reason, the unholy trinity of illegal late trading, abusive market timing and related self-dealing practices that have recently come to light are matters that affect us all, and they go right to the heart of the trust, the covenant, if you will, between mutual fund and other securities professionals and the individual investor.

As my colleagues and I have gathered evidence of one betrayal after another, the feeling I am left with is one of outrage, and I feel that not just as a prosecutor, but as a citizen and as a member of the investing public. It is intolerable when investment professionals, who are duty-bound to serve their customers' interests, instead serve their own. The conduct we have seen is antithetical to the duties that mutual funds, investment advisers, brokerage firms and their employees owe to fund shareholders. Individual investors have a right to expect fair treatment and, quite simply, they have not gotten it.

Along with the other regulators sitting at this table, the SEC is fully committed to ensuring that those responsible for betraying the trust of mutual fund shareholders are held accountable and

[1] The prepared statement of Mr. Cutler appears in the Appendix on page 59.

brought to justice. Indeed, that process has begun, starting, of course, with Mr. Spitzer's action against the Canary Partners hedge fund firm and its principal, Edward Stern. Since then, the Commission has brought five enforcement actions involving fraud against mutual fund investors. In each one, the Commission staff has worked in close coordination with State regulators, including my distinguished co-panelists, Mr. Spitzer and Mr. Galvin. I will touch on each of the cases very briefly.

On September 16, the Commission filed a civil action against Theodore Sihpol, Canary's primary contact at Bank of America Securities. We allege that Mr. Sihpol played a key role in enabling certain hedge funds to engage in late trading. That is putting orders in after 4 p.m., but receiving the old 4 p.m. price. On the same day the Commission commenced its action, the New York Attorney General filed a two-count criminal complaint charging Sihpol with larceny and securities fraud.

Less than 3 weeks later, the Commission and the New York Attorney General again announced parallel criminal and civil actions—this time against Steven Markovitz, formerly an executive and senior trader with a prominent hedge fund, Millennium Partners. According to the criminal charges and the SEC findings, Markovitz engaged in late trading on behalf of his firm. In an impartial settlement of the SEC's action, Markovitz agreed to be permanently barred from associating with an investment adviser or a registered investment company.

In the first action against a mutual fund executive for permitting abuse of market timing, on October 16, the Commission and the New York Attorney General announced the arrest, conviction and lifetime industry bar of James P. Connelly, Jr., former Vice Chairman of Fred Alger & Company. Market timing, of course, refers to the practice of excessive short-term buying and selling of mutual fund shares in order to exploit inefficiencies in mutual fund pricing. In its administrative order, the SEC found that Connelly had approved agreements that, contrary to Alger's prospectus disclosure, permitted select investors to market time certain mutual funds, in some cases, in exchange for the timers leaving at least 20 percent of their assets at Alger in buy-and-hold positions.

The Commission's order bars Connelly from the industry and imposes a $400,000 civil penalty.

Most recently, on October 28, in conjunction with the Secretary of Massachusetts, the Commission brought enforcement actions against Putnam Investment Management and two former Putnam portfolio managers, Justin M. Scott, and Omid Kamshad, in connection with Scott and Kamshad's personal trading in Putnam mutual funds.

We allege that Scott and Kamshad market timed the very Putnam funds they managed and that Putnam failed to take adequate steps to prevent or disclose their self-dealing activity or that of other Putnam personnel who engaged in excessive short-term trading of Putnam funds.

I think I can safely predict that many more enforcement actions will follow. We are currently conducting a broad-based inquiry of late trading, market timing and related self-dealing practices. On September 4, the Commission staff sent detailed compulsory infor-

mation requests to 88 of the largest mutual fund complexes in the country and 34 brokerage firms, including all of the country's registered prime brokers. And just last week, we sent similar requests to insurance companies that sell mutual funds in the form of variable annuities.

Based on the responses to these requests, Commission staff have been dispatched to conduct on-site inspections and interviews and further investigation at dozens of firms. Although we are continuing to receive and analyze the responsive information, I would like to highlight some of the most troubling items. I must emphasize that these are only preliminary and are the subject of continued, active investigation.

First, on the subject of late trading, more than 25 percent of responding brokerage firms reported that customers had received 4 p.m. prices for orders placed or confirmed after 4 p.m. E-mails submitted by approximately 10 percent of the responding mutual funds contained references to situations that possibly involve late trading. Three fund groups reported—or the information they provided indicated—that their staffs had approved a late trading arrangement with an investor.

Second, on the matter of market timing, we have already reported that 50 percent of responding fund groups appear to have had at least one arrangement allowing for market timing by an investor, but in addition to that, documents provided by almost 30 percent of responding brokerage firms indicate that they may have assisted market timers in some way, such as by breaking up large orders or setting up special accounts to conceal their own or their clients' identities, a practice sometimes called cloning, to avoid detection by mutual funds that sought to prevent abusive market timing. Further, almost 70 percent of responding brokerage firms reported being aware of timing activities by their customers.

Finally, let me mention another potentially abusive practice that has gotten attention as well—the selective sharing of mutual fund portfolio information. More than 30 percent of responding fund companies appear to have disclosed portfolio information in circumstances that may have provided certain fund shareholders the ability to make advantageous decisions to place orders for fund shares.

The Commission staff is following up on all of these situations closely, along with my colleagues at the table. Let me also point out that we are actively engaged in enforcement and examination activities in four other important areas involving mutual funds, some of which I know that Mary Schapiro will address.

The first area is mutual fund sales practices and fee disclosures. In particular, we are looking at just what prospective mutual fund investors are being told about revenue-sharing arrangements and other incentives doled out by mutual fund management companies and mutual funds themselves to brokerage firms who agree to feature their funds.

We are looking at whether there is adequate disclosure of the source and the nature of those payments and the fact that they may increase costs to investors, as well as create conflicts of interest between investors and the financial professionals with whom they deal.

In one case involving a major financial institution, we have already issued a Wells Notice of the staff's intention to recommend what I think would be first-of-their-kind charges by the Commission.

Our second area of focus is the sale of different classes of shares in the same mutual fund. Very frequently, a fund will have issued two or more classes of shares commonly referred to as A shares, B shares, and so on. Each class will have a different fee structure associated with it. In the last 6 months, we have brought enforcement actions against two brokerage firms—Prudential Securities and IFG Network Associates—in connection with the alleged recommendations that customers purchased one class of shares when the firms should have been recommending another.

The third area is the abuse of so-called break points. That is a fancy term for what are, in essence, volume discounts available to investors who make large purchases of mutual fund shares. Quite simply, we found numerous instances in which it appears that brokerage firms did not give investors the discounts to which they were entitled. This week, together with the NASD, we will be issuing Wells Notices to a significant number of brokerage firms for their failure in this regard.

The final area is the pricing of mutual funds beyond the context of market timing. We are actively looking at two situations in which funds dramatically wrote down their net asset values in a manner that raises serious questions about the funds' pricing methodologies.

Before I conclude, I would like to take a moment to address press reports that several months ago an employee in Putnam's Call Operator Unit told our Boston Office that individual union members were day trading Putnam funds in their 401(k) plan. Do I wish that we would have brought the Putnam case 2 months ago, instead of 2 weeks ago? Of course, I do. The SEC receives on the order of 1,000 communications from the public in the form of complaints, tips, E-mails, letters, and questions every working day. That is more than 200,000 a year.

We have made, and are continuing to make, changes in how we handle these, including giving more expeditious treatment to those that raise enforcement issues and instituting a monthly review of the disposition of each enforcement-related matter by the Division's senior management. Tips from whistleblowers are critical to our program. In fact, the investigation of personal trading at Putnam, which is what we ultimately sued Putnam for, was launched when we received a tip in that area just a few weeks ago.

Speaking more generally, I am proud of the Commission's record in the enforcement area. In our just-concluded fiscal year, the Commission brought 679 enforcement cases involving just about every conceivable type of securities violation. That is a 40 percent jump from just 2 years ago. We accomplished this dramatic increase with almost no increase in resources, and included in our most recent year's totals are some extraordinary efforts on behalf of the investing public:

One-and-a-half billion dollars in disgorgement and penalties designated for return to investors using Sarbanes-Oxley fair funds, a total of 60 enforcement actions against public company CEOs;

Nearly 40 emergency asset freezes and TROs to protect investors' money on a real-time basis, groundbreaking and important cases against brokerage firms and banks for their roles in the Enron debacle;

The first-ever case against a mutual fund management company for failure to disclose a conflict of interest in the voting of its fund's proxies;

A first of its kind case against a major insurance company for aiding and abetting an issuer's financial statement fraud;

Multiple cases alleging violations of the Commission's new selective disclosure rule;

And dozens of financial fraud cases against Fortune 500 companies and their auditors.

The dedication, commitment, and professionalism of our enforcement staff are second to none. With Congress's help, we have now begun to see additional resources. With more people and better technology, our mandate from Chairman Donaldson is to more proactively identify problems and to look around the corner for the next fraud or abuse.

With respect to mutual funds, I know that the Agency's routine inspection and examination efforts will be improved by adding new staff, increasing the frequency of examinations, and digging deeper into fund operations. We are working aggressively on behalf of America's investors to ferret out and punish wrongdoers wherever they may appear in our securities markets, including the mutual fund area. And at the same time that the Commission is looking backwards to identify and punish past misconduct, the Commission has been engaged in a comprehensive regulatory response designed to prevent problems of this kind from occurring in the first place. My colleague, Paul Roye, Director of the Division of Investment Management, will discuss those initiatives.

Thank you, and I would be happy to answer any questions that the Subcommittee has.

Senator FITZGERALD. Thank you, Mr. Cutler. Mr. Roye.

TESTIMONY OF PAUL F. ROYE,[1] DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. ROYE. Thank you, Chairman Fitzgerald, Ranking Member Akaka, and Senator Collins, and distinguished Members of the Subcommittee.

Like Steve, on behalf of the Securities and Exchange Commission, I appreciate the opportunity to discuss possible regulatory responses to recent allegations of abusive practices in the mutual fund industry, and initiatives to improve the regulatory framework governing mutual funds.

As has been noted, with over 95 million Americans invested in mutual funds, representing approximately 54 million U.S. households and a combined $7 trillion in assets, mutual funds are unquestionably one of the most important elements of our financial system.

[1] The prepared statement of Mr. Roye appears in the Appendix on page 80.

The conduct alleged in the various cases brought by the Commission, as well as the New York Attorney General and the Secretary of the Commonwealth of Massachusetts represent reprehensible conduct that are gross violations of the Federal securities laws, as well as basic fiduciary principles.

As my colleague Steve Cutler just outlined for you, the Commission has put in motion an action plan to vigorously investigate these matters, assess the scope of the problem and hold wrongdoers accountable. Now, while our enforcement efforts are a key tool in protecting the Nation's investors, another critical component is the regulatory framework designed to prevent or minimize these abuses from happening in the future or happening in the first place.

Before I discuss regulatory initiatives in this area, I would like to take a moment to place these initiatives in context. In recent years, the Commission has had a principle focus on strengthening the mutual fund governance framework. The Commission has adopted rules that effectively require fund boards to have a majority of independent directors, and require that independent directors select and nominate other independent directors to fill vacancies on fund boards.

We promoted the concept of independent legal counsel for fund directors, enhanced disclosures regarding directors, including information concerning whether the directors own shares of the funds that they oversee, and information about independent director potential conflicts of interest; as well as disclosures about the board's role in how they govern the funds, including the basis upon which they renew a fund's investment advisory contract.

More recently, the Commission has tailored the provisions of the Sarbanes-Oxley legislation to apply to mutual funds, including the provisions to improve oversight and internal controls, such as key officer certifications and code of ethics requirements. The Commission has proposed that each fund have a chief compliance officer reporting to, and accountable to, fund independent directors whose responsibility it would be to provide that the fund has procedures in place reasonably designed to ensure compliance with the Federal securities laws.

And the Commission also has supported key provisions of the legislation that has been referenced that was introduced by Congressman Richard Baker, to further enhance mutual fund governance, including provisions that give the Commission the authority to close gaps in the definition of independent director in the Investment Company Act of 1940.

Indeed, so far this year the Commission has proposed or adopted 16 different rulemakings related to mutual funds. Again, through these rulemakings, the Commission has sought to enhance fund governance and internal controls, improve fund disclosures, and minimize conflicts between funds and their managers.

We sought public input on additional measures that the Commission should take to improve the mutual fund regulatory framework so that we can avoid these problems that we are currently investigating.

In addition, our staff in September issued a comprehensive report on hedge funds, making a series of recommendations to im-

prove the Commission's ability to monitor the activities of these vehicles, the most significant being a recommendation to require that hedge fund advisers register under the Investment Advisers Act of 1940, and therefore become subject to Commission examination and routine oversight.

Now, this review of hedge funds and the staff's recommendations become all the more important when we consider that we have seen a number of hedge funds engaging in late trading and market timing activity of mutual fund shares, indeed, serving as the impetus for the current investigations and enforcement actions related to these activities.

Now, the 16 rulemakings that we have done so far in 2003, along with those to come, combined with the staff's work on hedge funds, will represent, to my knowledge, the Commission's most productive year in investment management regulation since the Commission was charged in 1940 with overseeing this segment of the financial services industry, and I think fund investors are benefiting from these proactive initiatives, but we are not done yet.

You can expect significant mutual fund regulatory initiatives before this year is through. On October 9, slightly more than a month after the New York Attorney General announced his actions against Canary Partners, Chairman Donaldson outlined a regulatory agenda to confront and address late trading and market timing abuses to help restore confidence in the fairness of the mutual fund operations and practices.

He requested our staff to submit rulemaking recommendations to the Commission this month to address these issues, and we are going to meet that demand.

In preparing its recommendations to the Commission, the staff is examining requiring that the fund or its designated agent, rather than intermediaries such as broker-dealers or parties that we do not regulate, receive a purchase or redemption order for fund shares by 4 o'clock for an investor to receive that day's price.

Now, this hard 4 o'clock cut-off we believe would effectively eliminate the potential for late trading through intermediaries that sell fund shares. Staff is also considering recommending that the Commission address late trading in connection with the recommendation to adopt the mutual fund compliance policies rule which the Commission proposed in February of this year. Again, this proposal calls for a chief compliance officer who is accountable to the fund directors, whose responsibility it would be to ensure that funds have effective policies and procedures in place to prevent such activity as late trading.

With respect to market timing, we are preparing recommendations to require explicit disclosure and fund offering documents of market timing policies and procedures. And this disclosure would enable investors to assess a fund's market timing practices and determine if those practices are in line with their expectations.

The rule recommendations requested by the Chairman would have a further component of requiring funds to have procedures to comply with these representations regarding market timing policies. Thus, if a fund's disclosure documents stated that it took action or will take action to discourage market timing, the fund will

be required to have procedures in place to assure that it is complying with these representations to investors.

The establishment of formal procedures would enable our examination staff to review whether or not these procedures are being followed and whether or not the fund is living up to its representations regarding curbing market timing activity.

The Commission also will emphasize the obligations of funds to fair value price their securities so as to avoid stale pricing, to minimize market timing arbitrage opportunities. We think this is an important measure to combat market timing activity.

Steve mentioned allegations of portfolio managers market timing the funds they manage or other funds in the complex, This raises issues regarding insider trading, as well as the need for an adherence by fund personnel to policies and procedures to prevent the misuse of material nonpublic information. We expect that this issue will also be addressed in the rulemaking recommendations that we are going to submit to the Commission later this month.

Recent allegations indicate that some fund managers may be selectively disclosing their portfolios in order to curry favor with large investors. Selective disclosure of a fund's portfolio can facilitate fraud and have severely adverse ramifications for a fund's investors if someone uses that portfolio information to trade against the fund. So, consequently, the Chairman has asked the staff to consider whether additional requirements are necessary to reinforce funds and adviser's obligations to prevent the selective disclosure of fund portfolio holdings information in a manner that can harm investors.

In addition to these initiatives, we have been asked to consider whether funds should have additional tools available to thwart market timing activity, such as mandatory redemption fees or allowing funds to retain the profits of short-term traders in their shares. If we take away the profit potential that can be gained by market timers, we can eliminate abuses in this area.

Now, Chairman Donaldson has emphasized that he will not hesitate to call for other regulatory measures if we discover additional information in the course of our investigation that merits regulatory action, and he has indicated that no reform, whether structural, fund governance or board composition is off the table. The Commission is committed to moving swiftly and aggressively to take all necessary steps to protect mutual fund investors from abusive and harmful activity.

In addition to the initiatives to address late trading and market timing abuses, the staff and Commission have been working on other initiatives designed to assist mutual fund investors in making the best investment decisions for themselves, to attack inappropriate mutual fund sales practices and bolster confidence in the mutual fund industry.

Now, these initiatives seek to provide for complete transparency of fees and expenses, improve the fund governance framework, including initiatives relating to fund advertising, fund-of-fund products, breakpoint disclosures regarding sales loads, shareholder report disclosure of operating expenses for investors in dollars and cents, more frequent disclosure of fund portfolio information so investors can make better asset allocation decisions, enhanced disclo-

sure of incentives and conflicts that brokers have in offering mutual fund shares to investors, and giving investors greater input into director nomination initiatives.

We are committed to moving forward with our mutual fund agenda in these areas as well. And I should also note that with the additional resources and funding from Congress, we are beefing up our oversight of the fund industry with additional staffing that will allow for more frequent inspections of funds to monitor for compliance with the Federal securities laws.

In conclusion, I would like to reiterate that the protection of our Nation's mutual fund investors is of paramount importance to the Commission and the staff. I can now assure you and assure the American public that the Commission will deal immediately with the reprehensible abuses that are taking place. We are committed to rooting out the problems, punishing the perpetrators and putting the proper rules in place so that these abuses do not happen in the future.

Again, I appreciate the opportunity to be here, and I would be happy to answer any questions.

Senator FITZGERALD. Mr. Roye, thank you very much.

Secretary Galvin, you may proceed. I would reiterate, we would ask that you stick to 5 minutes because we have to leave time both for another panel and for questions of both panels.

Thank you.

TESTIMONY OF HON. WILLIAM F. GALVIN,[1] SECRETARY OF THE COMMONWEALTH OF MASSACHUSETTS

Mr. GALVIN. Thank you, Mr. Chairman. I am Bill Galvin, Secretary of State and Chief Securities Regulator of Massachusetts. I want to commend Senator Fitzgerald, Senator Collins, and Senator Akaka for calling today's hearing to examine mutual fund abuses.

Mutual funds, as has been stated, play a major role in the wealth and savings of our Nation. Today, half of all American households invested nearly $7 trillion in mutual funds, but mutual funds are about more than money under management. Mutual funds are about the hopes and dreams of middle-income Americans, the hopes of a financially secure and dignified retirement, the dream of a college education for a child. Mutual funds are where America's dreams are invested.

Investors have placed their trust in mutual funds with the understanding that they would be treated fairly, that the risk of the market would be offset by the skill and commitment of fund managers. We are here today because in too many instances the mutual fund industry has failed to live up to its duty. The common theme running through all of the mutual fund issues that we have exposed in recent months is that the mutual fund industry is putting its own interest ahead of their consumers and customers.

While they market trust and competence, too often they have delivered only deceit and underperformance. We are also here today because self-policing and government laws and law enforcement have also failed to effectively protect the investor. The evidence that self-policing has failed is in the willingness of the entire indus-

[1] The prepared statement of Mr. Galvin appears in the Appendix on page 97.

try to quietly tolerate known market abuses while they parse words trying to describe clearly unethical practices as not illegal. Their past silence has convicted them of ineffectiveness.

Government laws and law enforcement have failed because they have failed in the past to aggressively and properly enforce the law. For too long, a culture of compromise and accommodation has overwhelmed enforcement efforts. Too often the guilty neither admit nor deny any wrongdoing and routinely promise not to cheat again until they can come up with a more clever way to do what they just said they would not do again.

For too long, while the merry-go-round of accusation and non-admission goes round and round, investors have been the losers. It has taken the coincidence of dramatic and tragic recent investor losses and aggressive State enforcement by people like Attorney General Spitzer and myself to convert investor outrage to a call for action.

We have uncovered insider trading in Massachusetts at its worst, fund managers exploiting their inside knowledge for personal profit at the expense of their customers. We have uncovered a pervasive pattern of breach of duty and corporate deceit at Putnam Investment, the Nation's fifth-largest mutual fund company. Simply put, investors were cheated.

In August, my office uncovered a hidden compensation scheme at Morgan Stanley, including cash prizes and other lucrative benefits designed the push Morgan Stanley mutual funds on unsuspecting investors who were seeking honest advice.

These enforcement actions are only two examples of the deep problems in the industry. Mutual funds violate investor trust in a number of ways—when mutual funds allow market timing for their employees, when mutual funds allow market timing for certain outside investors, perhaps as an incentive to generate or retain business, when mutual funds allow late trading in fund shares, when mutual funds pay higher commissions to brokers or other incentives to sell proprietary or in-house funds to investors rather than funds that may be more suitable to the investor's needs and when break-point discounts are ignored or concealed.

State securities regulators are often the first to identify investment-related problems and to bring enforcement actions to halt and remedy these problems. Any suggestion that the state regulators have hindered Federal enforcement of securities law is completely false. Any effort to restrict or preempt State enforcement must be called what it clearly is—anti-investor.

H.R. 2420 is a positive response to some of the many problems investors in mutual funds now face, and I endorse its objectives. The bill can be improved, however. The original language of Section 1, regarding fund operating expenses, should be restored. Each individual investor should be notified of the actual cost they are paying, and instead of simply disclosing soft-dollar costs, they should be banned.

Prompt passage of this bill is important to bring the regulation of mutual funds to the level of regulation that their role in our financial system demands, but laws alone are not enough. They must be vigorously enforced.

Again, I want to commend the Subcommittee for focusing attention on this situation. With strengthened laws and vigorous enforcement, we can give our Nation's investors the fairness and honesty they seek and the protection they deserve.

Thank you. I will be happy to answer any questions you might have.

Senator FITZGERALD. Secretary Galvin, thank you. Attorney General Spitzer.

TESTIMONY OF HON. ELIOT L. SPITZER,[1] ATTORNEY GENERAL FOR THE STATE OF NEW YORK

Mr. SPITZER. Thank you very much, Mr. Chairman, Senator Collins, and Senator Akaka. Thank you so much for having this hearing today.

Senator Fitzgerald, I would be tempted to ask that my testimony be stricken and your opening statement be substituted for it. It was a very powerful statement encapsulation of precisely what is wrong with the industry and, indeed, many of the ideas that need prospectively to be adopted to remedy the problems we have been discussing in past months.

I would also share in your kind words for Mr. Bogle, who for many years—decades perhaps—has been, as you said, a voice in the wilderness diagnosing these problems, and yet nobody wished to hear it.

It is indeed the case that others have said this occasionally, and I would wish to quote Paul Samuelson, who was not only a Nobel laureate in economics, but also one who was very wise in his understanding about capital markets. He said, about 35 years ago, "I decided that there was only one place to make money in the mutual fund business, as there is only one place for a temperate man to be in a saloon—behind the bar and not in front of the bar. So I invested in a mutual fund management company."

He understood very well, ultimately, how the incentive structure we created would result in money being made by those who managed, not necessarily to the exclusion, but certainly to the hindrance, of those on behalf they were investing.

One of the pities of what has now become a well-documented story and tale of abuse is that the evidence of this abuse is very obvious. Those who wish to look should have been able to see it. Those in management positions have understood, and if those on boards of directors or advisory companies or management companies had gone to even the minimal effort that they are supposed to go to, they would have seen these abuses.

Unfortunately, just as we saw last year in our investigation of conflicts of interest at the investment companies with respect to research, internal compliance, internal aggressiveness simply was not there. Indeed, most remarkably, the mutual fund companies, over the past 3 years, have protested their innocence. They have claimed that they are pure, they are clean as the driven snow. For many of us, the most remarkable intersection and most remarkable evidence of this was about a year ago, when there was a proposal, a very wise proposal that I think has been adopted by the SEC that

[1] The prepared statement of Mr. Spitzer appears in the Appendix on page 105.

would have required mutual fund companies to disclose how they were voting their proxies.

The mutual fund company, in what can only be described as an act of grotesque arrogance, said, no, we do not want to disclose this information. It will be too expensive—too expensive to tell the American public how they were voting the proxies of shares that were owned in trust for the American public at the very time that they were raking off $50 billion in fees, of advisory fees, and $20 billion in fees above and beyond that. Too expensive they said.

That, for me, and for many others, I believe, was the opening salvo in what, for us, was an effort to unwind what has been clear and ongoing abuses by an industry that has, until now, held itself to be above the law.

As you pointed out Senator Fitzgerald, in your opening comments, between 1980 and the present, funds under management have grown by 60 times, and yet fees have grown by 90 times. Where are the economies of scale that have been promised year after year by this industry, economies of scale that have been used, they believe, they have argued, to justify not only the 12b–1 fees, but every other type of fee that has been piled on top of what they have charged the American consumer.

CEO tradings. CEO trading has been revealed in past months. That should have been cleared to internal compliance, but nobody asked.

Redemption rates. There were many multiples of the assets under management. Clearly, this is a red flag that should have made it very evident to somebody somewhere inside these companies that trading patterns were amiss, and yet again nobody did anything. Clearly, there has been a problem here. And just to put this into perspective, in terms of an order of magnitude, we believe, and we know that there will be a dispute of this figure by the ICI. We believe these numbers are correct. We believe that on the order of a 25-basis point differential exists between what mutual funds are charged for management versus pension funds.

Twenty-five basis points does not sound like a great deal unless you aggregate the numbers. Twenty-five basis points spread across the entirety of the funds under management would save the American mutual fund investor $10 billion every year.

If mutual funds were charging what pension funds were charged for what we believe to be comparable services, $10 billion would flow back to the American investor. Those numbers swamp the impropriety that we have found in late-day trading and timing, and therefore deserve to be the subject of intense focus. Again, to put this into perspective for the individual investor, a small investor or an individual investor with $100,000 over 10 years would aggregate an incremental $6,000—merely by reducing by 25 basis points the fees that are charged by the management companies.

Why is this relevant? It is relevant because we do not believe the management companies have in any way, shape or form negotiated aggressively to drive those fees down.

Now, let me—and I understand that time is of the essence here—let me very quickly discuss two areas that are important, and this is the area, a question of how we handle this prospectively. Prospectively we must address two entirely distinct issues. One is the

regulatory framework for timing and late-day trading. I think it should be understood by all investors and this Subcommittee that the rules with respect to those issues are basically clear. We do not necessarily, although I would encourage the SEC to adopt new rules, the problem here has not been an absence of rules, the problem has been a failure of compliance. It is outright illegal conduct that was not caught, that should have been caught and that is now being caught and will be aggressively prosecuted.

In order to reach a settlement with my office for violations of either late trading or timing, let me make it very clear what the companies that committed improper acts will have to do, and I will merely focus on two issues. One, they will have to assure us that there is a compliance program that will guarantee that these abuses will be caught prospectively;

In addition to full disgorgement and restitution to shareholders, there will need to be a disgorgement of all—and I repeat the word "all"—fees that were earned with respect to any fund during the period of time during which there was illegal behavior. There is absolutely no room for the receipt of fees during the period of time during which funds are violating a clear fiduciary duty. This number will be big, it will impose pain, and it should.

Second, there is an entirely distinct area, and this you alluded to, Mr. Chairman, the governance of these funds. This is where we need to rethink, in its entirety, the framework that has been created legislatively. There is no question at all the boards of directors of the mutual funds have been inert, they have been passive, they have failed. They have utterly failed the investor. They have misunderstood their role. They have not been responsive to the appropriate parties, and this must change. The ideas that you captured in your opening statement, at a minimum, must be embodied in law, and I applaud you for suggesting them.

Let me add one more notion to that litany that you described, and that is something called a Most Favored Nation's clause. This is a notion that I think should be forced upon the boards. They should require that their fee structures with management and advisory companies include a Most Favored Nation clause that would stipulate that if any other entity is receiving a lower price for the same service, the entity on whose board they sit must receive that lower price. This would cut to the heart of what we believe is an impropriety, which permits pension funds and others to pay less than mutual funds are paying for comparable services and would address that chasm, the $10-billion divide that separates what investors get from what they should get.

Let me make one very quick final point. Much has been said and made recently of the relationship between my office and the SEC. There are times when, indeed, I have been critical of the SEC and their failure to catch some of these abuses. I do not regret or withdraw my comments or my feeling that we collectively, as prosecutors and regulators, should have done better. However, I wanted to be perfectly clear at several levels.

One, we have, we will continue, and we have absolutely no difficulty corroborating in entirety with the SEC. We will work hand in glove with them as we go forward. They are, must be and will continue to be the primary regulator of the securities markets. The

enforcement bureau, under the leadership of Mr. Cutler, has done a yeoman's work in the past years trying to clean up what has been a torrent, a tidal wave of abuses, and I have nothing but respect for the job that they have done. And so I hope that those who think that there is some divide between us and wish to play upon that perception, I hope that they will be corrected in that very important misconception.

Thank you very much, Mr. Chairman.

Senator FITZGERALD. Thank you, Mr. Spitzer. Ms. Schapiro.

TESTIMONY OF MARY L. SCHAPIRO,[1] VICE CHAIRMAN AND PRESIDENT OF REGULATORY POLICY AND OVERSIGHT, NATIONAL ASSOCIATION OF SECURITIES DEALERS

Ms. SCHAPIRO. Thank you very much. Good morning, Mr. Chairman, Senator Akaka and Senator Collins. I appreciate having the opportunity to testify on behalf of NASD.

NASD is the world's largest securities self-regulatory organization. We have a nationwide staff of more than 2,000 who are responsible for writing rules that govern securities firms, examining those firms for compliance and disciplining those who fail to comply. Last year, NASD filed more than 1,200 new enforcement actions, levied record fines and barred or suspended more individuals from the securities industry than ever before.

The reprehensible conduct that has brought us all here today, which cheats the public and degrades the integrity of American markets, will not be tolerated. Any broker or firm that misleads a customer or games the system can expect to be the subject of aggressive enforcement action.

Due to their enormous growth and popularity in recent years, NASD has paid particular attention to how brokers sell mutual funds. While NASD does not have jurisdiction or authority over mutual funds or their advisers, we do regulate the sales practices of broker-dealers who provide one distribution mechanism for mutual funds.

Our regulatory and enforcement focus has been on the suitability of the mutual fund classes that brokers recommend, the sales practices used, the disclosures given to investors, compensation arrangements between the funds and brokers and whether customers receive appropriate breakpoint discounts. We have brought some 60 enforcement cases this year in the mutual fund area and more than 200 over the last 3 years.

Throughout routine examinations, we have found that in 1 out of 5 transactions in which investors were entitled to a breakpoint discount, that discount was not delivered. Thus, many brokers imposed the wrong sales load on thousands of mutual fund investors—in effect, overcharging investors, by our conservative estimate, $86 million in the last 2 years.

NASD has directed firms to make immediate refunds, and in the next several weeks, with the SEC, we will announce a number of enforcement actions seeking significant penalties.

Brokers are also prohibited from holding sales contests that give greater weight to their own mutual funds over other funds. These

[1] The prepared statement of Ms. Schapiro appears in the Appendix on page 111.

types of contests increase the potential for brokers to steer customers towards investments that are financially rewarding for the broker, but may not be the best fit for the investor.

In September, we brought a case against Morgan Stanley for using sales contests to motivate its brokers to sell Morgan Stanley's own funds. The sales contests rewarded brokers with prizes, such as tickets to Britney Spears and Rolling Stones concerts. This case resulted in one of the largest fines ever imposed in a mutual fund sales case.

We have also recently proposed a rule requiring disclosure of two types of cash compensation—payments for shelf space by mutual fund advisers to brokerage firms that sell their funds and differential compensation paid by a brokerage firm to its salesmen to sell the firm's proprietary funds. Customers have a right to know that these compensation deals which create serious potential for conflict of interest exist, whether the compensation is paid in cash or in the form of basketball tickets.

Over the last 2 years, NASD has brought more than a dozen major cases against brokers who have recommended that investors buy Class B shares of mutual funds in which the investors incur higher costs and brokers receive higher compensation. We have more than 50 additional investigations of inappropriate B class sales in the pipeline.

This kind of enforcement effort is continuing with great vigor at NASD. We are now looking at more than a dozen firms for their practices of accepting brokerage commissions in exchange for placing particular mutual funds on a preferred or recommended list. In this effort, we are investigating all types of firms, including discount and on-line broker-dealers and fund distributors.

A more recent focus of ours has been an investigation into late trading and market timing. In September, we sought information regarding these practices from 160 firms. Our review indicates that a number clearly received and entered late trades. Other firms were not always able to tell with clarity whether or not they had entered trades late. This imprecision indicates poor internal controls and recordkeeping, issues we will also pursue.

As we continue our examinations and investigations into these matters, we will enforce NASD rules with a full range of disciplinary options, including fines, restitution to customers, and the potential for expulsion from the industry.

Mutual funds have also been a focus of NASD's investor education efforts. This year alone we have issued investor alerts on share classes, principal protected funds, breakpoint discounts, and we unveiled an innovative mutual fund expense analyzer on our website that allows investors to compare expenses and fees for funds and fund classes and highlighting when they should look for breakpoint discounts.

All of these issues, breakpoints, after-hours trading, market timing, and compensation agreements, are important to NASD because they are important to investors. We are committed to building the integrity of our financial markets and view our mission in the area of broker sales of mutual funds as an important component of that overall goal.

In closing, I also want to commend Congressman Baker for his work. NASD supports H.R. 2420 and applauds his efforts to bring increased transparency to the mutual fund industry.

I thank you, Chairman Fitzgerald, for your leadership in investigating this area, and we appreciate again the opportunity to testify. I would be happy to answer questions.

Senator FITZGERALD. Thank you very much.

We will begin the questioning now, and I would like to start with Mr. Cutler.

I just want to get this straight. In your opening statement, where you describe the results of the surveys you have sent out to brokers, did you send surveys to 34 brokers and brokerage firms?

Mr. CUTLER. That is right. Actually, they are compulsory because, given our inspection power, the brokerage firms must provide us with the relevant information, but, yes, you have it.

Senator FITZGERALD. And you sent the survey to 88 mutual funds?

Mr. CUTLER. Mutual fund complexes, that is correct.

Senator FITZGERALD. Complexes.

Mr. CUTLER. Yes.

Senator FITZGERALD. Now, you found that 25 percent of the brokers are allowing late trading; is that correct?

Mr. CUTLER. Well, first, let me again emphasize that these are preliminary findings and further follow-up is certainly going to happen, but, indeed, more than a quarter of the responding brokerage firms reported that they are aware that customers have received 4 p.m. prices for orders placed after or confirmed after 4 p.m.

Senator FITZGERALD. And late trading is a violation of the law.

Mr. CUTLER. Yes, it is, Senator.

Senator FITZGERALD. And you also reported that more than 30 percent of the mutual funds have selectively disclosed nonpublic fund information to certain customers; is that correct?

Mr. CUTLER. Well, at this point, I would not say that it is to customers, but, yes, we have concerns that at least in 30 percent of the responding fund companies, that there was some disclosure of portfolio information under circumstances that at least raise a question in our minds, was this intended to benefit an investor? There are some circumstances, of course, Mr. Chairman, in which it is appropriate to make fulsome disclosure of portfolio information to a ratings agency under circumstances where a ratings agency would agree to keep the information confidential.

The responses we got did not give us that assurance that the disclosure, on a selective basis of portfolio information, was done under circumstances with appropriate confidentiality agreements in place.

Senator FITZGERALD. If someone uses the material, nonpublic information, given to them from a mutual fund to trade in the mutual fund's shares, would that be a crime?

Mr. CUTLER. I think that would be a violation of the central provision of the Federal securities laws, Section 10(b), the anti-fraud provision, and any violation of the Federal securities is also potentially a criminal violation. We, at the SEC, do not have criminal

jurisdiction, but, yes, indeed, it is potentially a subject of criminal prosecution as well.

Senator FITZGERALD. Getting to the bottom line here, we are talking about serious wholesale criminal violations coming to light, are we not, Mr. Cutler?

Mr. CUTLER. Again, I am loathe to pre-judge until we have done a more complete investigation, but I certainly share your concerns 100 percent.

Senator FITZGERALD. Mr. Roye, you are in charge of the policy development; is that correct?

Mr. ROYE. That is correct, Senator.

Senator FITZGERALD. You have a lot of good ideas about how we can fix specific problems that have come to light in the investment industry, such as the late trading, and market timing and so forth. But at the end of the day, is it not becoming apparent that there is just so much abuse going on out there, and we are treating so many problems, and as soon as we treat some of these problems, new problems are likely to arise? Do you not think it is time we need to reassess how mutual funds are governed to make sure that the directors' interests are better aligned with those of their fund shareholders?

Mr. ROYE. I would agree with that statement. I think that we have been sidetracked, if you will, by the latest series of matters that have come to light. The Commission for several years has been engaged in an effort to try to strengthen, as I outlined in my oral statement, the mutual fund governance framework.

And again we spent a lot of time responding to both Congressman Baker and Ranking Member Kanjorski, on the House side, in terms of identifying issues. They sent detailed information requests to us. We outlined a number of issues that we were concerned about, and we were pleased to see a lot of the initiative that was reflected in the bill that Congressman Baker put forth in the House Financial Services Committee, and the Commission largely endorsed that.

But I think that it does point up, and as has been outlined, the number of issues that we are having to deal with from breakpoints to sales practice issues and some of the issues that Steve pointed to, in terms of proxy voting violations, valuation issues that go beyond the pricing issues.

We need to focus on those issues, and you are right, we can write rules, but a lot of these rules and a lot of the practices are already illegal, as has been outlined, and it calls for a collective effort, from an enforcement standpoint, to hold wrongdoers accountable and then perhaps structural changes to enhance the oversight of the industry.

In connection with our compliance rule proposal, we asked for comment from the public as to other private sector initiatives that the Commission might pursue to bolster its oversight of the industry. We asked questions about whether or not there should be a self-regulatory organization for the industry. We asked whether or not there were additional things that auditors could do in the scope of auditing funds. Should we have third-party independent compliance reviews of funds? We asked those questions and asked for comment.

We supported an increase in the percentage of independent directors. We pointed out that there were gaps in the definition of who an independent director can be on funds and pointed out the problems with that. So I think there are fundamental issues that we have to grapple with.

Senator FITZGERALD. Mr. Spitzer, you have looked carefully over the last few months at the Investment Company Act. What do you think about it, in general, since we have all of these conflicts of interest between the investment managers and the fund directors? And what do you think should be done with respect to the Investment Company Act, specifically?

Mr. SPITZER. I agree with your initial critique of it in your opening statement; that it is not only porous, but it makes Swiss cheese look like a solid wall, that there are clearly dynamics that have emerged over the past few decades that were not contemplated by those who enacted the statute. There has been, at its most basic level, a complete failure of the fiduciary obligation on the part of those who sit on the boards. Some of this can be traced back to the statute. We want to redefine who the governing entities must be, can be, who the individuals who serve on those boards should be, and I think this calls for the sort of legislative solution that you have outlined in your opening statement.

It must be revisited. The governing structure of the mutual fund industry needs to be reexamined from the very top.

Senator FITZGERALD. Now, the Investment Company Institute is going to testify in the next panel. Many in the fund industry might say that the interests of the investment adviser are aligned largely with the interests of fund shareholders. Because if the advisory firm is charging too high a fee, for example, to the fund, then the returns will not be that good. Ultimately the fund will not grow as rapidly as it otherwise might, and therefore they will not gain business. They are going to have to treat their fund well or their own business is not going to grow.

What would you say to that critique?

Mr. SPITZER. Well, sometimes good logic still gets you to an illogical conclusion. I think the logic is not necessarily flawed, but the problem is that if you look at the track record, what you see is that virtually, there is no evidence that boards actually reconsider who the adviser should be, who the fund managers should be. Because the boards have been chosen by the managers and the advisers themselves, the boards never ask the hard questions and, in fact, say to a fund manager or to an adviser, we are getting rid of you. We are switching our funds elsewhere.

In addition, what we have found, and I think this is where the gamesmanship of the past year fits in, what we have found is that fund advisers and fund managers have found other ways to increase their own compensation. They can increase the funds undermanagement by striking deals with market timers to get sticky funds into various funds, to let them lie fallow in those other funds, therefore, increasing their own compensation, even if the returns are not sufficient. And the reason the insufficient returns do not trigger their dismissal is the boards have been complacent.

The common thread that runs through the mutual fund industry, that has run through the entirety of the scandals that exploded

over the last several years from Tyco, WorldCom, Enron, on down to the issues we dealt with, with research analysts on Wall Street has been board complacency—boards that simply do not rise up to the task with which they have been charged.

And the issue that I think faces the Congress and your Subcommittee is how do you craft a statute that will reinvigorate those boards to get them to actually challenge investment advisers and fund managers to do what has to be done?

Senator FITZGERALD. You have on your books in the State of New York the Martin Act, which goes back to, I think, 1921, and it is thought to be the broadest securities law on the books anywhere. In enforcing the Martin Act, do you view as illegal when a mutual fund allows an investor to have market timing capacity?

The SEC has testified that a large percentage—I think you said 50 percent—of the mutual funds have disclosed an arrangement with someone that gives them market timing capacity. It is not clear to me, under Federal law, whether merely giving someone market timing capacity is a crime. Do you believe it is a crime under the Martin Act?

Mr. SPITZER. The answer is it depends. I believe it is a violation of the fiduciary duty that a board and a manager have to protect the interests of their shareholders.

Senator FITZGERALD. Well, they have that duty under State law——

Mr. SPITZER. Under State and Federal law.

Senator FITZGERALD [continuing]. And Federal law.

Mr. SPITZER. Absolutely.

Senator FITZGERALD. So, if it is a violation of the fiduciary duty, would it not be a violation of the Investment Company Act?

Mr. SPITZER. I believe that it is a violation of their fiduciary duty and therefore violative of the law. That is correct. Now, we can parse it a bit more carefully because there are disclosures that are made by mutual funds in their prospectuses that address the issue of market timing, and one has to examine, theoretically, those prospectus statements to determine whether or not the behavior that the entity, the fund, undertook violates that prospectus.

Senator FITZGERALD. Can a disclosure that they allow market timing trump a fiduciary duty to treat all fund shareholders the same?

Mr. SPITZER. It cannot trump a fiduciary duty, but if there is a specific disclosure that says there will be those who try to market time, we will do our best to prevent it, but will not be able——

Senator FITZGERALD. Well, it is essentially then a disclosure that we are going to give somebody preferential treatment.

Mr. SPITZER. No. If they fail to catch somebody, perhaps they are not violating their fiduciary duty. If they knowingly permit and then accept compensation for permission to time, then there is no question in my mind they are violating their fiduciary duty, violating the law and will be charged if they are caught.

I have added the component of payment and knowledge, which I think is—knowledge I think everybody would agree you could not charge them without knowledge. Payment we take as perhaps the final push over the edge.

Senator FITZGERALD. I am going to turn it over to my colleagues to ask questions, but I just wanted to see if either of the witnesses from the SEC would care to comment on that issue.

Mr. CUTLER. Sure. I think Mr. Spitzer is right insofar as you can certainly overcome, in my mind, a prospectus disclosure if you can also establish that the adviser personally benefited from the arrangement, and where we can show that, where we can show it was not a matter of one slipping through the nets, but that there was an advantage taken——

Senator FITZGERALD. Are they not getting fees every time there is trading?

Mr. CUTLER. Of course, they are, but it depends on the type of arrangement that is reached. And we are obviously looking at all of these very hard.

You start with the prospectus disclosure, but you do not end the analysis there.

Senator FITZGERALD. Well, thank you.

I would like to turn it over to Chairman Collins to ask questions.

Chairman COLLINS. Thank you, Senator Fitzgerald.

Mr. Roye, Mr. Bogle noted in a recent interview that there is an old saying in corporate America, and that is, "When you have strong managers, weak directors and passive owners, it is only a matter of time before the looting begins."

I want to talk to you about the role of the boards of director and, in particular, about the possibility that the directors are not doing an effective job because they are so overcommitted. They are serving on so many different boards within a family of funds.

In looking at the SEC filings, I noticed that there is tremendous overlap among the boards of directors in fund families. There are, in fact, plenty of fund family directors who serve on the boards for 80 or even 90 different funds, which seems too many to me.

The Chairman of Bank of America's Nation's Fund sits on the boards of 85 funds. The Chairman of Janus sits on 113 fund boards. Now, I realize that many of the funds have similar structures and approaches. So there may be some economies of scale, if you will, but it is hard for me to see how anyone, any one director, could effectively monitor the activities of so many different entities.

Is the SEC taking a look at this area as far as issuing guidelines to limit the number of boards that a director can serve on within the same family of funds?

Mr. ROYE. I think you point out real limitations in terms of director oversight. I think every director who serves on a mutual fund board, who is in a mutual fund complex, has to ask him- or herself whether or not they are effective.

You point out that there are directors who sit on multiple fund boards. As you indicate, there are common issues between funds. When you get into issues like how they are sold, and how their transfer agent is operating, a lot of those issues are the same for every fund. So, once directors ask questions about those types of operations, the answers apply really across the board to all funds. Of course, when you get to particular funds, you get into different investment objectives, policies, different portfolio managers, different performance, and you get into individual issues with regard to each fund.

But I think you are right in that there is a limit, and I think the problem that we have, as the government, is prescribing exactly what that limit is. To this point in time, I think what we have done is look to the directors to exercise that judgment.

And there can be benefits of serving on multiple boards in the sense that issues come up, problems come up, and you can make sure that those issues do not creep into your other funds where you see a problem in one fund and directors sitting on common boards can benefit from that information flow.

But I think you are right, that there is a limit, and I guess the question is, from the standpoint of the government, what should our role be? What is the right number of funds to effectively oversee? And to this point, we have looked to the directors to make that judgment.

I know that the Investment Company Institute, in its best practices for fund directors, has recommended that directors do a self-evaluation periodically to assess whether or not they are effective, are they organized the right way. I think that we try to get a sense of that when we go in and do examinations, looking at their committee structures and how they function. But to this point, we have not gone down the path of coming up with what is the right number.

Chairman COLLINS. I would note that there are also monetary issues at work here. It is very lucrative if you are serving on many of these individual boards, and given the pattern that we have seen of lax oversight, widespread abuses and the lucrative incentives to serve on as many boards as you possibly can, I think this is an area that the SEC really needs to take a hard look at.

I cannot imagine how individual directors, serving on 80, 90, even 100 boards, even if they have a lot in common, can be doing a truly effective job, and yet those directors are well compensated for serving on each of those boards. So I would encourage the SEC, as you take a look at the issue of whether or not there need to be more independent directors, to also look at whether directors are overcomitted and not able to exercise effective oversight.

Mr. ROYE. Let me just add that, in terms of director compensation, this is an area where we have forced disclosure of how much directors are paid so that investors can make judgments about that compensation.

I think this is also an area where, at the SEC, when you talk about the regulatory framework and the statute, we have certain authorities where we can act. And, indeed, as I outlined how the rulemaking tried to require a majority of independent directors, self-nominating directors, independent legal counsel, when we advanced issues like that through rulemaking, there were people who told us that we were exceeding our authority to do that, and so this might be an area where we may need some legislative help in terms of addressing an issue like you outlined.

Chairman COLLINS. Thank you.

Mr. Cutler, you explained to us that the SEC receives thousands of tips from the public and that it is difficult sometimes to sort through those, and it may be difficult to identify ones that are worth following up on, but the SEC has another I would argue far

more effective tool to use, and that is the examination and audit process.

I would like to know, first of all, whether you believe that the current audit schedule is adequate to enforce the law. I know mutual funds have to register with and regularly report to the SEC. They must submit to regular audits and examinations by the Commission staff. I am wondering why these problems were not revealed through the examination and audit process.

Mr. CUTLER. And I do not oversee that process, but let me do my best to address your question, Senator Collins. I think it is a very fair question.

I know that in recent years the SEC could examine funds and fund advisers only once every 5 years. There are over 6,000 mutual funds in our country and over 7,000 advisers, and so there are some resource constraints here at issue. As recently as 1994, I am told, the average frequency for examining advisers was once every 22 years. So that number has come way, way down.

With the additional resources that I know that you were instrumental in helping us to get, Senator, in the last few months, we have moved towards a cycle of every 2, 4 or 5 years for advisers and funds based on the level of risk posed by the individual firms. And as we absorb new staff, I know that our Office of Compliance Inspections and Examinations will be continuing to evaluate whether the cycle should be further reduced. But you are absolutely right. Examinations have to be a key component to how the agency gathers intelligence and understands what is happening out there in the industry.

Chairman COLLINS. Thank you, Mr. Chairman.

Senator FITZGERALD. Senator Akaka.

Senator AKAKA. Thank you very much, Mr. Chairman.

The testimony this morning has indicated that there is serious abuse out there. There is a need to take steps to stop the abuse and restore investor confidence.

Mr. Cutler, on page 2 of your statement you indicate that the SEC's second area of focus is on sales practices. You pose a question about customer understanding of revenue sharing and shelf space payments. What have you learned about consumer understanding of these relationships, and what is necessary for investors to be able to make informed decisions?

Mr. CUTLER. Well, from my perspective, and it is an enforcement vantage point, as opposed to a regulatory vantage point, I have seen at least one significant matter in which—and there are more—but one that is on the forefront of my mind where it is clear to me that customers did not have a fulsome understanding of what it was that the broker who was selling them the product was getting out of that sale. And it strikes me that that is the fundamental question we all have to ask. When someone recommends a transaction to you, Senator, you have a right to understand that the person recommending that transaction to you, the firm recommending that transaction to you has an interest and that they may have gotten a payment, if you will, to feature that recommendation.

You mentioned shelf space, and I think that is the right terminology. We have learned of many situations in which funds were paying the brokerage community to feature their product on a pre-

mier shelf, and it strikes me that investors deserve to know that sort of incentive has been created.

Senator AKAKA. Thank you. Let me shift to the other side of the panel.

Ms. Schapiro, you mentioned that you are conducting an examination sweep of brokers and dealers to determine how investment companies pay to be included on firms' featured mutual fund lists and why they receive favorable promotional or selling efforts.

What have you learned so far about these relationships during the sweep?

Ms. SCHAPIRO. Thank you, Senator.

Well, we are, in fact, conducting a sweep focused on 12 major broker-dealers to determine how they have been paid by funds for inclusion on a preferred or recommended list, and as I said, we are looking at all different kinds of broker-dealers—on-line firms, discount firms, full service and fund distributors.

Clearly, we are in an environment where there are so many mutual funds who are vying for visibility in the distribution chains that they are willing to pay a broker-dealer or direct brokerage commissions to a broker-dealer in return for appearing on that preferred or recommended list. It is a clear violation of NASD rules. We will announce some cases very shortly and, as I said, we have an examination sweep ongoing in that area as well as in a number of other areas.

If I can harken back to your question to Mr. Cutler, the concern about investors understanding fees and expenses I think underlies many of the problems we have here. There is a lack of clarity in the disclosure. Investors have to go multiple places to find out about things like directed brokerage, soft dollars, expenses, front-end sales loads, contingent deferred sales charges, many things you all have referenced in your opening comments.

We need to have disclosure that is concise and in one place so that investors understand what they are paying for with all of the fees and expenses, what reduces their initial investment and what the impacts are on their return as a result and, as well, what are the conflicts that compensation practices create for brokers that encourage them to sell one product over another because it benefits the broker and not necessarily the investor?

Senator AKAKA. Mr. Galvin, let me pursue soft dollars. In your statement, you state that soft dollars should be banned.

Mr. GALVIN. Yes.

Senator AKAKA. Please explain to the Subcommittee why you believe it is necessary to ban the use of soft dollars.

Mr. GALVIN. Well, I think oftentimes soft dollars are places that funds develop additional sources of revenues and fees that really ultimately end up coming out of the consumer, but are hidden from them—I think just what Ms. Schapiro was describing, the complexity of an individual confronting a broker to find out what it is actually going to cost them.

I think we have to put this all in context, especially in mutual funds. Mutual funds are where people go for a sense of safety. Oftentimes, people who go there are either unsophisticated or choose not to be sophisticated. They want a simple transaction. They want some protection, and they ought to know what the fees are. They

ought to know what the costs are. And I think the good part of the disclosure provision of the current bill, H.R. 2420, is good, but I frankly think they ought to be banned because I cannot see a basis for where does the benefit go to consumers that soft dollars are still part of the system. It is complex enough without dealing with soft dollars already. Why can we not make it more clear? I think we need to draw bright lines.

One of the difficulties, and I think it is apparent here, as we have all been grappling with these various terminologies is, although it is a simple concept, mutual funds, it is very complex when you try to explain it to people, and we all have some idea what we are talking about. Imagine the average consumer that is confronted or trying to understand exactly what is going on.

I think we have to somehow codify a sense of ethics, a catch-all for the industry so that there will be the opportunities so that we will not be having to think twice or three times whether something that is clearly unethical is also criminal.

One of the things we saw for instance in the sales practices issues at Morgan Stanley was the complete failure to disclose any sales contests, huge bonuses to office managers, deferred compensation. Imagine, for a minute, Senator, if I were your broker and said to you, "I recommend you buy this product, but before you buy this product, Senator, I want to tell you I am getting more money to sell it to you. My deferred compensation has improved, and I am entered in a trip, and I can go to some nice place, but that had absolutely nothing to do with my decision to recommend this product to you." I think you would ask me some other questions, and yet I do not think that individuals get the benefit of that, and that is the problem.

Senator AKAKA. Mr. Spitzer, following up on soft dollars, what is your evaluation of the use of soft dollars, and do you agree with Secretary Galvin's assessment that they should be banned?

Mr. SPITZER. I am not yet at the point where I wish to make that bright line or statement. We have not been investigating the soft dollar issue in particular. We have been having enough fun tracing the hard dollars, and we found those flowing to more interesting places.

There have been so many opportunities for fraud and misconduct, and I think the numbers that Steve revealed in his testimony, in terms of the frequency of abuse, make that clear. We have been looking at the overall structural relationships among the parties and trying to clarify to the consumer what the problems were.

In answer to your question before, what have we learned from our inquiry, the first thing I learned is the companies do not want us to look; the second thing we learned was that they will try to hide the evidence occasionally; the third thing we found is that when we finally get the E-mails, it is not a pretty picture. And the end result is that we have opened up a window into a morass of conflicts of interest, not only the soft dollars, where I have no reason to disagree with Bill's conclusion, but I am not yet at the point where I have studied the issue sufficiently to say outright ban them. I think inquiry needs to continue.

But what is eminently clear is that this is a window into what has been foggy, murky and impossible to understand. And if you

think about, to draw an analogy, somebody mentioned shelf space, which you think about in a supermarket context most often, when you pick up a product at the supermarket, it has a nice little chart on the back that gives you your nutritional information, which Congress thought was an appropriate type of disclosure for folks so they would understand what they are eating, what they are buying. And we have rules about pricing, common pricing among equally weighted products, things that have worked well for consumers.

We do not have those rules for mutual funds. There is no capacity to seek comparability in the examination of costs, returns, and what you actually pay. That is what I think the consumer is owed and what we are demanding.

Senator AKAKA. Thank you. Let me continue to pursue the issue of soft dollars and ask Mr. Roye and Mr. Cutler about their use.

The SEC released a study on soft dollars in September 1998. The report indicated that soft dollars were used to pay for research, salaries, office rent, telephone services, legal fees, entertainment, among other expenses. What trends, if any, in the use of soft dollars have you seen since a report was issued?

Mr. ROYE. I will respond to that.

You are correct, the Commission examination staff did a study of soft dollars and made a series of recommendations in that area to improve disclosure, improve transparency. Indeed, we have some follow-on proposals that are pending in that area for investment advisers.

I think, as was pointed out again in the Baker legislation, the Commission endorsed the reexamination of the soft dollar area. It does introduce conflicts. You know, managers generating commissions to produce benefits, they could be research benefits, they could be nonresearch benefits, and the way the statute works is that they are protected if they gained research for that, but if it is outside the research definition, it could be problematic, even unlawful.

Indeed, Steve's group has brought enforcement actions against some investment advisers for violations of soft dollars and soft dollar abuses. So we still see abuses in this area, but it is an area where conflicts are introduced, and they have to be managed, at the very least they have to be disclosed, and we have endorsed the reexamination of that.

It is a complicated issue in the sense that if you ban soft dollars, the way some have argued, you get into issues of how research is paid for? Mr. Spitzer, Steve, the Commission negotiated a settlement of the research analyst matter. A lot of that research that is provided by independent research analysts is paid for in soft dollars. So it is a very complicated issue, but I think it is one worthy of further examination. Indeed, they are looking at it in the U.K. currently and deciding what approach they are going to take on soft dollars.

Senator AKAKA. Thank you very much.

Senator FITZGERALD. Senator Akaka, thank you.

All of you, you have been wonderful witnesses. Thank you so much for being here.

We are going to move on. Actually, Congressman Baker is here now. He has arrived in Washington, and if the second panel would just hold back for 1 minute so we can let Congressman Baker give his statement, we will then take a 5-minute break and reconvene with the full second panel.

Thank you all for being here. You have been terrific witnesses. Thank you.

Congressman Baker, thank you very much for being here. I know that you have a full schedule, and we are happy to accommodate you at this time. While you were gone, Senator Akaka and I both commended you on the extraordinary leadership you have shown in attempting to reform the mutual fund industry, and I likened you to John the Baptist as a voice crying out in the wilderness. You, like John Bogle, had been talking about this issue for years. You introduced a wonderful bill before the current scandals came to light.

Congressman Richard H. Baker is from the Sixth District of Louisiana. He is Chairman of the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises. That includes Fannie Mae and Freddie Mac, and that is a whole other area in which that we have had hearings.

Congressman Baker introduced H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act of 2003. I believe you introduced that in June of this year. This bill would help investors gain a clearer understanding of the fees they are charged for investing in mutual funds and strengthen the role of independent directors who are charged with guarding the interests of fund investors.

He has also been a leading advocate of regulatory reform in the securities industry and is working tirelessly to restore investor confidence.

I also want to take this opportunity to recognize the year-long effort of the House Financial Services Committee to reform the mutual fund industry. Led by Chairman Oxley and Subcommittee Chairman Baker, long before any scandals came to light, the Financial Services Committee has brought the issue of mutual fund reform to the forefront.

My Subcommittee will continue to collaborate with the House Financial Services Committee on this and other important issues facing the securities industry.

Congressman Baker, I welcome you to the Senate and thank you for making the time to participate in this hearing. You may proceed with your statement, and I understand you just flew into Washington this morning. Is that correct?

Mr. BAKER. Yes, sir, that is correct.

TESTIMONY OF HON. RICHARD H. BAKER,[1] A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA, CHAIRMAN, SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES, COMMITTEE ON FINANCIAL SERVICES, U.S. HOUSE OF REPRESENTATIVES

Mr. BAKER. I appreciate the gentleman's very gracious introduction, and I would perhaps characterize my efforts slightly differently. My dad told me if you hang a tie in the closet and leave it there long enough, sooner or later it will come back into fashion. And I kind of feel like I have been hanging in the closet for a long time and events have just changed. But I do appreciate very much your interest in the subject and your leadership here in the Senate in providing direction. I look forward to working with both of you as we move forward on this difficult subject.

When the bill was introduced, there really was not a crisis. I was merely directing attention to the difficulty in understanding what it is that working families get at the end of a year when they get that mutual fund statement and sit down at the kitchen table and try to figure out where the money went.

My son, who is doing better in life than I, had two different funds, and came to me, the smart guy, to help him understand. After a bit of embarrassment, I determined that I needed to go to school and try to understand how this reporting system was intended to work. That led to a number of other observations that I thought would be in the best interests of working families.

As the Senators know, 95 million Americans now invest in mutual funds, over half of all households, virtually everyone, through the workplace or through some other opportunity, is a direct investor in this great economy, and that is as it should be because those investors now, in such large number, provide enormous capital for business expansion and job opportunities. So it is important we have a system that functions properly—one that they feel they are being treated fairly.

I also want to speak to the work for a moment of that of Attorneys General Spitzer and Galvin. Although we have had disagreements on other substantive issues, I think their work in pursuit of wrongdoers in the mutual fund industry is outstanding and highly appropriate.

In only one example of Mr. Galvin's work, there was a group of New York State union officials, apparently, who had access to information and each afternoon would engage in market timing events. Ten such individuals engaged in over 3,000 trades over a 3-year period. It became known within the mutual fund company that facilitated the trades as "the boilermaker hour." That type of conduct is so egregious it is hard for one to imagine how it could be endured by those in a professional position of responsibility as fiduciaries of working families' money.

With the introduction of H.R. 2420, there are a number of elements to the bill which I will quickly recite and concentrate only on one or two that I think warrant a little discussion.

---

[1] The prepared statement of Mr. Baker appears in the Appendix on page 120.

We enhanced fee disclosure. We require enhanced portfolio manager disclosure of compensation and their holdings. We try to make sure that the breakpoints, those discounts you earn when you buy more of the shares, are given appropriately, disclosure of revenue sharing agreements, portfolio transaction expenses. This is something that I think deserves a great deal of attention.

That is how frequently the shares or the stocks held by the fund are bought and sold. Some call it churning. On average, a fund will hold a stock now for only about 11 months. It certainly adds a new perspective to long-term investing.

There is a fund, Fred Alger Management Fund, with assets of about $2 billion for the year 2002, had $9 billion of redemptions in a single year, for a turnover rate of 440 percent. One has to question the legitimate purposes for such a high level of turnover, and there are many who have in excess of 100 percent of turnover, disclosure of directed brokerage arrangements, disclosure of the soft dollar arrangements, and some attention has been given by the first panel to whether soft dollar arrangements should be made illegal entirely. Almost as to refocus the debate a bit, whether it is a good thing or a bad thing, we at least ought to know about it, but more importantly, the scope of soft dollar problems fades in far less importance when you are looking at the broader picture of mutual fund mismanagement.

And so I would hope that we not let that issue cloud the judgment on the broader array of reforms which are really warranted.

Enhanced Audit Committee requirements, a simple thing. A no load fund ought to be no load. Today, you can have up to 25 basis points of 12b–1 fees assessed, and you still maintain the title "No Load Fund," even though you do not know that you are paying that fee.

I would like to focus a little bit on things that are not in the bill. I think we made a good start, but I do not believe we have got it all right, and this is where I think the members of this panel can be very helpful.

I waged a valiant effort, but in the end lost, on the importance of an independent chair for mutual fund governance. Most investors do not really get the real picture of what the chairman of the mutual fund's responsibilities are as the CEO of the management company.

The board hires the management company to come in and run the investment portfolio of the mutual fund company. The mutual fund is owned by its individual shareholders—the moms and pops. The management company is also owned by shareholders, but it is a different group of shareholders.

The two goals of those two companies are different. The mutual fund company wants to make as much money as possible by limiting the payments to the management company. The management company shareholders want to make as much money as possible by making fees from the mutual fund.

I think it incredibly important, particularly given the operational professional judgments that have been absent in far too many cases for the chairman, and with the addition of a chief compliance officer who would report only to the independent chairman, to have the authority to determine if the management company is per-

forming its job in a manner appropriate for the shareholders of the mutual fund. Imagine how hard it must be for those individuals who are CEO of the management company, as the chairman of the board of the mutual fund, to fire themselves from their own contractual relationship.

It seems to me to be a clear-cut conflict of interest, and so I would heartily recommend the Subcommittee revisit that issue.

There should be a clear and explicit prohibition, although I believe it to be a violation of insider trading provisions, to preclude market timing in their own funds. There should be a prohibition that makes it impossible for a manager to simultaneously operate a mutual fund and a hedge fund. Hedge fund payments to management tend to be a bit more lucrative than those payments made by a mutual fund because of the risk engaged in operating a hedge fund.

There is a case where a manager was market timing his mutual fund for the benefit of his own hedge fund. That behavior is, if not criminal, certainly ought to be soon.

Another issue is whether any mutual fund at all should be permitted to utilize market timing as a management tool. I question the validity or benefit to the shareholders of such action.

I believe there should be clear, concise disclosure of executive and portfolio manager compensation. Simply stated, are they investing in the funds just like the shareholders for whose money they are charged with the responsibility of managing, and how much do they make at your expense? This is the case for all Fortune 500-traded publicly operating companies. Mutual funds should be no different with that enhanced disclosure.

Mr. Chairman, I think your work is creating a unique opportunity for us in the Congress, but it is in recognition of our significant responsibilities on behalf of those 95 million investors. Many had dreams of early retirement, of buying that special home, perhaps of putting the kids through school or college, and those plans have been dramatically restructured.

Now, almost every investor in the market has felt discomfort over the past several years, but the reasons for the financial loss were clearly printed on the front page of the newspaper. We did not like it. We all understood it, and we accepted our losses.

However, in my opinion, significant amounts of money have also been taken from mutual fund shareholders that they do not know they are losing. It is not clearly illegal acts that the attorneys general are pursuing that cost shareholders money. It is the legally permissible conduct that is simply not disclosed. Providing investors with a clear, concise statement of the investing facts is all that is really required.

Mutual funds can be a very helpful tool for financial security, but not all mutual funds are equal. About 80 percent of all mutual funds in a given year underperform the stock market's S&P 500 index, and the average actively managed stock mutual fund returns about 2 percent less to its shareholders than the stock market returns in general, and fees matter, as Mr. Bogle, I am sure, will visit in a moment.

A $10,000 investment for 20 years, with an average annualized return of 12 percent, you will get dramatically different results

with just a small change in administrative expenses. With a half-a-percent rate, your investment net is about $87,000. With a full service 2 percent fee charge, your investment is worth about $64,000. The only variable is the difference between a 2 percent management fee and a half-a-percent fee, and that equates to $22,862. Fees do matter.

Whether a particular mutual fund meets your needs should be an informed decision every investor should make based on the facts and full disclosure. In the capital markets hearing back in March of this year, one of the industry representatives said it very well. "Investors then are fully informed and free to make their own decisions about whether a fund offers the right combination of investment performance and service that justifies the fee being charged or not. As in any competitive, free-trading market, the ultimate power rests, as it should, with the judgment and wallets of mutual fund shareholders."

That is the way it should be, and I believe there are many within the industry, and certainly many within the Congress, who want to work together to structure a marketplace that works that way. Unfortunately, I have come to the conclusion it is not working that way at all.

With your leadership, Mr. Chairman, and the assistance of the Members of your Committee, I think we can provide a blueprint for what the industry says it wants to build, and that is a mutual fund marketplace that is fair to all, based on complete disclosure of the investing facts, with rules applied equally to everyone.

Thank you, Mr. Chairman.

Senator FITZGERALD. Congressman Baker, thank you so much for coming over here, and, again, we want to commend you on the outstanding job you have been doing. We hope to work with you in the future. Senator Akaka has a bill that he has prepared that would help reform the mutual fund industry along the lines of the bill you have introduced in the House, and I intend to work with Senator Akaka as we pursue bipartisan legislation in the Senate that would mirror the reform efforts you have begun in the House.

We wish you good luck in your pursuits over there because I know we are fighting against a very powerful industry. There is actually an old phrase that a Chicago alderman once said. His name was Paddy Bauler. And back in the 1950's, he famously observed that "Chicago ain't ready for reform."

Well, I am not sure the mutual fund industry is ready for reform yet, but whether it is ready or not, it needs to be reformed. And so I thank you and look forward to continuing to work with you. Thanks for coming over today.

Mr. BAKER. You are very kind and generous with your remarks. I look forward to working with you gentlemen as well.

Senator FITZGERALD. Thank you.

Senator AKAKA. Mr. Chairman, I also want to add my gratitude to Congressman Baker for your leadership in this effort. I look forward to working with you as well. Thank you.

Mr. BAKER. Thank you, Senator.

Senator FITZGERALD. At this time we would like to take a very brief 2- or 3-minute break so everyone can stretch. Then we will reconvene with the second panel. Thank you.

[Recess.]

Senator FITZGERALD. I would now like to introduce our next panel of witnesses.

John C. Bogle is the founder and former CEO of the Vanguard Group and the President of Bogle Financial Markets Research Center. He created Vanguard in 1974 and served as Chairman through 1997 and Senior Chairman through 1999. Mr. Bogle has received a number of awards and distinctions for his leadership at Vanguard, which is one of the two largest mutual fund organizations in the world and the first organization to offer an indexed mutual fund. If I am not mistaken, Vanguard is the only mutual fund where the funds actually own Vanguard.

Mr. BOGLE. That is correct, Mr. Chairman.

Senator FITZGERALD. Mr. Bogle is also the author of four books on investing and mutual funds.

Also with us today is Mercer E. Bullard. Mercer Bullard is the founder of Fund Democracy, a nonprofit membership organization that serves as an advocate and information source for mutual fund shareholders and their advisers. Mr. Bullard is also an Assistant Professor of Law at the University of Mississippi, where he teaches in the areas of securities and banking regulation, corporate finance, and contracts. Mr. Bullard was formerly an Assistant Chief Counsel in the SEC's Division of Investment Management, where he was responsible for a wide range of matters involving mutual funds and investment advisers.

Matthew P. Fink is the President of the Investment Company Institute, the National Association for the American Mutual Fund Industry, representing over 8,600 mutual funds across the country. Mr. Fink has been with the Investment Company Institute since 1971 and has served as its president for the past 12 years.

Again, I would like to thank all of you for being here today to testify. In the interest of time, we would ask that you submit your written statements for the record. They will be included in full as part of the record. And we would ask that you try as best as you are able to summarize your remarks for the Subcommittee in a 5-minute opening statement.

Now, I am informed that Mr. Bogle needs to leave this building at 1:30 so we can get him on a train out of town, and we are going to try and keep that commitment to Mr. Bogle.

Mr. Bogle, we may begin with you, and I mentioned in my opening remarks that Vanguard, as I understand it, is the only fund in the country that is set up in a truly mutual way in which the fund owns Vanguard. In all other instances of mutual funds, you have a separate advisory firm typically that, I gather, sets up the funds, and you set up Vanguard so that the interests of the operators of Vanguard were more aligned with the funds. Could you address that structure that you have just at the outset? I think it is a very important point.

TESTIMONY OF JOHN C. BOGLE,[1] FOUNDER AND FORMER CEO, THE VANGUARD GROUP

Mr. BOGLE. Yes, I am happy to do that. We created an organization in which actually the mutual funds own all of the common stock of Vanguard Group, Incorporated, which is our investment manager. We operate at cost, and each fund just picks up its own proportion, its share of that cost. There is no profit to any outside organization. When we actually employ external investment managers, we negotiate with them very vigorously on behalf of the funds that they are negotiating with. And, in fact, in some cases we get the fees down to less than one basis point—not 10 basis points, Mr. Chairman, one basis point. So we not only have the ability to run at cost, we have the ability to negotiate at arm's length.

Senator FITZGERALD. You get the fees for investment management down to one basis point?

Mr. BOGLE. Yes. I will confess that our equity funds sometimes run as high as 10 or even 15 basis points.

Senator FITZGERALD. Not one point. We are talking basis points. One basis point.

Mr. BOGLE. Yes. Our Ginnie Mae fund is a managed mortgage-backed securities fund, and it has a fee of nine-tenths of a basis point, not 10 basis points but less than one basis point.

Senator FITZGERALD. What kind of a fee does the typical——

Mr. BOGLE. Well, just 0.9 basis points generates a staggeringly large fee of—I think it is about $3 million a year. How could anybody possibly spend that much on that kind of management? Just think about it for a minute. So we ought to all be looking, by the way, Mr. Chairman, at dollar amounts of fees and not fee rates. You know, this industry, it is almost as if there was a conspiracy many years ago, and they said, What is the biggest number we can think of to relate our management fees to? And someone said, How about we use all the assets of the fund? So we get this 1.5 or 2 percent fee, which looks very small, but we do not say that 3 percent all in costs, counting trading costs for equity funds, is 30 percent of the stock market return in a market returning 10 percent and actually 100 percent of the equity premium—that is to say, stocks usually yield about 3 percentage points more than bonds, and at a 3 percent cost in an equity fund, you might just as well own a bond fund as a stock fund. It is a staggering large cost.

Now, if I may move on to my opening statement, first of all, I obviously deeply appreciate your incisive and insightful opening statements, and I have to say, Mr. Chairman, I am deeply humbled by your comments because the only thing I have ever had to offer this industry or this world is common sense—I am not a big brain—and some sense of trust for other people's money. It is interesting that my extreme statements of yesterday seem overnight to be statements of great moderation, and that which was once heresy is now dogma.

I have been involved in this industry ever since 1951—or 1949, when I began to write——

[1] The prepared statement of Mr. Bogle appears in the Appendix on page 130.

Senator FITZGERALD. Could you pull that microphone a little bit closer so everybody can hear? Thank you.

Mr. BOGLE. Yes. I began my involvement with this industry ever since 1949 when I began to write my senior thesis at Princeton University. In 1951, I went to work with industry pioneer Wellington Management Company and headed that company from 1965 to 1974, during which period I was also the Chairman of the Board of Governors, part of that period, of the Investment Company Institute. It was in 1974 when I founded this new mutual fund organization called the Vanguard Group of Investment Companies.

It is peculiar but true that Vanguard represented my attempt to create a firm that would measure up to the goals I set forth for the mutual fund industry in that original senior thesis at my university, to place the interests of fund shareholders as the highest priority, to reduce management fees and sales charges explicitly, to make no claim of ability to beat the stock market, and to manage funds—and this is a direct quote from that ancient thesis—"in the most honest, efficient, and economical way possible." And through Vanguard, we have done our best to meet those goals, and as a result, Vanguard has become the lowest-cost provider of financial services simply by delivering the staggering economies of scale that exist in the money management business. In fact, Vanguard's unit costs are down about 60 percent since we began, and the industry's unit costs are up about 60 percent. That is quite a contrast. And also with $650 billion of assets, that low-cost theory has enabled us, because some investors understand, to become one of the two largest firms in this field.

After I gave up my position as Vanguard's senior chairman, I have been engaged in writing, researching, and speaking about investing in the fund industry and, for that matter, corporate America and the New York Stock Exchange, including half a dozen oped pieces for the *New York Times* and the *Wall Street Journal,* one of which castigated the industry for taking the position that we should not tell our own owners how we are voting their shares, as well as several additional books, now four in all, all presenting strong and, I hope, well-reasoned views of this industry's imperative need to better serve its shareholders.

But I am sorry to tell you, Mr. Chairman, the fund industry has yet to measure up to those idealistic yet wholly realistic goals that I urged upon the industry back in 1951.

Disgusting, as they are to someone like me, who has made fund management his life's work, the recent market timing scandals, as you observed yourself, sir, have a good side. They call attention to the profound conflicts of interest that exist between fund managers and fund shareholders, conflicts that arise from an inherently flawed governance structure in which fund owners in practice have little, if any, voice. The trading scandals are just the small tip of an enormous iceberg of conflict.

While the costs of international time zone trading has been estimated at about $5 billion, the costs of managing the industry's nearly $7 trillion of assets in stock, bond, and money market funds came to some $123 billion, counting trading costs, in 2002 alone, a cost that is largely—think about this a minute, sir—indeed al-

most entirely responsible for the reason that mutual fund returns fell short of the returns available in the financial markets. Gross return minus cost equals net return. It is inescapable and, yes, sir, costs matter.

If the management fees that represent the major portion of those costs were subject to arm's-length negotiation between funds and their managers, it is true that tens of billions of dollars could be saved and added to investor returns year after year after year.

The kind of stewardship that demands that fund directors effectively represent the shareholders who elected them and to whom they are responsible under the law is rarely found in this industry. Rather, managers focus on salesmanship, their agendas dominated by a desire to bring in assets under management. That marketing agenda led us, as you know, sir, to create hundreds of risky new economy funds during the stock market bubble, not because they were prudent investments but simply because we thought the public would be eager to buy them. And in the ensuing market crash, those very funds cost our shareholders hundreds of billions of dollars, even as fund managers were reaping tens of billions of dollars in extra advisory fees.

The conflicts of interest that engendered these unhappy and costly outcomes for fund shareholders must be resolved, and must be resolved in favor of fund owners and not fund managers.

My formal statement sets forth a series of governance reforms that I believe are required to set the balance straight, and I strongly urge you to consider them.

I want to add just very briefly, let me say that I love the mutual fund industry, and I have loved it ever since we first met in 1949. But we have lost our way, and we must return to our proud heritage. It is the recent scandals that give us the opportunity to build a fund industry that is worthy of our heritage, one that returns to what I have been doing and trying to get done a long time, sometimes I think I have been working on it forever: Giving the mutual fund industry's 95 million investors a fair shake.

Thank you, sir.

Senator FITZGERALD. Thank you very much, Mr. Bogle. Mr. Bullard, you may proceed.

TESTIMONY OF MERCER E. BULLARD,[1] FOUNDER AND PRESIDENT, FUND DEMOCRACY, INC

Mr. BULLARD. Thank you. Chairman Fitzgerald, Ranking Member Akaka, and Members of the Subcommittee, thank you for inviting me to testify here today.

The occasion for this hearing is for me, and I believe all of us, an unhappy one. The U.S. fund industry is in the middle of the worst scandal in its history. Shareholders' faith in the securities markets has once again been shaken, this time with respect to an industry that has had a relatively scandal-free reputation.

About this few disagree. About how to deal with this scandal there is significant disagreement. Some believe that the scandal involves only a few bad apples, a few isolated instances of fraud, the failure of fund rules. In my view, the scandal involves more than

[1] The prepared statement of Mr. Bullard appears in the Appendix on page 154.

a few bad apples. It reaches into the highest executive ranks of some fund managers. It involves a number of different types of frauds at a large number of fund complexes. It demonstrates not a failure of fund rules but a systemic failure of compliance.

The alleged frauds were no surprise. They were open and notorious. The most substantial harm to shareholders, harm caused when funds used stale prices, has been well known for years and exploited by professional and retail investors alike.

Academics have published numerous studies on stale pricing, estimating that shareholders lose hundreds of millions or even billions of dollars every year. There have been articles describing how to exploit stale prices in popular financial press. Three years ago, I wrote two articles describing the problem of stale pricing and showed how a fund using stale prices could lose 2 to 3 percent of its assets because of stale prices in a single day.

This has not been a problem for some complexes that have chosen to protect their shareholders. Vanguard and Fidelity, for example, among others, routinely fair-value their portfolios to ensure that their funds' prices are not stale. The question for this Subcommittee is why managers and directors of other funds did not take steps to protect their shareholders.

The alleged frauds of late trading, market timing, and commission overcharges similarly reflect a shocking failure of oversight by fund managers and directors. Commission overcharges, late trading, stale pricing, and illegal market timing can and will happen and probably continue to happen, even in an ideal compliance environment. Fund directors and managers cannot and should not be held accountable for individual instances of fraud. But the extraordinary pervasiveness of these frauds demonstrates that the problem is that the compliance environment in much of the fund industry has become corrupted. The scope of these frauds could not have been realized if fund directors and managers had ensured that procedures were in place that were reasonably designed to detect and prevent these frauds and that periodic spot checks were conducted to ensure the procedures were working.

When alleged frauds such as these show a systemic failure of compliance, structural reform is necessary. It is not enough to change the rules when the problem is that existing rules were routinely ignored. The oversight system for mutual funds must be addressed.

Toward that end, I propose that Congress create a mutual fund oversight board to supplement the SEC's oversight of the fund industry. The Board would have examination and enforcement authority over fund boards. It would be financed from assessments on fund assets and appointed by the SEC.

Americans are increasingly being expected to prepare for their retirement security on their own. But if their investments are simply going to be lost to fraud, in some cases perpetrated by the very persons to whom they have entrusted their financial futures, they will naturally turn away from our markets with potentially disastrous consequences for their retirement security and this country's economic future. I strongly recommend that Congress take strong steps to restore America's faith in the fund industry.

Thank you again for the opportunity to appear before you today, and I am happy to answer any questions you might have.

Senator FITZGERALD. Thank you. Mr. Fink.

TESTIMONY OF MATTHEW P. FINK,[1] PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. FINK. Thank you, Mr. Chairman. Like many of you here today and the witnesses that preceded me, I am outraged at the shocking betrayal of trust exhibited by some firms and people in our industry.

As you said, Mr. Chairman, I have been at the institute for 32 years. Mr. Bogle, who was one of the people who hired me 32 years ago, I love the mutual fund industry. And in virtually every discussion I have had over those three decades with Members of Congress and regulators and the media, when asked why the mutual fund industry has been so successful, I have attributed it largely to what Mr. Bullard just said: It has had a pretty scandal-free record because it has been committed to integrity.

The investigations raise very serious questions about that integrity. I can assure you that I and the fund leaders are totally committed to answering every one of those questions. We want to rebuild trust, renew public confidence, and reinforce our history of putting the interests of fund shareholders first. This is because it is the best way for the funds, many funds who are not involved in the investigations, to continue to serve their investors well and for those who are involved to turn around and embrace needed reforms. And I can assure you, Mr. Chairman, that as far as we are concerned, every type of reform is on the table for consideration.

I think it is clear that action has to be taken in three areas: first, government officials must identify and sanction every single person or firm who violated the law; second, fund shareholders who were harmed must be made right; and, third, strong regulatory reforms must be put in place to make sure these abuses never happen again.

Let me turn to the third area of regulatory reform. The SEC, as you heard this morning, has laid out a blueprint. In connection with this, last week the Investment Company Institute called for three actions in each of the three areas of major abuse: Late trading, short-term trading, and trading by insiders.

First let me talk about late trading. Current law, as you have heard, requires that orders to buy or sell fund shares have to be placed by investors by 4 p.m. Some orders may not actually be received by the mutual fund until many hours later. For the large number of transactions, 90 percent, that do not go directly to the fund but come through brokers or 401(k) plans or other intermediaries, the fund gaining assurance that the orders were placed before 4 p.m. is very difficult and, in fact, in many cases is impossible. Therefore, our recommendation is designed to solve this problem.

We have called upon the SEC to require that all orders must be received by the fund itself by 4 p.m. This is very tough medicine, Mr. Chairman. Longstanding business practices will have to

[1] The prepared statement of Mr. Fink appears in the Appendix on page 186.

change. Millions of shareholders, thousands of brokers, banks, 401(k) plans, and other intermediaries will be affected. And hundreds of fund companies will be affected. Nevertheless, we urge the SEC to move as quickly as possible, given the practical changes of implementing this scheme.

My chairman, Paul Haaga, has stated that the 4 p.m. deadline "represents all that can be done to slam the late trading window shut." We are committed to keeping this window shut and locked permanently.

The second area is abusive short-term trading, market timing. Chairman Donaldson has outlined ways to address these concerns. While some funds had policies and disclosure to discourage market timing, they, in fact, applied those policies unfairly or inconsistently, to say the least. And we endorse all of Chairman Donaldson's plan.

We have also concluded that on top of that, a substantial new regulatory requirement is needed. In fact, about the same day Mr. Bogle came out with the same type of plan. Mutual funds face great difficulty in enforcing their policies against late trading because for many accounts—and I cannot give you an estimate, but I would say perhaps 30 percent of fund assets—the shareholder's account is not with the fund. The fund does not even know his or her name. It is with a broker, bank, 401(k) plan, a so-called omnibus account. There we only know the omnibus account name. We do not know anything about the individual shareholders or their transactions. Therefore, the funds cannot easily, or it may be impossible for them to enforce, their bans on short-term trading. Therefore, we recommend that the SEC require virtually all funds in this country to impose a 2 percent redemption fee on any sale of fund shares for 5 days following purchase. I think Mr. Bogle recommended a 30-day window, but it is the same type of idea.

A standard industry-wide requirement like this could help intermediaries police their accounts. And I also want to make it clear that 100 percent of the proceeds of the redemption fee goes to the fund and its long-term shareholders, not to the fund's management or the intermediaries.

Let me just talk about the last and I think the most shocking issue: Abuse of trading by fund insiders. Last week, we learned of allegations that some fund managers have themselves engaged in short-term trading in their own funds. This is totally abhorrent. We support any steps necessary to make it clear that this is illegal. Moreover, we have called upon our members to amend their existing codes of ethics.

Back in 1994, there was a scandal, smaller than the current one, where people who worked at mutual funds were buying stocks or bonds in front of their funds or possibly in front of their funds, and the industry came out with very tough procedures, best practices, to stop that. It included, for example, Mr. Chairman, any gains anybody who worked for a mutual fund made on a trade within 60 days, even if the fund never thought about buying or selling that security, would have to be disgorged—reporting, post-trade monitoring, prior clearance, a whole bunch of controls. We understand both from the mutual funds and from the regulators this seems to have stamped out insider bad trading, short-term trading in stocks

and bonds. Nobody thought at the time, frankly, to cover mutual fund shares. Everybody thought it would be a good idea for the fund managers to eat their own cooking and invest in their funds. We think these codes ought to be extended appropriately to cover trading in mutual fund shares.

Let me just conclude, Mr. Chairman. It is also clear, as all the witnesses have said, that broader reforms are needed. We can address these three existing ones, but we do not want to be back here addressing a fourth one next year or 2 years from now. It is clear to me we need strong compliance systems and far better mechanisms for fund directors to determine that those compliance systems are working, not just in late trading and market timing but in all areas.

The SEC recently issued a major rule proposal in this area, and we urge its adoption as swiftly as possible. We are also open to many of the measures that have been discussed today. I probably heard 20 or 30. And I have a feeling that if you took all the witnesses—government, industry, industry critics, etc.—there is probably 70 or 80 percent agreement among all that list. There will be differences of opinion, but I think there is general agreement.

Mr. Chairman, in conclusion, I recently announced—I might say before the scandal—that I would be retiring after 32 years. And I promise with all of my heart to every member of this Subcommittee, all the other government officials involved, and, above all, the Nation's 95 million shareholders, that I personally will use all of my own energies during my remaining tenure to see that these abuses are stamped out and that necessary reforms are, in fact, put in place. Thank you.

Senator FITZGERALD. Thank you very much, Mr. Fink. It is indeed an irony that you were hired 32 years ago by Mr. Bogle and here you wind up on the same——

Mr. FINK. Among others. I don't think he wants to——

Senator FITZGERALD. Among others. [Laughter.]

I am not quite sure how they ever made Mr. Bogle the president of the ICI, and I want to ask him about how the industry has changed over the years.

You said in your testimony, Mr. Fink, that any and all reforms, including several of those discussed by the previous panel, are on the table and you are open to consider. Let's talk about some of those reforms.

Mr. FINK. Sure.

Senator FITZGERALD. What about having an independent chairman of the board for the mutual fund, independent of the advisory firm?

Mr. FINK. Well, I knew you would ask the difficult ones. If I said 80, you are into the 20 percent. I have to say, factually, I am very worried about solutions that appear to do something and do not do anything. Of the four firms in Canary that Mr. Spitzer brought his first case against, two have independent chairs. Of the total of eight firms that have been named today, as the list has grown—Alger, Alliance, Putnam, etc.—three of the eight have independent chairs. So I have a feeling——

Senator FITZGERALD. Do you think it is a problem with the definition of "independent?"

Mr. FINK. No. These are truly independent. I think an independent chair does not make much difference, Mr. Chairman, and I will tell you why. Right now, by law, by SEC rule, you have to have a majority of independent directors. Industry best practices are two-thirds. Probably industry practice may be two-thirds or better, in fact, so those independent directors can choose whoever they want to be chair from among themselves. They can set the agenda. They can set priorities. And when I ask independent directors who I respect they want the management company person to stay as the chair. Why is that? Well, that job is largely administerial, organizational, agenda building. It is easier for the person who is there full-time to do that. They say we will make the big decisions, but we only come in once a month or once a quarter. So I think there is a practical issue.

I would just be wary of something that sounds good. Only 20 percent of the industry have independent chairs now, and yet three of the eight cases have independent chairs and it has not been a cure-all. So I guess in my own view, Mr. Chairman, I am skeptical.

Senator FITZGERALD. Well, let me ask you this, Mr. Fink: Why is it that Vanguard is able to negotiate lower fees with its investment advisers than virtually all others. Does any other mutual fund have lower fees from their investment advisers than Vanguard?

Mr. BOGLE. I think it is fair to say as a categorical that no other funds—there may be a single isolated fee here or there, but I would be astonished to see even one that pays lower advisory fees than Vanguard.

Senator FITZGERALD. And you have set up Vanguard so that you have eliminated those conflicts between the director of the funds and vendors to the fund.

Mr. BOGLE. Right.

Senator FITZGERALD. Well, why is it that not one of the other 8,600 mutual funds in this country is not able to negotiate the kind of fees that Mr. Bogle's firm has?

Mr. FINK. Well, I think Mr. Bogle put his finger on it. You have got to remember—and Jack can correct me—Vanguard was created with existing—a lot of money in existing funds that reorganized themselves to do this. And as Jack said, there is no profit motive, so it would not pay Senator Fitzgerald or Matt Fink to go out and start a fund company that way because we would not make any money at it. So you kind of need an existing body of assets and then, I don't know, internalize, mutualize. It is an unusual thing. But that is unrelated to the independent chair issue, Mr. Chairman.

I am simply saying that you could pick—we have 20 percent of the industry with independent chairs. I do not think their track record for compliance, ethics, is any better than the 80 percent without independent chairs.

Senator FITZGERALD. Mr. Bogle, would you care to respond?

Mr. BOGLE. Yes. First, let me say that Vanguard started with an existing asset base of around $1 billion, $1.4 billion, and so we did have an asset base on which to build this mutual structure. And I will say, Mr. Chairman, I do not expect anybody to start a mutual fund group, except sort of someone like me, without an idea of an

entrepreneurial profit. But that should not go on forever. You know, a child becomes an adult, and when we leave the billion-dollar level and have scores of fund organizations that are running $10 and $20 and $100 billion, they ought to grow up and think about having an internally managed structure.

It almost offends common sense to think a $200 billion aggregation of assets has to hire another company to run it. What sense would that make?

Senator FITZGERALD. Well, let me ask you this: Are there any other truly mutual mutual funds? Vanguard is the only one. We do have mutual savings banks. We have credit unions. They are organized. They are not-for-profit. Theoretically, they should have better interest rates that they offer to the customers. I think what has happened in practice is they have not been able to run banks or savings and loans out of town because their service is not as good, probably because there is not the profit motive there.

But what would be wrong if the government created a means to encourage the formation of more truly mutual mutual funds?

Mr. BOGLE. I think public policy should work in the direction of requiring consideration of mutualization after a fund gets to a certain size. One way this industry has changed over the long span I have been in it was, when I came in it, all management companies were private companies. They were private partnerships or private corporations owned by the investment adviser, and the SEC successfully kept people from going public to capitalize their fiduciary office. The SEC lost a case in court in 1958. We now have many public companies. And we also have what is really harmful to the industry and to the shareholders, and that is, 36 of the 50 largest fund organizations are giant financial conglomerates. And when a big conglomerate buys a mutual fund business for $2 billion, they say to whoever they get to run it for them, "We want $240 million a year of profit—that is a 12 percent return on their capital—and if you cannot get it, we will hire somebody who can get it."

So that conglomeratization has moved the management away from this closely held group out into this distant financial colossus. At that stage fund complexes, if they have an independent board and an independent staff, will be able to say, look, we are going to mutualize.

Mr. FINK. Mr. Chairman, two things. Jack paints a golden age. Well, we would not have had the Investment Company Act in 1940, which is the toughest of Federal securities statutes, if bad stuff was not going on in the 1920's and 1930's by these wonderful non-conglomerate people. I mean, bad stuff was going on——

Senator FITZGERALD. We called them investment trusts in those days.

Mr. FINK. Yes, investment trusts.

Second, why does somebody start a mutual fund? I am XYZ, T. Rowe Price, Fidelity. I start it. I spend a lot of money to get it growing. I hope to make a lot of money in the future. I do not expect that my directors 5 years from now, unless I do something terribly wrong, are going to move it. It is my creation. And the investor does not expect it. When I invest in the T. Rowe Price X fund,

I do not expect tomorrow they are going to move the management to Fidelity or Putnam or Strong. It is a different situation.

If I can just say this, Mr. Chairman, the Investment Company Act was created, and the problems we face today are because there are inherent conflicts in managing other people's money. No doubt about it. The Investment Company Act tried to put in checks and balances to address that. In 1970, before my time, Mr. Bogle worked on it. Congress made the only major amendments to the Act to increase those checks and balances. We may very well be at a point where more checks and balances ought to be considered. But I do not think we have moved from a golden age to an age of knaves. There has always been a problem. It takes different forms. And we all have to think about—the industry for its own well-keeping has to think about—how to do it.

Senator FITZGERALD. Mr. Bullard.

Mr. BULLARD. Mr. Chairman, it is important to remember that while Vanguard is the leader on cost, there are fund companies that are competing directly with Vanguard on cost and in some cases doing it very successfully. TIAA–CREF, USAA——

Senator FITZGERALD. Now, TIAA–CREF is someone——

Mr. BULLARD. It is a separate entity, but it is a nonprofit.

Senator FITZGERALD. It is not-for-profit, right. Does anybody else——

Mr. BULLARD. Well, for example——

Senator FITZGERALD. Does any for-profit firm compete closely on cost?

Mr. BULLARD. Yes, sir. In fact, the biggest threat to Vanguard right now is exchange-traded funds, which are consistently offered by for-profit entities, and most people believe Vanguard missed a great opportunity to reduce its expense ratios that are now being undercut by those funds being offered by Barclay's Global.

And I also might add, the largest fund complexes generally correlate fairly consistently with lower costs, with Fidelity, Vanguard, American Funds, and T. Rowe Price.

Senator FITZGERALD. The exchange-traded funds do in general have lower costs. Is that correct?

Mr. BULLARD. Yes, they have lower costs with the same indexed funds than those offered by Vanguard.

Senator FITZGERALD. Vanguard offers an exchange-traded fund.

Mr. BOGLE. We do. Let me be clear on this. First, nobody competes with us on cost, Mr. Bullard notwithstanding. I mean, TIAA's costs are about 10 or 15 percent higher; USAA's are probably 100 percent higher; Fidelity's are 200 to 300 percent higher. So no one competes there with really rock-bottom costs.

The trick of the ETFs, the exchange-traded funds, is all the costs of administration are basically thrown over to the marketplace, so people pay for them with their brokerage commissions and things of that nature. We have an ETF owning the total stock market index. We can run that for—I believe the number is 12 basis points, where the fund itself when we run is 15 to 20 basis points. So the differences are small but they are there. So we are in the business. No one is going to take that business away.

Senator FITZGERALD. While we are talking about fees, what about enhanced disclosure of fees? Is it not true, Mr. Fink, that

small differences in fees, in management fees and other fees, charged to a mutual fund can over time result in very big differences?

Mr. FINK. I could not agree more, and the SEC has issued—the debate here is which way to enhance fee disclosure, generally. The SEC has issued a proposal that the annual report you get and the semiannual report—you get a report twice a year—would tell you at the beginning of the period if you had $10,000 invested what the $10,000 would be worth at the end of the period and what the expense—what your pro rata share of the expense would be.

Senator FITZGERALD. Does that SEC regulation require every single expense be included in the calculation?

Mr. FINK. We have to define "expense." The ongoing operating expenses, we get back to an issue with Mr. Bullard whether you can put—and maybe Mr. Bogle. Brokerage commissions and trading costs are not in there because they are generally hard—they are not ongoing expenses.

Senator FITZGERALD. Well, aren't we deceiving an investor in a fund that allows a lot of churning and market timing if we are not making some attempt to quantify how they are being——

Mr. FINK. I am all for an attempt to quantify, but I would not put it in the expense ratio.

Senator FITZGERALD. You are offering an attempt to quantify. The ICI would go——

Mr. FINK. Yes.

Senator FITZGERALD [continuing]. Along with that.

Mr. FINK. Yes.

Senator FITZGERALD. Mr. Bogle, would you like to address what fees are not disclosed in the required disclosures that the SEC mandates in the prospectuses?

Mr. BOGLE. Yes, I would like to at least make this one comment. The SEC and the ICI seem to have come to agreement that you can multiply $10,000 by the fund's expense ratio to get the amount of dollars that would be involved. But they do not seem to be able to multiply the actual value of your account times that expense ratio.

I find that absolutely astonishing in this technological age. It is one simple multiplication that the computer can do to give you the dollar cost number you want. So I do not understand what is going on over in this negotiation.

Senator FITZGERALD. I want to make sure I understand this. Are you recommending a change to the SEC disclosure requirements? Instead of having them pick $10,000, you are recommending that they pick what?

Mr. BOGLE. The asset value of your account at year-end. Multiply that by the existing expense ratio.

Now, I would not yet go——

Senator FITZGERALD. Does the expense ratio encompass all expenses?

Mr. BOGLE. No. That is just the fund expenses, which are essentially management fees and other operating expenses.

Senator FITZGERALD. What are the other expenses?

Mr. BOGLE. The other expenses are—well, they are quite numerous. One is portfolio turnover costs, which I have a very low estimate of, much lower than most people. I put that in at about 8 per-

cent—8/10s of 1 percent, excuse me. So you would add that, for example, to the 1.6 average expense ratio, and that would get you to 2.4 percent.

Most funds have sales charges. If you amortize them over time, it is probably another 40 basis points, something like that. There are out-of-pocket costs. There are opportunity costs. Most funds are not fully invested so you pay an opportunity cost, that being the difference between long-term stock market returns and, say, money market returns, which comes to around another 30 basis points.

So if one wants to think that mutual funds cost around 3 percent a year, one would not be far off. The fact is, Mr. Chairman, that we have done the study of fund performance since 1984, and the average fund has turned in a 9.3 percent annual return while the stock market has turned in a 12.2 percent annual return. That happens to be a 2.9 percent percentage point difference.

And if I may expand on that, we have also found out the average fund investor during that period has earned a return of just 2.6 percent, which I believe to be substantially overstated. That is for another day.

Senator FITZGERALD. So we are missing 7 percent somewhere.

Mr. BOGLE. Yes, somewhere along the way, and——

Senator FITZGERALD. Is that part of what I referred to in my opening statement as the skim? Was that all skimmed off?

Mr. BOGLE. Well, actually, that is not the skim. That is the net result of an industry that used to sell what we made becoming an industry that makes what will sell, and that is, we market funds, technology funds, right at the high of the market. The money pours into them, and then it starts to pour out when it goes down. Even at the high, the money is pouring out of value funds, let's call them old economy funds, into new economy funds. And investors have paid a huge penalty for that, partly, in fairness, their own fault, their own greed, probably their own jealousy of their neighbor. But the industry brings out those funds, promotes them, advertises them, and if you look at the March 2000 issue of *Money Magazine*, 44 mutual funds were advertising their performance there, and they were offering to the investment public, believe this or not, Mr. Chairman, an average return over the previous year of plus 85.6 percent, come and get it. But, of course, nobody got it. The market went down and they lost their money.

Senator FITZGERALD. Mr. Fink, what about Mr. Bogle's suggestion that in the prospectus, in addition to the expenses that are now required to be disclosed and netted out in calculating the return over the years, what if we add portfolio turnover costs, sales charges, out-of-pocket costs, and opportunity costs?

Mr. FINK. A lot of them are in there now. At the front of every prospectus is a fee table that lists the operating expenses that the fund pays.

Senator FITZGERALD. Are they in a graph? Are they in a bar graph?

Mr. FINK. The opportunity costs, I want to be clear, some are in, some are not, because opportunity cost experts do not know how to capture that. There is a debate, to be fair about that.

But 90 percent, I think to be fair, of what Mr. Bogle listed is in the prospectus fee table, and then it tells you, if you had $10,000

invested for 1 year, 3 years, 5 years, exactly how much you would have paid out from those expenses.

Senator FITZGERALD. So you have no trouble with disclosing all those costs and putting them in the graph?

Mr. FINK. Some of the opportunity costs, I don't——

Senator FITZGERALD. Except for maybe opportunity costs.

Mr. FINK. Maybe one other, but, yes, no problem at all.

Senator FITZGERALD. You have no problem if we require all of those expenses to be put in the calculation that is used to derive the graphs?

Mr. FINK. I think I am right. Yes, I think so.

Senator FITZGERALD. OK. You think so?

Mr. FINK. I don't know if I am missing something. That is all.

Mr. BOGLE. You are not missing anything.

Senator FITZGERALD. Senator Akaka.

Mr. BOGLE. We have a new convert.

Senator AKAKA. Thank you very much, Mr. Chairman.

I want to shift the discussion a little bit. We have been talking about management and I want to shift more towards disclosure and particularly shift to information. I want to know what is the most useful and understandable relevant information that investors need to have to make sound financial decisions prior to purchasing mutual fund shares. I would like to move into that. As part of that discussion, I want to talk about mutual fund advertising since that is where many investors learn about funds.

Mr. Bogle, what is your evaluation of mutual fund advertising? Do you believe that it is misleading to investors, and what needs to be done to prevent investors from being misled by advertisements?

Mr. BOGLE. The first thing, and I did not always feel this way, but we live and learn. I believe that mutual fund performance advertising is inherently misleading on the face of it. We get this free shot. When times are good, we advertise very high returns. When times are bad, we either advertise nothing or we advertise our bond funds. The record is very clear on that. It is opportunistic, it is overly zealous, and it is inherently misleading.

So I would say you cannot show performance numbers, and when I started Vanguard, I said we will never advertise a performance number, nor ever have we. So that is what should not be shown.

What should investors think about? Investors should just simply understand that active management is in many respects a charade, that all mutual fund active managers end up being average. How could it be otherwise? And, therefore, they lose the market by the amount of costs. So investors ought to think first about how diversified is the fund and shouldn't I just own the entire stock market rather than trying to pick a manager.

Second, it is so important that they understand costs, that is right up there after diversification.

Third, they ought to look at fund portfolio turnover. There is direct correlation not only between cost and investment returns, but between level of turnover in investment returns. I mean, it cannot be more obvious, and if you look in my written statement, you will see that if you combine those two costs, the low-cost quartile of funds does better than the high-cost quartile of funds by 3.5 per-

centage points every year. And you can put that in every one of the Morningstar nine boxes. The pattern is unmistakable. The higher the turnover, the higher the costs, the worse the returns investors get. If we could talk investors out of looking at past performance, that would be a good thing.

If we could talk them out of buying specialty funds and sector funds—they are always doing it after they turn in good performance. Investing is actually a matter of great simplicity. Get the diversification as wide as you can, the cost as low as you can, and close your eyes and hold on for the rough ride that common stocks have been giving investors since the beginning of time. So my first rule is: Don't do something, just stand there. And my second rule is: Don't peak, never look. And you'll be fine when you retire if you follow those rules.

Senator AKAKA. Thank you, Mr. Bogle. Mr. Fink, do you believe that brokers should be required to disclose in writing to those who purchase mutual company shares the amount of compensation the broker will receive as a result of the transactions? If so, why?

Mr. FINK. We have called, I think beginning in 1995, for brokers to——

Senator FITZGERALD. If I could just interject for a moment, Mr. Bogle has to leave now, and I want to thank Mr. Bogle for coming here today. He has honored us by his presence. We thank you for the good work you have done over your illustrious career, and I hope to stay in touch with you as we work through some reforms that you have been arguing for for years.

Thank you so much for being here.

Mr. BOGLE. I would be glad to help, Mr. Chairman, in any way that is within my power. Thank you, sir.

Senator FITZGERALD. Many thanks.

Mr. Fink, I am sorry for that.

Mr. FINK. First of all, Mr. Akaka, your question is a good one because I ought to point out, 90 percent of funds are not bought directly as in Vanguard. Ninety percent of people buy through a broker, a bank, a financial adviser, or 401(k) plan. So the amount of people who look at an advertisement right away for a prospectus is a very small sliver, just to put it in context.

Yes, the broker should disclose if he is getting special compensation for shelf space for featuring one fund over another. Now, it may be hard to do an exact dollar amount because the arrangements don't run that way. Some brokerage firm will say pay us $1 million this quarter, we will feature your fund. It would be hard for the broker, that individual broker, to explain what he or she is getting. It's maybe nothing. But there ought to be disclosure if the broker is being specially compensated, yes.

Senator AKAKA. Mr. Ballard, which is the more accurate indicator of transaction costs: Portfolio turnover or brokerage commissions, and why?

Mr. BULLARD. I am aware of only one academic study that actually looks at the correlation between actual commissions and turnover, and that concluded that there is not a very strong correlation between turnover and commissions. And, in fact, the expense ratio itself, which does not include commissions, is a stronger indicator. So in a choice between the two, at least to the extent we have some

academic literature on it, the sign is that turnover ratios are not a strong indicator.

In addition to that, I would say that when you have the number available itself, there really is not a good argument for using a proxy for that number. We know the dollar amount of commissions being paid by funds. There is no excuse for not immediately incorporating that into the expense ratio.

And to answer the other part of your question—what are the other components of portfolio transaction costs?—they are generally considered to be four: Commissions, which are dollar amounts that all agree are generally objective; two other areas, market impact—that is the actual impact on the price of a security caused by the fund trading it—is another cost; a third cost is spread impact—that is the amount of the spread between the bid and the ask price that is paid by a fund every time it trades; and then, finally, what you were talking about before, which are opportunity costs, which there is general agreement are the most difficult to measure.

As a general matter, fund directors are responsible for reviewing the execution obtained by fund managers, and they are legally required to consider commissions, market impact, and spread costs. So they are being objectively quantified and being considered by directors. I don't know if there are any who are looking at opportunity costs, and that may be something that is too subjective to incorporate in that number. But at a minimum, those three elements—commissions, market impact, and spread—should certainly be included in an objective amount that, albeit not perfect, certainly is better than leaving investors in the dark about what may be a fund's single largest expense.

Senator AKAKA. Thank you. This is a question that either one of you can answer. There have been some, including Secretary Galvin on the previous panel, who have called for banning the use of soft dollars. Do you believe soft dollars should be banned and why? Mr. Fink please respond first.

Mr. FINK. OK. I want to make it clear. It was Congress who blessed soft dollars in 1974 in Section 28(e)—maybe I shouldn't say that with the Senators sitting here, but Congress did it in 1974 in Section 28(e) of the 1934 Act. All advisers, mutual funds, pension funds, public pension funds, charities, endowments, all managers—this is not a uniquely mutual fund problem. We are considering in our own office a position on total abolition, but there is an easier first step to take that we are also considering.

For many years after 1974, the SEC took a very restrictive reading of what were legitimate soft dollars. There had to be research produced by the brokerage firm that you did the execution with. In 1978, they came out with a much broader interpretation which allows people to buy all kinds of stuff. So an easy remedy, barring trying to get Congress to repeal it, would be to cut it back to 1978, not just for mutual funds but for all users of soft dollars.

One other thing, Senator Akaka. You read before some of the uses people were making based on the SEC report. That report I think is 4 years old. It looked at both mutual funds and private money managers. It found a series of abuses in private money managers. I hold my breath these days, but I think it did not find a single abuse in the mutual fund area. So I am saying I think the

funds have been pretty good, at least the last check, living up to the current rules. But an easy thing for the SEC to do, an easier thing to do would be to cut it back, cut the permissible usage back, and then think about abolition.

Senator AKAKA. Mr. Bullard, what are your comments on whether the use of soft dollars should be banned?

Mr. BULLARD. Certainly, Senator. I would agree with Mr. Fink's recommendation, but I think there is a broader question involved. And as a general matter, my view is that you should leave, when you can, these questions to the market to decide. If the market believes that a fund manager who pays 6 cents a share for a trade and gets research is making efficient use of those dollars, then that is something that we should be able to live with. If the market decides they want the fund manager to spend 2 cents a share and not get research, we should also be able to live with that.

The problem, though, is that the market cannot make a decision. The market is not being told in any way the actual cost, that actually 4 cents a share more that is being paid for the fund using soft dollars. So before we get to the point of deciding whether to abolish soft dollars, I would rather have them disclosed. They are included in commissions. Include them in the expense ratio and let the market decide. And if it wants to punish funds that use soft dollars, so be it.

But as Mr. Fink pointed out, they are used very widely. They are used by Vanguard. Vanguard uses its soft-dollar payments essentially to reduce its custodial fees, generally.

So this is a practice that isn't inherently abusive. It may drive up costs, but I think principally because it is not fully disclosed and transparent.

Senator AKAKA. Thank you gentlemen for your responses. My time has expired, Mr. Chairman.

Senator FITZGERALD. Mr. Bullard, I would like to ask you about a proposal I have recommended, and I think Attorney General Spitzer also recommended it in his opening statement. We recommend that mutual fund directors be required to competitively bid out their management, their investment management contracts. What do you think of that proposal?

Mr. BULLARD. I think that proposal would substantially change the mutual fund industry as we know it in ways that we could not predict. As a general matter, if you have good disclosure of fees and you have standardized disclosure of performance, again, I would leave it to the market to decide which funds they want to invest in.

Essentially, we have a board of directors who sits in a sense second-guessing judgments made by shareholders to which manager they want and what expense ratio they want to pay. And in a best world, I would like to leave that decision to shareholders and have fund directors applying an ultimate fiduciary test to make sure as a back-up that those fees are not excessive and that those fund managers are complying with the law.

So I would not recommend requiring that they bid out those contracts because essentially it is not clear to me what decision the shareholder would be making anymore if they buy a Fidelity fund and——

Senator FITZGERALD. Do you advise any mutual funds?

Mr. BULLARD. Do I? No.

Senator FITZGERALD. Mr. Fink, what do you think about requiring that the investment advisory——

Mr. FINK. I think it is contrary to the factual situation. I decide—Mr. Bogle knows me and I decide to buy the Vanguard XYZ fund because it is managed by Vanguard. I do not expect tomorrow that the Vanguard board says, gee, we are leaving for Fidelity or T. Rowe Price or Putnam or Strong.

You have to remember, people created these funds as products. There are conflicts in running it. That is why you have independent directors. But the fund is not a freestanding entity that every year just decides what it wants to do. The manager created the fund as a product. We ought to control the manager, disclosure, conflict rules, but it would make no sense to put the contract out for bid. I am a consumer. I am buying a Ford. I do not expect tomorrow that magically it is going to be a Chevrolet. I mean, it is a funny kind of thing.

Senator FITZGERALD. Do the funds that have the lowest fees seem to attract the most funds in the marketplace?

Mr. FINK. Generally, yes. I don't know if I can phrase that right. Not perfectly, but the last time we looked, 77 percent of shareholder accounts that we could identify were in funds at the lower half of the expense thing. Now, that is probably because over time expense and performance have some relationship. So generally, yes. Fidelity is the largest fund. Vanguard, which is the cheapest, is the second largest. Not perfectly, but in general, yes.

Now, I would make another point if I can. This gets confusing. We keep talking about the 10 percent of people who are doing their own, sitting in their living room, reading Mr. Bullard, reading Mr. Bogle's editorials, reading Morningstar. Ninety percent of people do not act like that. They rely on their broker, financial planner, etc., and their funds are going to be more costly than the direct funds because they have costs relating to distribution.

Senator FITZGERALD. And most of them do not know that their broker is getting a 12b–1 fee for steering them to a fund, do they?

Mr. FINK. That I do not know.

Senator FITZGERALD. Do you have any problem if the brokers are required to send a written confirmation to the person they have steered into a mutual fund that that broker is getting 12b–1 fees?

Mr. FINK. I think it is proposed now, but not required. Am I right, 12b–1 is in the prospectus?

Senator FITZGERALD. It is in the prospectus, but I am saying——

Mr. FINK. Not confirmation, no.

Senator FITZGERALD. I have recommended that there be a written statement sent from the broker to the customer who is being steered into a fund that this broker is getting a fee for steering the person.

Mr. FINK. That is——

Senator FITZGERALD. I do not know how many people are going to get that from reading the prospectus, but they would probably have to have a law degree and have had a securities law course, and particularly a securities law course that focused on the Invest-

ment Company Act to really glean everything that could be gleaned out of there.

Mr. BULLARD. That is right, Senator. You really hit on the key division between types of disclosure. There is the prospectus, which really gets to how much is this investment going to cost me. But what you are getting at is a different kind of disclosure, and that is, what are the incentives that broker has for pushing this fund? If you buy IBM stock or Dell or some other company, you are required to get a confirmation, and it tells you how much your broker got paid. Mutual funds are virtually the only kind of security that are excepted from that because of an SEC no-action letter issued more than 20 years ago.

Mr. FINK. I think the SEC is revisiting that, by the way, if I am right, as part of the break points.

Mr. BULLARD. They have been reviewing it for about 4 years. That is true.

Senator FITZGERALD. Mr. Fink, in my opening statement I said that Congress had, in effect, turbocharged the growth of the mutual fund industry by setting up all sorts of vehicles for tax-deferred savings, 401(k) plans, IRAs, multiple types of IRAs, Keogh plans, and college loan accounts. Is it not true that Congress' actions in that regard have benefited the growth of the mutual fund industry?

Mr. FINK. Tremendously, but to put the numbers on the table, if you took 401(k) and all defined contribution plans, yes. The answer is yes. But I do not want to exaggerate it. If you took all the 401(k), 457, 403(b), all the DC plans, mutual funds are about 30 percent. Investments are going 70 percent into something else; IRAs, individual recruitment accounts of all types—Roth IRA, back-end IRA, front-end IRA, etc.—with 40 percent. So, yes, it has been a big boost for the fund industry, but it has been a big boost for insurance annuities, bank collective funds, company stock, you name it. We are not the only beneficiary. That is all I want to say.

Senator FITZGERALD. Well, given that Congress has set up such vehicles that benefit and facilitate the growth of the mutual fund industry, wouldn't it be reasonable to expect, since Congress has funneled so much of America's household, college, and recruitment savings to your industry, that we have some really pretty tough safeguards, tougher than are now on the books, to guard all that savings?

Mr. FINK. Absolutely, yes.

Senator FITZGERALD. And you are prepared to work with this Subcommittee and others to address some of the reforms, and you understand, too, that if trust in the industry is eroded over time, it will erode the industry's growth?

Mr. FINK. Oh, yes. This is not beneficent on the industry. The industry realizes that in a product that does not have FDIC insurance or state insurance funds, we are totally reliant on public confidence. And anything like these scandals that erodes it is terrible for the industry itself. And, in fact, Mr. Baker's bill, as it came out of the Committee, we were fine with. I think there the debate was not the terms of that bill, but whether it could be done better through Congress or the SEC. I mean, that was part of the debate.

Yes, we are open to reforms. I said earlier—I tried to keep a running list when I was sitting there of the 20 things I heard. I think 75 or 80 percent are probably fine. On the rest, there probably is as much dispute among the critics as among the industry and the critics, I think.

Senator FITZGERALD. I wonder if you agree with those who question whether directors can be both insiders of the investment advisory company and directors of the fund? I believe that it is difficult for human beings to serve two masters.

Mr. FINK. I looked it up. It is from St. Matthew, oddly enough. [Laughter.]

But if I can, yes, no one can serve two masters. So the Investment Company Act does two things about this. One is it says that, through SEC rules, a majority have to be independent. And whenever there is a conflict issue—if you think of yourself at a board meeting, 12 issues, probably 10 or 11 do not present a conflict between the fund and the adviser, between the shareholders and the adviser. The law requires in areas like contract renewal, on the advisory contract, the underwriting contract, 12b–1, etc., that there you need a separate vote of the independent directors. So in cases where there is conflict, you take the interested people out. They do not count.

Senator FITZGERALD. How come so few of the funds are competitively bidding out their investment advisers?

Mr. FINK. I think for the reason that Mr. Bullard said. When someone buys a share of Vanguard prime cap fund, I am really buying Vanguard management. I do not expect the directors tomorrow to move me to Fidelity or T. Rowe Price.

Senator FITZGERALD. But isn't your clientele here somewhat captive? They have a 401(k), and money is automatically funneled into it every month. So isn't some of this money kind of lazy? It does not investigate as it ought to investigate, and so maybe we have to have special rules here in Congress?

Mr. FINK. I think you need special rules for mutual funds, yes, for collective vehicles where there are millions of people, they have to be represented by directors, there have to be rules on conflicts.

Senator FITZGERALD. So why not require competitive bidding of investment managers?

Mr. FINK. Just for the reason I stated. I think even in the typical 401(k) plan, or a lot of the big ones, you have Fidelity, Vanguard, T. Rowe Price, and Putnam. So people can move around among them in those funds.

Mr. BULLARD. Chairman Fitzgerald, I think it is possible that in the long run that step may be needed. But one step that I think we have never really tried is to light a hot enough fire under fund directors so they would negotiate hard over the fees that are currently in place. And it is clear, as indicated by these massive compliance breakdowns, they are not doing that.

Senator FITZGERALD. Aren't most fund directors often they are employees of the money manager?

Mr. BULLARD. That is right. Many of them are. And what I would like to see is——

Senator FITZGERALD. Isn't most of their annual income coming from the firm they would be negotiating with?

Mr. BULLARD. That is exactly right.

Senator FITZGERALD. So how can you have a negotiation with yourself?

Mr. BULLARD. Well, I would propose to have some source of an outside independent body setting out what the fiduciary standards are for reviewing advisory contracts, which currently does not exist and the SEC does not do. There are funds that have expense ratios that are 10 or 15 percent of assets, and the SEC has chosen never to bring an action against them for the director's violation of fiduciary duty.

Senator FITZGERALD. Ten or 15——

Mr. BULLARD. Ten of 15 percent. And the SEC has decided to completely——

Senator FITZGERALD. Can you name any names?

Mr. BULLARD. If you go on Morningstar's site, you will be able to run a check, and you will find tiny funds with 10 percent expense ratios. And if the SEC is not going to go after those funds, it is pretty hard to ask the fidelitys to negotiate fees separately.

Senator FITZGERALD. Mr. Fink, a final question.

Mr. FINK. Can I comment?

Senator FITZGERALD. Yes, go ahead.

Mr. FINK. When you are negotiating the contract—I happen to have my handy-dandy copy of the Investment Company Act. It says that the contract has to be approved by a majority of the directors who are not parties to such contract or affiliated parties to such contract, and they meet without the interested directors being there. So in the negotiation——

Senator FITZGERALD. Well, what do you think is wrong with the fund directors that Mr. Bullard referred to who agreed to an investment advisory contract that charges—did you say 10——

Mr. BULLARD. An expense ratio, not an advisory contract.

Senator FITZGERALD. But that would include the——

Mr. BULLARD. That would include—the advisory contract might be 2 percent or 3 percent.

Senator FITZGERALD. OK.

Mr. FINK. They can be sued. They can be sued not only by the SEC but by any shareholder. Section 36(b) of the Investment Company Act gives an express Federal right of action for any fee that breaches a fiduciary duty or is unreasonable.

Mr. BULLARD. The SEC has never sued such a fund.

Senator FITZGERALD. But private lawsuits would be welcome in this regard?

Mr. FINK. I do not know about welcome——

Mr. BULLARD. There are class actions all over——

Mr. FINK. There are a lot of them.

Mr. BULLARD. There is no money in it.

Senator FITZGERALD. There is no money in those suits?

Mr. BULLARD. There is no money in suing a $10 million fund for charging a 15 percent expense ratio.

Senator FITZGERALD. Final question. Attorney General Spitzer said that he wants to make sure that all the mutual funds that he has found in his investigation of the late trading and market timing disgorge all of the fees that they earned during the period that

the illegal practices were going on. What is the Investment Company Institute's position?

Mr. FINK. I have no position on that. It seems to me that is between Mr. Spitzer and the defendants, sir.

Senator FITZGERALD. OK. All right. Thank you both. Senator Akaka.

Senator AKAKA. Thank you very much, Mr. Chairman. This hearing has been very helpful and it will help us craft the kind of bill that will help the people of our country. I want to thank our panelists for your responses.

Thank you.

Senator FITZGERALD. Thank you. You have both been terrific. We appreciate your patience. It has been a long morning and afternoon. Thank you very much.

For your information, the hearing record will remain open until 5 p.m. on Friday of this week in the event that other Senators would like to submit questions. And if there is no further business to come before this Subcommittee, this hearing is adjourned.

[Whereupon, at 1:49 p.m., the Subcommittee was adjourned.]

APPENDIX

Testimony Concerning Recent Commission Activity To Combat Misconduct Relating to Mutual Funds

by Stephen M. Cutler,
Director, Division of Enforcement,
U.S. Securities & Exchange Commission

Before the Senate Subcommittee on Financial Management, the Budget, and International Security, Committee on Governmental Affairs

November 3, 2003

Chairman Fitzgerald, Ranking Member Akaka, and Members of the Subcommittee:

I. Introduction

Thank you for inviting me to testify today on behalf of the Securities and Exchange Commission concerning alleged abuses relating to the sale of mutual funds. With more than 95 million Americans invested in mutual funds, representing approximately 54 million U.S. households, and a combined $7 trillion in assets, mutual funds are a vital part of this nation's economy and millions of investors' financial security. For that reason, I share the outrage and disappointment of Chairman Donaldson, and so many others, at the misconduct that recently has come to light. It is intolerable when investment professionals -- who have a duty to serve the best interests of their customers -- instead put their own interests first. That way of thinking is antithetical to the responsibilities investment advisers, broker-dealers, and their employees owe to mutual fund investors. Mutual fund investors have a right to expect fair treatment, and when they do not receive it, we at the Commission will demand it on their behalf.

Accordingly, the Commission has undertaken an aggressive agenda to identify and address problems in the mutual fund industry. That agenda has both an enforcement component, which I will discuss, and a regulatory component, which my colleague Paul Roye, Direct of Investment Management, will address.

The enforcement piece of the Commission's agenda relating to mutual funds currently is focused on four types of misconduct, each of which may result in the interests of financial services firms or their employees being placed above the interests of investors. I will touch on each briefly, and then turn to the Commission's response to the recent revelations of serious misconduct relating to the trading of mutual funds.

The first area of priority, which I will discuss in detail in a moment, is late trading and timing of mutual fund shares.

Our second area of priority focuses on sales practices. In particular, what are prospective mutual fund investors being told about revenue sharing arrangements and other incentives doled out by mutual fund companies to brokers selling their funds? Do customers understand that their broker is being paid to sell a particular fund? And when these payments are being made from fund assets, do customers understand that their own investment dollars are being used to foot the bill for the mutual funds' premium "shelf space" at the selling broker's office? Such fees may increase costs to investors as well as create conflicts of interest between investors and the financial professionals with whom they deal. The Commission's Office of Compliance Inspections and Examinations is

conducting a series of examinations of industry practices in this area, and the Division of Enforcement has investigations underway exploring possible abuses.

Our third area of priority in the mutual fund arena is the sale of different classes of mutual fund shares. Many mutual funds offer multiple classes of shares in a single portfolio. For each class of shares, a mutual fund uses a different method to collect sales charges from investors. Class A fund shares are subject to an initial sales charge ("front-end load"); discounts on front-end loads are available for large purchases of Class A shares. Since the sales fee is paid up front, Class A shares incur smaller "rule 12b-1 fees," a fee the mutual fund pays for distribution costs, including payments to the broker-dealers and their registered representatives selling fund shares.

Class B shares, by contrast, are not subject to an up-front sales charge. Instead, they become subject to a sales charge (a "contingent deferred sales charge" or "CDSC") only if, and when, they are redeemed before the end of a specified holding period. Class B shares usually automatically convert to Class A shares after a specified number of years. Because Class B share investors only pay a CDSC, if any, at the time that they redeem their shares, the funds pay higher rule 12b-1 fees on Class B shares to defray the associated distribution expenses. As a result, brokers typically earn larger commissions on Class B shares than on Class A.

The Commission's examiners have made this an area of priority for review in examinations. In addition, the Commission has brought two enforcement actions

involving the sales of Class B shares to investors who were not made aware by their registered representatives that they could purchase Class A shares of the same mutual fund at a discount. For example, on July 10, 2003, the Commission brought a case against Prudential Securities in connection with the sale of Class B shares. Prudential had in place policies and procedures requiring reps to advise their clients of the availability of different classes of mutual funds and fully explain the terms of each. Prudential branch managers were also expected to approve all purchases greater than $100,000 and confirm the suitability of the choice of fund class. The Commission found, however, that Prudential failed to adopt a sufficient supervisory system to enable those above the branch manager to determine whether these policies and procedures were being followed. Under Prudential's system, branch office managers were solely responsible for ensuring that registered representatives followed the firm's mutual fund policies and procedures. As a result, when the rep's branch manager failed to abide by and enforce Prudential's policies and procedures, the firm had no way of detecting the lapse. In resolving the Commission's action, Prudential was censured and agreed to pay disgorgement and a civil penalty. The Commission's action against the registered representative and branch manager, which charges them with fraud, is pending.

The final priority area is to address the abuse of so-called "breakpoints." Breakpoints are the specified investment levels at which the discounts available on front-end loads for large purchases of Class A shares increase. Earlier this year, examiners at the SEC, NASD, and NYSE completed an examination sweep and outlined the results in a report, "Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding

Discounts on Front-End Sales Charges on Mutual Funds."[1] Together with the NASD, we have under active investigation instances in which it appears that investors were entitled to receive breakpoint discounts based on the size of their purchase of Class A shares, but where the firms failed to provide discounts.

This brief overview of the Commission's enforcement agenda with respect to mutual funds is intended to give you a sense of the scope of our activities. I recognize, however, that today's hearing was prompted by recent revelations involving late trading and timing of mutual funds. Accordingly, I will now turn to that subject.

II. SEC Response to Misconduct Relating to Mutual Funds

As you well know, the conduct of mutual funds and the financial intermediaries with and through which they do business, recently came to the public's attention when New York Attorney General Eliot Spitzer announced an action involving abusive mutual fund trading practices by a hedge fund, Canary Capital Partners, LLC. The Canary action identified two problematic practices – late trading of mutual funds and timing of mutual funds. Late trading refers to the practice of placing orders to buy or sell mutual fund shares after the time at which the funds calculate their net asset value ("NAV") -- typically 4:00 p.m. Eastern Time ("ET") -- but receiving the price based upon the prior NAV already determined as of 4:00 p.m. Late trading violates the federal securities laws concerning the price at which mutual fund shares must be bought or sold and defrauds

[1] The report is available at: http://www.sec.gov/news/studies/breakpointrep.htm.

innocent investors in those mutual funds by giving to the late trader an advantage not available to other investors.

"Timing" abuses refer to excessive short-term trading in mutual funds in order to exploit inefficiencies in mutual fund pricing. Although market timing itself is not illegal, mutual fund advisers have an obligation to ensure that mutual fund shareholders are treated fairly and that one group of shareholders (i.e., market timers) is not favored over another group of shareholders (i.e., long term investors). In addition, when a fund states in its prospectus that it will act to curb market timing, it must meet that obligation.

Abusive market timing can dilute the value of mutual fund shares to the extent that a trader may buy and sell shares rapidly and repeatedly to take advantage of inefficiencies in the way mutual funds prices are determined. Dilution could occur if fund shares are overpriced and redeeming shareholders receive proceeds based on the overvalued shares. In addition, short-term trading can raise transaction costs for the fund, it can disrupt the fund's stated portfolio management strategy, require a fund to maintain an elevated cash position, and result in lost opportunity costs and forced liquidations. Short-term trading can also result in unwanted taxable capital gains for fund shareholders and reduce the fund's long-term performance. In short, while individual shareholders may profit from engaging in short-term trading of mutual fund shares, the costs associated with such trading are borne by all fund shareholders.

Following the announcement of the Canary Capital case, the Commission put in motion an action plan to vigorously investigate the matter, assess the scope of the problem, and hold any wrongdoers accountable. Specifically, the Commission is proceeding on three fronts, utilizing its enforcement authority, its examination authority, and its regulatory authority. I will address the first two areas of the Commission's efforts.

A. Recent Enforcement Efforts Relating to Mutual Fund Trading

In the enforcement area, we are working aggressively to pursue wrongdoing, and are doing so in close coordination with State regulators, including Mr. Spitzer and Mr. Galvin in Massachusetts. Thus far, the Commission has brought actions against persons associated with three different types of entities – a broker-dealer, a hedge fund, and two mutual funds – each of which can play a role in disadvantaging long-term mutual fund investors. Our actions to date address allegations of both late trading and market timing. I will briefly summarize those actions.

On September 16, the Commission filed a civil action against Theodore Sihpol, a salesperson at Bank of America Securities ("BOA"), who was Canary Capital's primary contact at Bank of America. Specifically, the Commission issued an administrative order instituting proceedings in which the Division of Enforcement (the "Division") alleges that Sihpol played a key role in enabling certain hedge fund customers of BOA to engage in late trading in shares of mutual funds offered by Bank of America, including the Nations Funds family of funds and other mutual funds. Based on the conduct alleged in

the Commission's Order, the Division alleges that Sihpol violated, and aided and abetted and caused violations of, the antifraud, mutual fund pricing and broker-dealer record-keeping provisions of the federal securities laws. In its action, the Division is seeking civil penalties, disgorgement and other relief, which may include permanently barring Sihpol from the securities industry.[2] Simultaneous with the issuance of the Commission's order, Sihpol surrendered in connection with Attorney General Spitzer's filing of a two-count complaint charging him with larceny and securities fraud.

Less than three weeks later, the Commission and the New York Attorney General announced criminal and civil actions against Steven B. Markovitz, formerly an executive and senior trader with the prominent hedge fund firm Millennium Partners, L.P. In the New York Attorney General's criminal action, Markovitz pleaded guilty in State Supreme Court to a violation of New York's Martin Act. The SEC's administrative order finds that Markovitz committed securities fraud. In partial settlement of the SEC's action, without admitting or denying the SEC's findings, Markovitz consented to cease and desist from violations of certain provisions of the federal securities laws, and to be permanently barred from associating with an investment adviser or from working in any capacity with or for a registered investment company. The SEC also is seeking disgorgement and civil penalties in amounts to be determined later.

According to the criminal charges and the SEC findings, Markovitz engaged in late trading of mutual fund shares on behalf of Millennium, one of the nation's largest

[2] In connection with the SEC's order, a hearing will be scheduled before an administrative law judge to determine whether the allegations contained in the order are true and to provide Sihpol an opportunity to respond to them.

hedge fund operators, with more than $4 billion under management. With the assistance of certain registered broker-dealers, Markovitz placed mutual fund orders after 4:00 p.m. ET, but obtained the prices that had been set as of 4:00 p.m. ET. By SEC rule, Markovitz's post-4:00 p.m. orders should have received the prices set on the following day. This illegal trading allowed Millenium to take advantage of events that occurred after the markets closed.

In its first action against a mutual fund executive for permitting market timing, on October 16, the Commission and the New York Attorney General announced the arrest, conviction, and lifetime industry bar of James P. Connelly, Jr., former Vice Chairman and Chief Mutual Fund Officer of Fred Alger & Company, Inc., a prominent mutual fund firm. Connelly pled guilty to the crime of Tampering with Physical Evidence. The criminal charges against Connelly stem from his repeated efforts to tamper with an ongoing investigation of illegal trading practices in the mutual funds industry, including by directing subordinates to delete emails called for by subpoenas.

In its administrative order, the SEC found that Connelly approved agreements that permitted select investors to "time" certain mutual funds managed by Alger, a practice that violates an adviser's fiduciary duties and adversely affects the value of the fund being timed. In this case, the timing arrangements were also inconsistent with Alger's public disclosures in prospectuses and Statements of Additional Information filed with the SEC. According to the Commission's order, Connelly was involved in timing arrangements at Alger from the mid-1990s until 2003. By early 2003, Connelly was

requiring that investors seeking timing capacity agree to maintain at least 20% of their investment at Alger in buy-and-hold positions, sometimes referred to as "sticky assets."

In settling the SEC action, Connelly neither admitted nor denied the SEC findings. The Commission's order directs Connelly to cease and desist from future violations of various provisions of the federal securities laws; bars him from association with any broker, dealer or investment adviser; bars him from serving in various capacities with respect to any registered investment company; and imposes a $400,000 civil penalty.

Most recently, on October 28, the Commission brought actions against Putnam Investment Management LLC ("Putnam") and two former Putnam Managing Directors and portfolio managers, Justin M. Scott and Omid Kamshad, in connection with the personal trading by those Managing Directors in Putnam mutual funds. The Commission filed a civil injunctive action against Justin M. Scott and Omid Kamshad charging each of them with securities fraud. The complaint alleges that Scott and Kamshad, for their own personal accounts, engaged in excessive short-term trading of Putnam mutual funds for which they were portfolio managers. According to the complaint, Scott and Kamshad's investment decision-making responsibility for those funds afforded them access to non-public information about the funds, including current portfolio holdings, valuations and transactions. The complaint further alleges that Scott and Kamshad's short-term trading violated their responsibilities to other fund shareholders, that Scott and Kamshad failed to disclose their trading and that, by their trading, they potentially harmed other fund shareholders.

The Commission issued an administrative order instituting proceedings against Putnam in which the Division of Enforcement (the "Division") alleges that Putnam engaged in securities fraud by failing to disclose to the funds or to the fund boards the potentially self-dealing transactions in fund shares by Scott, Kamshad and other employees. The Division further alleges that Putnam failed to supervise Scott, Kamshad and other employees, that it failed to have policies and procedures reasonably designed to prevent the misuse of non-public information and that it failed adequately to enforce its code of ethics.[3]

Against the individual defendants the Commission is seeking injunctive relief, disgorgement, penalties, and such equitable relief as the court deems appropriate. As to Putnam, the Division is seeking relief in the form of a cease-and-desist order, disgorgement, a penalty, and such other relief as the Commission deems appropriate.

B. The Commission's Use of Examination Authority

As I noted, the Commission's response to the revelations of misconduct in the mutual fund area is multi-pronged. The second area of authority that we are utilizing aggressively is the Commission's examination authority, which entitles us to obtain promptly information and records from regulated entities. Accordingly, immediately following the Canary announcement, relying on the Commission's examination powers, the Commission's staff sent detailed information requests to 88 of the largest mutual fund complexes in the country and 34 broker-dealers, including prime brokerage firms and

[3] In connection with the SEC's administrative order, a hearing will be scheduled before an administrative law judge to determine whether the allegations contained in the order are true and to provide Putnam an opportunity to respond to them.

other large broker-dealers. These written requests sought information on each entity's policies and practices relating to market timing and late trading. In the case of mutual funds and broker-dealers, we have obtained information regarding their pricing of mutual fund orders and adherence to their stated policies regarding market timing. We also have sought information from mutual funds susceptible to market timing regarding their use of fair value pricing procedures to combat this type of activity.

The examination staff is still analyzing the information received as a result of these requests, and in many cases has sought additional details. Some firms' responses are still incomplete. Nevertheless, some firms' responses have warranted aggressive follow-up, and thus, Commission examiners have been dispatched to conduct onsite inspections and interviews at a number of firms. Responses from some other firms have already led to referrals to the enforcement staff for further investigation. All told, SEC staff across the country are looking at the activities and practices of dozens of firms.

Although we are continuing to receive and analyze information in response to our requests, based on the information analyzed to date, we are in a position to provide you the following *preliminary* results. It is important to be clear that these results are *preliminary* and are under active review by our staff.

1. Preliminary Results Involving Late Trading

a. Conduct of Broker-Dealers

The staff sent letters to 34 broker-dealers requesting extensive information. The responses indicate the following:

- **Most broker-dealer firms have policies or procedures prohibiting late trading:** More than 75% of responding broker-dealers reported that they have policies that prohibit accepting or confirming a customer order to purchase or redeem mutual fund shares to be filled at the 4:00 p.m. NAV if the customer order was placed after the close of trading at 4:00 p.m. Many firms, however, noted exceptions to these policies that allow orders entered after 4:00 p.m. to be filled at that day's NAV. Reasons identified for exceptions included order back-logs, errors or mistakes in order entry, and systems problems.

- **Several broker-dealers appear to have allowed customers to place or confirm orders after 4:00 p.m.** More than 25% of responding broker-dealers reported that customers have placed or confirmed mutual fund orders after 4:00 p.m., and received the 4:00 p.m. NAV. For example:

  - **Two broker-dealers allowed customers to place orders until 4:15 p.m.:** One firm reported that it permitted customers to place mutual fund orders up to 4:15 p.m. for all funds that had not supplied it with an earlier cut-off time.

The other firm permitted customers to place orders up to 4:15 p.m. if they had been speaking with a registered representative prior to 4:00 p.m.

- **One broker-dealer allowed customers to cancel orders between 4:00 p.m. and 4:15 p.m.:** This firm reported that its processing system permitted certain registered representatives and operations personnel to enter or correct orders until 4:15 p.m.

- **One broker-dealer permitted customers to trade until 4:30 p.m.:** This firm reported that it had an informal agreement that provided six introducing broker-dealers with trade-input capability until 4:30 p.m.

- **One broker-dealer allowed customers to confirm orders until 4:45 p.m.:** This firm reported that it allowed several customers to place orders during the regular trading day that were then subject to confirmation by the customers until 4:45 p.m.

- **One broker-dealer allowed customers to place orders until 5:30 p.m.:** This firm reported that its electronic order entry system permitted customers to place orders for non-proprietary mutual funds until 5:30 p.m. and still receive that day's NAV.

As noted, our examination and enforcement staff is aggressively examining or investigating each of these situations to determine the facts surrounding the trading and whether the trading violates the federal securities laws.

b. Conduct of Mutual Funds

The 88 mutual fund groups responding to the staff's requests have a total of $ 5.7 trillion in assets, which is approximately 90% of the fund industry's total assets, and have about 4,100 individual funds or portfolios under management. Again, Commission staff is following up on these responses to ascertain specific facts, but preliminary results indicate:

- **Most funds make disclosures of order receipt deadlines:** More than 95% of the responding fund groups make disclosures regarding the time their NAV is calculated, and also state in those disclosures that an order must be received by an agent of the fund before the NAV is calculated in order to receive that day's NAV.

- **Contracts require 4:00 p.m. cutoff:** Virtually all of the funds that sell shares through intermediaries appear to have contractual arrangements with each intermediary requiring the intermediary to observe the typical 4:00 p.m. ET cutoff time for the flow of orders to receive that day's NAV.

- **Most funds reported no knowledge of late trading by intermediaries:** Almost 90% of responding fund groups said they were not aware of any late trading in their shares.

- **Some emails provided by responding funds groups indicate there may have been late trading:** Emails submitted by approximately 10% of the responding funds contained references to situations that possibly involved late trading, and we are following up on these emails.

- **Most fund groups allow intermediaries to send orders after 4:00 p.m.:** More than 80% of the responding fund groups reported that they allow late processing of share orders that were received by an intermediary before the daily order cutoff (not in violation of the law).

- **Most, but not all, fund groups report no late trading was approved by their staff:** Three fund groups reported, or the information provided indicated, that their staffs had approved a late-trading arrangement with an investor. SEC staff is following up on these reports.

2. Preliminary Results Involving Market Timing

a. Conduct of Broker-Dealers

- **Documents provided by almost 30% of responding broker-dealers indicate that they assisted market timers in some way:**

- Documents provided by three broker-dealers indicated that they broke up customer orders into smaller sizes in order to avoid detection by funds or the firm's own internal surveillance.

- Documents provided by four broker-dealers indicated that they advertised, marketed or solicited market timing services.

- Documents provided by three broker-dealers indicated that they entered into arrangements or set up special accounts with customers to facilitate market timing activities.

- **Many broker-dealers were aware of timing activities by their customers:** Almost 70% of responding broker-dealers reported being aware of timing activities by their customers.

b. Conduct of Mutual Funds

- **Almost all funds have some kind of anti-market timing policy:** More than 90% of responding funds with long-term investment objectives have policies aimed at identifying and deterring the disruptive effects excessive short- term trading in fund shares could have on such funds' performance and expenses. (Money market funds usually do not have market timing policies and prohibitions

and do not restrict the purchase and redemption activities of shareholders. Money fund NAVs cannot be arbitraged because their NAVs are a constant $1 per share.)

- **Most funds had some prospectus disclosure concerning market timing:** More than 80% of responding funds made disclosures in their prospectus or Statement of Additional Information ("SAI") regarding the adverse impact market timing could have on the fund, and the fund's policy of monitoring for such trading by shareholders and taking remedial actions to stop such trading.

- **Most market timing policies are discretionary**: Typically, a fund group's market timing policy, and its disclosure concerning that policy, provides the fund or its agents enough flexibility to allow some short term trading in situations that are deemed to be not disruptive to the fund, such as shareholders following asset allocation investment strategies.

- **Market timing is a very popular strategy:** Many fund groups' responses expressed the view that there are numerous institutional and individual investors who pursue market timing, often through intermediaries and omnibus accounts, and who attempt to conceal their identities from funds. As a result, they suggested there must be constant monitoring of shareholder activity coupled with follow-up actions when disruptive market timing activity is identified.

- **Most fund groups have some kind of monitoring program:** More than 90% of responding fund groups appear to have active programs to monitor shareholder activity, identify shareholders that may be placing excessive numbers of short term trades, and take action to stop future trading.

- **About half of the fund groups appear to have some kind of agreement or arrangement with frequent traders:** 50% of responding fund groups appear to have one or more arrangements with certain shareholders that allow these shareholders to engage in market timing – i.e., these shareholders have been given "market timing capacity." The market timing of persons with these arrangements appears to be inconsistent with the groups' policies, and in some cases, the fund groups' prospectus disclosures and/or fiduciary obligations. We are aggressively following up on these arrangements.

    - **Quid pro quo arrangements**: Although the information provided in this area is limited, it appears that many of the persons proposing a special arrangement to get market timing space offered to invest so-called "sticky" or long-term assets in one or more funds in the complex. In most of the situations where sticky assets were discussed, the funds in which these assets were to be invested were not the same funds to be market timed by the person involved in the arrangement.

- **No disclosure**: None of the funds that appear to have special market timing arrangements has specifically disclosed the existence of the arrangements in their prospectuses or SAIs.

3. Preliminary Results Involving Disclosure of Portfolio Holdings

Another area in which the staff's inquiries have exposed possible abuse is the selective disclosure of mutual fund portfolios. Most funds regularly provide portfolio information to service providers, such as custodians, administrators, securities lending agents, pricing services, and rating agencies, with the understanding that such portfolio information will not be used to make investment decisions to place orders for fund shares. In general, such disclosures are appropriate and necessary to the operation of the funds. However, our *preliminary* results in this area, based on responses by mutual fund groups, suggest the possibility of inappropriate selective disclosure of fund portfolios:

- **One-third of funds indicated some questionable disclosures of portfolio information:** More than 30% of responding funds appear to have disclosed portfolio information in circumstances that may have provided certain fund shareholders the ability to make advantageous decisions to place orders for fund shares, and that warrant follow-up investigation. For example, funds frequently stated that portfolio information was provided to consultants without further descriptions of who these consultants were and for what reasons portfolio information was given to them. The funds did not report that they had any

knowledge that such information was used by these entities to improperly trade or recommend trades in funds' shares.

This information, too, is being probed further by Commission staff.

III. Conclusion

The Commission's investigation of mutual fund trading abuses is continuing on multiple fronts. I want to emphasize that we will aggressively pursue those who have violated the law and injured investors as a result of illegal late-trading, market-timing, self-dealing, or any other illegal activity we uncover. Those responsible for these practices *will* be identified and *will* be held fully accountable.

Wherever possible, the Commission also will seek recompense for investors in connection with mutual fund fraud. We will, of course, continue to work closely and cooperatively with state officials who also are taking steps to protect investors.

I would be happy to answer any questions that you may have.

Testimony Concerning Initiatives to Address Concerns in the Mutual Fund Industry

by Paul F. Roye
Director, Division of Investment Management,
U.S. Securities & Exchange Commission

Before the Senate Subcommittee on Financial Management, the Budget and International Security, Committee on Governmental Affairs

November 3, 2002

Chairman Fitzgerald, Ranking Member Akaka and Members of the Subcommittee:

I. Introduction

On behalf of the Securities and Exchange Commission (the "SEC" or the "Commission"), I appreciate the opportunity to discuss possible regulatory responses to recent allegations of abusive practices in the mutual fund industry and initiatives to improve the regulatory framework governing mutual funds. With over 95 million Americans invested in mutual funds, representing approximately 54 million U.S. households, and a combined $7 trillion in assets, mutual funds are unquestionably one of the most important elements of our financial system.

The conduct alleged in the various cases brought by the Commission, as well as the New York Attorney General and the Secretary of the Commonwealth of Massachusetts represents reprehensible conduct that is in violation of the anti-fraud and other provisions of the securities laws, as well as of basic fiduciary principles. The Commission has put in motion an action plan to vigorously investigate those matters,

assess the scope of the problem and hold any wrongdoers accountable. My colleague Stephen Cutler, the Director of the Commission's Enforcement Division, will outline for you the steps the Commission has taken to address the alleged misconduct. While our enforcement efforts are a key tool in protecting the nation's investors, another critical component is a regulatory framework designed to prevent or minimize the possibility of these abuses from happening in the first place. At Chairman Donaldson's behest, the staff is progressing quickly to draft rules to directly address market timing and late trading abuses, as well as other issues raised in these cases, and is actively working on initiatives to strengthen the mutual fund regulatory framework.

II. Late Trading, Market Timing and Other Abusive Activity

On October 9, Chairman Donaldson outlined a regulatory agenda to confront late trading and market timing abuses to help restore investor confidence in the fairness of mutual fund operations and practices. The Commission is also addressing the practices of intermediaries that sell fund shares, as a number of the issues that the Commission is addressing in the mutual fund area flow in large measure from the intermediaries or middlemen who are in the chain of distribution for selling fund shares.

A. Late Trading

Before I discuss the regulatory reforms that the staff is preparing for Commission consideration with respect to late trading, I would like first to define it for you. "Late trading" refers to the practice of placing orders to buy or sell mutual fund shares *after* 4:00 p.m. east coast time, when most mutual funds calculate their net asset value

("NAV"), but receiving the price based on the prior NAV already determined at 4:00 p.m. Late trading also refers to the practice of placing conditional trades prior to 4:00 p.m. with the option of withdrawing or confirming the trades after 4:00 p.m.

Late trading enables the trader to profit from market events that occur after 4:00 p.m. but that are not reflected in that day's price. In particular, the late trader obtains an opportunity for a virtually risk-free profit when he learns of market moving information and is able to purchase mutual fund shares at prices set *before* the market moving information was released.

Current Commission rules prohibit late trading by requiring funds, their principal underwriters, dealers and others authorized to consummate transactions in fund shares to assign the next computed net asset value to any order to purchase or redeem a fund's shares, a process that is known as forward pricing. The forward pricing requirement is also typically reflected in dealer or selling agreements between funds and those who sell their shares.

Given the concern over recent allegations of late trading in fund shares, and circumvention of the forward pricing requirement by some intermediaries, Chairman Donaldson has requested that the staff prepare rulemaking recommendations to prevent or curb late trading abuses in the future. The Chairman requested that the staff submit these recommendations to the Commission this month. The staff diligently is working to meet the Chairman's timetable with the goal of recommending considered and comprehensive proposals designed to eliminate or significantly minimize the potential for

late trading abuses and assure fund investors that the value of their investments will not be diluted through this practice.

In preparing our rule proposals, the staff is examining the feasibility of requiring that a fund (or certain designated agents) – rather than an intermediary such as a broker-dealer or an unregulated third party – must receive a purchase or redemption order prior to the time the fund prices its shares for an investor to receive that day's price. For most funds, this approach would mean that the fund would have to receive the order by approximately 4:00 p.m., east coast time, for the investor to receive that day's price. A rule amendment along these lines could effectively eliminate the potential for late trading through intermediaries that sell fund shares and would put control of the process squarely on the fund, or its designee such as an affiliated transfer agent or principal underwriter. While this approach could minimize late trading opportunities, the staff is gathering information from a variety of mutual fund market participants to understand fully the ramifications, implications and feasibility of such a change.

The staff also is considering addressing late trading issues in connection with a recommendation that the Commission adopt its proposed compliance policies and procedures rule, which was proposed in February of this year. This rule, if adopted by the Commission, would require funds and investment advisers to (i) have comprehensive compliance policies and procedures in place reasonably designed to prevent violations of the federal securities laws, (ii) annually review those policies and procedures, and (iii) designate a chief compliance officer, accountable to the board of directors of the fund.

The staff is strongly considering recommending that the Commission also expressly indicate that funds should have procedures and controls in place to guard against the late trading of their shares. While these were the kinds of policies and procedures contemplated by the rule proposal, having an express obligation to have such policies and procedures could further prevent abuses in this area.

The rule is designed to ensure that funds and advisers have policies and procedures in place that will lessen the likelihood of securities law violations, detect any violations that do occur, and provide guidance on appropriate responses to such violations for fund officers. These rules would help protect investors by improving day-to-day compliance with the federal securities laws, they should also increase the efficiency and effectiveness of the Commission's mutual fund examination program which tests funds internal controls and procedures. The requirement to have a chief compliance officer reporting to the fund's board of directors should enhance the ability of fund directors to effectively monitor compliance of the funds and their service providers with the federal securities laws.

B. Market Timing

In addition to late trading concerns, recent events have also exposed abuses related to market timing, including the alleged overriding of stated market timing policies by fund executives to benefit large investors at the expense of small investors, or to benefit the fund's adviser. There also have been allegations of fund management personnel market timing funds that they manage or other funds in the fund complex.

Mutual funds that invest in overseas securities markets are particularly vulnerable to market timers who take advantage of time zone differences between the foreign markets on which international funds' portfolio securities trade and the U.S. markets which generally determine the time that NAV is calculated. Thus, market timers frequently purchase or redeem shares of mutual funds that invest internationally based on events occurring after foreign market closing prices are established, but before the funds' NAV calculation, typically at 4:00 p.m. Market timers generally then purchase or redeem the fund's shares the next day, for a quick profit at the expense of long-term fund shareholders. Funds that invest in small cap securities and other types of specialty investments, including high yield funds, also can be the targets of market timers.

Although market timing itself is not illegal, mutual fund advisers have an obligation to ensure that mutual fund shareholders are treated fairly and that one group of shareholders (*i.e.*, market timers) is not favored over another group of shareholders (*i.e.*, long term investors). In addition, when a fund states in its prospectus that it will act to curb market timing, it cannot knowingly permit such activities.

The staff has been working with the mutual fund industry to address the negative impact of market timing on long-term shareholders. Last year, the staff issued an interpretive letter permitting funds to provide for delayed exchanges of shares from one fund to another in order to combat market timing.[1] Permitting delayed exchanges can deter market timing, since market timers seek to effect transactions on a specific day to take advantage of perceived market conditions. In addition, in a letter issued in 2001, the

[1] See Letter to the Investment Company Institute (pub. avail. Nov. 13, 2002).

staff clarified funds' obligations to fair value their portfolio securities, including international securities, if a significant event occurs between the time that a security's closing price on an exchange is established and the time that the fund calculates its NAV.[2] Fair valuation addresses the problem of a portfolio security's market closing price not accurately reflecting its value because of a significant intervening event.

Again, Chairman Donaldson has instructed the staff to submit its recommendations related to market timing to the Commission this month. In particular, Chairman Donaldson requested that the staff prepare recommendations to require explicit disclosure in fund offering documents of market timing policies and procedures. Many funds currently disclose their policies on these matters but such disclosure is not mandatory. The disclosure requested by Chairman Donaldson would enable investors to assess a fund's market timing practices and determine if they are in line with the investors' expectations. The disclosure requirement would permit flexibility among funds to adopt policies and procedures that are best suited to the funds' investments and the needs of its investors. For example, some funds welcome market timers, and other funds such as money market funds cannot be timed because of their stable net asset value. These funds would not be required to adopt policies to prevent market timing, but instead would be required to disclose their open policy with respect to these practices, if relevant.

The rule recommendations requested by Chairman Donaldson would have a further component of requiring funds to have procedures to comply with their

---

[2] See Letter to Craig S. Tyle, General Counsel, Investment Company Institute, (pub. avail. April 30, 2001).

representations regarding market timing policies and procedures. Thus, if a fund's disclosure documents stated that it discouraged market timing, the fund would be required to have procedures outlining the practices it follows to keep market timers out of the fund. The establishment of formal procedures would also enable the Commission's examination staff to review whether those procedures are being followed and whether the fund is living up to its representations regarding market timing activity.

Allegations of portfolio managers market timing the funds they manage or other funds in the fund complex, raise issues regarding insider trading, as well as the need for, and adherence by fund personnel to, policies and procedures to prevent the misuse of material, non-public information. We expect that the issue will also be addressed in the rulemaking recommendations to be submitted to the Commission later this month.

Chairman Donaldson also indicated that, in addition to promoting new rules to address market timing – including the adoption of the compliance policies and procedures rule, the Commission should emphasize the obligation of funds to fair value their securities to minimize market timing arbitrage opportunities. As I stated earlier, in 2001 the staff reminded the fund industry of funds' obligation to fair value their holdings under certain circumstances. In making this reminder, the staff cited Commission precedent. However, recent events warrant a reiteration of the Commission's views regarding fair value pricing.

Finally, Chairman Donaldson also stated that, in connection with its rulemaking initiatives, the Commission should reinforce the obligation of fund directors to consider the adequacy and effectiveness of mutual fund market timing practices and procedures. As with other fund policies, directors should assess the effectiveness, and oversee the implementation, of fund policies related to market timing.

C. Selective Disclosure

Recent allegations also indicate that some fund managers may be selectively disclosing their portfolios in order to curry favor with large investors. Selective disclosure of a fund's portfolio can facilitate fraud and have severely adverse ramifications for a fund's investors if someone uses that portfolio information to trade against the fund. Consequently, Chairman Donaldson has asked the staff to consider whether additional requirements are necessary to reinforce funds' and advisers' obligations to prevent the misuse of material, non-public information, including selective disclosure of portfolio holdings information.

D. Other Possible Actions

Chairman Donaldson has also asked the staff to consider whether funds should have additional tools available to thwart market timing activity. These include: (1) requiring funds to impose redemption fees on market timers; (2) allowing redemption fees of higher than 2 per cent; (3) expanding options to delay exchanges; and (4) allowing funds to retain gains from short-term trading activity. Moreover, the Chairman has asked whether additional requirements are necessary to reinforce funds' and advisers'

obligations to comply with their fiduciary obligations. We will carefully consider any regulatory recommendations from the Investment Company Institute's task force on abusive short-term trading of fund shares, as well as those from the task force on late trading activity. Chairman Donaldson has emphasized that he will not hesitate to call for other regulatory measures if we discover additional information in the course of our investigation that merits regulatory action. The Commission is committed to moving swiftly and aggressively to take all necessary steps to protect mutual fund investors from abusive and harmful activity.

III. Other Commission Initiatives

Our highest regulatory priority at this time is to address abusive activity in the mutual fund industry. The staff and Commission have also been working on other initiatives designed to assist mutual fund investors in making the best investment decisions for themselves and to bolster confidence in mutual funds. These initiatives seek to improve disclosure to fund investors, as well as improve fund governance and shareholder participation in the governance of funds.

A. Fund Advertising

In September, the Commission adopted rule amendments to modernize mutual fund advertising requirements to encourage more responsible advertising. The new amendments, which go into effect on November 15, require that fund advertisements state that investors should consider a fund's fees before investing. The amendments also

require advertisements to include information about the fund's investment objectives and risks, as well as an explanation that the prospectus contains this and other important information about the fund. The amendments also strengthen the antifraud protections that apply to fund advertising and encourage fund advertisements to provide information to investors that is more balanced and informative, particularly in the area of investment performance, so that investors have access to up-to-date performance information.

In addition to rulemaking initiatives, the Commission has engaged in educational efforts to caution investors against the dangers of overemphasizing fund performance in investment decisions. These efforts included publishing an investor alert on the Commission's website that explains the importance of looking beyond past performance in making investment decisions. The Commission also placed a "cost calculator" on the SEC website that allows investors to compute the impact of fees and expenses of various funds on their performance and facilitates comparison of funds.

B. Fund of Funds

The Commission also in September proposed for public comment new rules under the Investment Company Act that would broaden the ability of one fund to acquire shares of another fund, so called "funds of funds." These funds often are used as asset allocation vehicles for a fund to gain exposure to a sector of the market by investing in another fund. This proposal also included recommended amendments that would improve the transparency of the expenses of funds that invest in other funds by requiring that the expenses of the acquired funds be aggregated and shown as an additional expense

in the fee table of the acquiring funds, thereby giving investors in these funds more complete information about expenses.

C. Proxy Voting

In January, the Commission adopted rules that require mutual funds to disclose their proxy voting records. These rules enable fund shareholders to monitor their funds' involvement in the governance activities of portfolio companies. Under the rule, funds are required to file their proxy voting record with the Commission, which will make it publicly available through the EDGAR system. The rules also require mutual funds to disclose in their registration statements the policies and procedures they use to determine how to vote proxies related to portfolio securities. Funds have already begun complying with this requirement, and they are required to start filing their proxy voting reports next year.

D. Breakpoint Disclosure

The staff anticipates making recommendations to the Commission that would improve the disclosure of breakpoint discounts, which are discounts on front-end sales loads based on the aggregate amount of purchases of a fund's shares. Funds that offer breakpoint discounts must disclose the breakpoints and related procedures in their offering documents. Brokers that sell shares of funds that offer discounts have an obligation to help ensure that shareholders are receiving those discounts. Late last year, however, the staffs of the NASD and the SEC identified concerns regarding breakpoints. The staffs discovered that many fund investors were not receiving the appropriate discounts. The SEC and NASD took swift action - reminding funds and brokers of their

obligations, requiring brokers to assess the extent of the problem, and directing the industry to convene a task force to address the problem. In July, a Joint NASD/Industry Report on Breakpoints was released containing recommendations to assure that investors receive available discounts on mutual fund shares subject to front-end sales loads.[3]

The Breakpoint Report contains a number of recommendations to limit the problems associated with the provision of breakpoint discounts, as well as to improve the disclosure of breakpoint opportunities. Chairman Donaldson has directed the staff to draft a rule for Commission consideration consistent with these recommendations to help ensure that investors receive the appropriate discounts in the future. In addition, the NASD and SEC staffs continue to monitor and quantify the problem and have directed firms that have failed to provide the appropriate breakpoints in the past to compensate and make whole any affected investor. The SEC and the NASD also will continue to investigate, and where warranted, will bring enforcement actions in this area.

E. Shareholder Report Disclosure of Operating Expenses

The Commission also has proposed additional disclosure to increase investors' understanding of the expenses they incur when investing in a mutual fund. Under this proposal, mutual funds would be required to disclose in their shareholder reports the "dollar amount" of fund expenses paid by shareholders on a prescribed investment amount -- based on both the fund's actual expenses and return for the period, as well as the fund's actual expenses for the period based on an assumed return of 5 percent per year. By using both these measures, the dollar disclosure would enable investors to

[3] Report of the Joint NASD/Industry Task Force on Breakpoints, July 2003.

determine the amount of fees they paid on an ongoing basis, as well to compare the amount of fees charged by other funds. The goal of the proposal is to educate investors and to encourage cost competition among funds. This proposal also would require more frequent disclosure of portfolio holdings (*i.e.*, quarterly rather than semi-annually) to enhance investor understanding of the securities in the fund's portfolio so that investors can make better asset allocation decisions.

F. Highlighting Broker Incentives and Conflicts of Interest

Another area that the staff is examining is how to increase investor understanding of the incentives and conflicts that broker-dealers have in offering mutual fund shares to investors. Initiatives the staff is considering in this area include a comprehensive revision of mutual fund confirmation form requirements. A revised confirmation could include information about revenue sharing arrangements, incentives for selling proprietary funds and other inducements for brokers to sell fund shares that may not be immediately transparent to fund investors.

G. Fund Governance

The Commission is engaged in efforts to enhance the independence and effectiveness of independent directors of mutual funds. Mutual funds are governed by a board of directors that typically consists of a majority of independent directors. Because independent directors of funds must play a critical role in overseeing the funds' operations and fund shareholders rely on independent directors to protect their interests, it is imperative that funds, like public corporations, have mechanisms in place that provide

independent directors with sufficient disclosure of important information, particularly with respect to conflicts of interest. If adopted, we believe that the Commission's rule proposal requiring funds to have chief compliance officers and requiring that these officers report directly to fund boards, including the independent directors, will help to facilitate this upward flow of information. We note that the audit committee listing standards of the Sarbanes-Oxley Act already require, among other things, that listed companies, including exchange-traded funds, establish compliance procedures. The staff endorses the provisions of HR 2420 that would extend the audit committee listing rule requirements to mutual funds.

In the past year, as outlined below, the Commission has adopted other rules that we believe enhance fund governance, including the effectiveness of independent directors.

1. ***Sarbanes-Oxley Requirements.*** Mutual funds are subject to the corporate governance requirements of the Sarbanes-Oxley Act. In each rule that the Commission has proposed or adopted under the Act, it applied the corporate governance requirements to both operating companies and mutual funds, with some tailoring for the unique aspects of mutual funds. These rules include the rules on CEO and CFO certification requirements, code of ethics requirements, disclosure of audit committee financial experts, auditor independence and, most recently, audit committee listing standards.

2. ***Director Nomination Rules.*** The Commission has included mutual funds in initiatives to increase shareholder participation in the director nomination process. In August, the Commission proposed rule changes to strengthen disclosure requirements relating to the nomination of directors and shareholder communications with directors. The proposals apply to both operating companies and mutual funds, and would implement the first part of the recommendations of a Commission Staff Report issued on July 15, 2003, regarding improvements to the proxy process.[4] The enhanced disclosure provided by the proposal should benefit fund shareholders by improving the transparency of the nominating process and board operations, as well as increasing shareholders' understanding of the funds in which they invest.

To implement the second part of the staff's proxy nomination recommendations, the Commission, last month, proposed rule amendments to permit shareholders of both funds and operating companies greater access to proxy materials for the purpose of nominating directors. The proposed rules represent an effort by the Commission to strengthen the proxy process, for fund shareholders' direct benefit, while at the same time carefully balancing concerns about fund operations and fund governance requirements.

Under the proposal, funds would be required to include in their proxy materials the names and certain other information regarding shareholder nominees for fund directorships, where there are particular indications that long-term shareholders (*i.e.*, those who have been invested in a fund continuously for at least three years), with significant investments in the fund, need enhanced access to further an effective proxy process. Any nominating shareholder or group of shareholders would be required to

---

[4] Review of the Proxy Process Regarding the Nomination and Election of Directors (July 15, 2003).

represent that its nominee to a fund board is "independent," or not an "interested person" as defined in the Investment Company Act. The proposed rules would also enable fund shareholders to engage in limited solicitations to form nominating shareholder groups and engage in solicitations in support of their nominees without disseminating a proxy statement. Comments on the Commission's proposal are due December 22nd, and we will review those comments with an eye toward ensuring that fund investors have appropriate opportunities to nominate their representatives to fund boards.

* * * * * * * * *

In conclusion, I would like to reiterate that the protection of our nation's millions of mutual fund investors is of paramount importance to the Commission and the staff. I can assure you that it is of the utmost importance to the Commission to deal immediately with the reprehensible abuses that have taken place, and we are committed to rooting out the problems, punishing the perpetrators, and putting the proper rules in place so that these abuses do not happen in the future. Again, I appreciate the opportunity to be here today and I would be happy to answer any questions that you may have.

TESTIMONY OF WILLIAM FRANCIS GALVIN

Secretary of the Commonwealth of Massachusetts

Before the
Subcommittee on Financial Management, the Budget, and International Security
U.S. Senate Committee on Governmental Affairs

Mutual Funds: Trading Practices and Abuses that Harm Investors

November 3, 2003

I am Bill Galvin, Secretary of State and Chief Securities Regulator of Massachusetts. I want to commend Senators Fitzgerald and Akaka for calling today's hearing to examine mutual fund abuses.

Mutual funds play a major role in the wealth and savings of our nation. Today, half of all American households have invested nearly $7 trillion in mutual funds. But mutual funds are about more than money under management. Mutual funds are about the hopes and dreams of middle-income Americans – the hopes of a financially secure and dignified retirement; the dream of a college education for a child. Mutual funds are where America's dreams are invested.

With the decline of interest rates paid on savings, mutual funds have in many instances become the substitute bank of necessity for middle income Americans seeking a reasonable return on their savings.

Investors have placed their trust in mutual funds with the understanding that they would be treated fairly – and the risk of the market would be offset by the skill and commitment of the fund managers.

We are here today because in too many instances the mutual fund industry has failed to live up to its duty. The common theme running through all of the mutual fund issues that we have exposed in recent months is that the mutual fund industry is putting its own interest ahead of their customers – while they market trust and competence too often they have only delivered deceit and underperformance.

We are also here today because self policing and government laws and law enforcement have also failed to effectively protect the investor. The evidence that self policing has failed is in the willingness of the entire industry to quietly tolerate known market abuses while they parse words trying to describe clearly unethical practices as not illegal, their past silence has convicted them of ineffectiveness.

Government laws and law enforcement have failed because they have failed in the past to aggressively and promptly enforce the law. For too long a culture of compromise and accommodation has overwhelmed enforcement efforts. Too often the guilty neither admit or deny any wrongdoing and routinely promise not to cheat again until they can come up with a more clever method to do what they just said they would not do again.

For too long while the merry-go-round of accusations and non-admission go round and round, investors have been the losers.

It has taken the coincidence of dramatic and tragic recent investor losses and aggressive and state enforcement by people like Attorney General Spitzer and myself to convert investor outrage to a call for action.

All mutual fund investors should have an equal opportunity for profit and an equal opportunity for risk. Mutual funds should be precisely that – mutual. Unfortunatley, that is not the case. My investigation has revealed that special opportunities exist for certain mutual fund investors at the expense of the vast majority.

Several months ago my office launched an investigation into mutual fund trading practices. The Enforcement Section of the Massachusetts Securities Division has filed an administrative complaint against Putnam Investment Management, Inc. and two of its employees for violating the anti-fraud provisions of the Massachusetts Uniform Securities Act.

Our investigation found that, in effect, two classes of investors existed at Putnam. The first class were the connected investors – those privileged insiders who were able to skim the funds through a legal trading activity known as "market-timing." The second class were the average investors who placed their trust in Putnam to follow its own policies, including the policy against market timing.

We have uncovered an unsettling pattern of personal deceit, breach of duty, breach of trust and corporate deceit at Putnam Investments, the nations' fifth-largest mutual fund company. It is troubling when you have an industry like this that has spent so much time building the trust of its investors, and then this company failed to honor that trust and ignored it over a period of years. That makes the actions we uncovered at Putnam all the more grievous.

Mutual funds are traditionally designed to be long-term investments for buy and hold investors and are the favored investments for the retirement plans of working Americans. Certain investors, however, have attempted to use mutual funds to generate quick profits by rapidly trading in and out of certain mutual funds. Typically, these so called "market timers" seek to capitalize on stale fund prices, often focusing on price discrepancies involving international funds.

Market timers take advantage of price inequities, but do so at the expense and to the detriment of long-term shareholders. Mutual fund advisers have a fiduciary duty to treat all shareholders equitably. This obligation would preclude granting one group of shareholders (*i.e.*, market timers) privileges and rights not granted to all shareholders (*i.e.*, long-term investors). In addition, when a fund's prospectus disclosure indicates that the fund management will act to limit market timing, it cannot knowingly permit such activities.

Boston-based Putnam Investments is an investment adviser that offers and sells proprietary mutual funds to institutions and individuals. Putnam also acts as the administrator for defined contribution plans, such as 401(k) plans, and offers plan participants a choice of Putnam mutual funds in which to invest their retirement savings. In return for providing these services, Putnam receives a management fee and its funds benefit from the influx of large amounts of plan assets.

The investigation by Massachusetts securities regulators found that Putnam administered the retirement plan of the Boilermakers Local Lodge No. 5 of

New York. Despite prospectus disclosures that indicated market timing would not be tolerated, from at least January 2000 to September 2003 participants in the Boilermakers' retirement plan were permitted to market time Putnam international and other mutual funds.

By market timing, at least 28 Boilermaker plan participants made anywhere from 150-500 trades over a three-year period. At least one individual made $1 million in a retirement account over a three-year period by market timing the Putnam International Voyager Fund ("Voyager Fund"). During that same time period, the total trading volume in and out of the Voyager Fund amounted to approximately half a billion dollars. Each individual profited from over $100,000 to over $1 million in the three-year period.

One Putnam employee stated that the trading activity of the Boilermakers was so prolific that 3 to 4 p.m. was known as "boilermaker hour" within Putnam's Norwood, Massachusetts, office.

The mutual fund prospectus for the Voyager Fund and other Putnam mutual funds created the misleading impression that Putnam would not tolerate excessive exchange activity or market timing. As recognized in the prospectus, this market timing policy was to protect long-term investors from the negative effects of excessive trading, including but not limited to: dilution of share value, negative tax consequences, increased transaction costs, and loss of fund investment opportunities. Unbeknownst to long-term shareholders, Putnam allowed certain mutual fund shareholders, such as the Boilermakers, to engage in market timing activity in direct contradiction to the prospectus disclosure.

The Voyager Fund prospectus also clearly stated that Putnam fund management has the authority to reject market timing trades. For the sake of retaining plan assets invested in Putnam mutual funds and in order to secure future business, Putnam failed to reject short-term trades and permitted certain shareholders, such as the Boilermakers, to market time their international mutual funds. By permitting market timing activity by

certain plan participants, Putnam effectively allowed these customers to capture a portion of the fund's gains from the long-term shareholders within the fund.

Not only did Putnam permit certain plan participants to market time in their international funds, but also even more outrageous — allowed the fund's own managers to market time Putnam funds. At least six Putnam fund managers engaged in market timing, four of whom were timing in international funds they actually oversaw as part of a team of investment managers.

What makes this case so egregious is that Putnam executives knew the firm's policies were being violated. Not only did they conceal this violation, but they joined in and engaged in what can only be called corporate deceit.

Since 1998, Putnam knew that at least two employees had been market timing Putnam funds for which they acted as fund managers. Despite this knowledge, for two years Putnam turned a blind eye and failed to take any remedial action to stop market-timing trades. In early 2000, for example, Putnam merely cautioned two fund managers about moving fund balances and discouraged future market timing. Remarkably, the fund managers were allowed to retain personal profits already gained and were permitted to continue to manage the funds.

Not surprisingly, Putnam's ineffectual warnings were no more than an internal slap on the wrist and did nothing to deter market-timing activity by its employees. Both employees continued to market time Putnam funds. In fact, for three years Putnam overlooked market-timing activity by its own fund managers and took no action until late 2003, ironically following state and federal regulatory inquiries.

Market timing activity by Putnam fund managers amounts to a blatant violation of the manager's fiduciary duty to protect the interests of all of the fund's shareholders. Moreover, the fund manager's market timing activity is a flagrant violation of the fund's prospectus disclosure, which states that Putnam management will police and prevent

rapid short term trading. Such trading activity and practices is fraud under the Massachusetts Uniform Securities Act.

While today's headlines are filled with mutual fund jargon such as "market timing" and "late trading", the simple point is that people are being cheated.

The Putnam case is not an isolated example of this double standard. In fact, mutual funds now have an established history of putting their concerns over those of their customers. In August, for instance, my office charged Morgan Stanley with violations of Massachusetts anti-fraud laws by offering cash prizes and other incentives to encourage brokers to sell Morgan Stanley mutual funds to investors creating a high-pressure sales culture. My office found that Morgan Stanley brokers competed in contests to sell certain Morgan Stanley owned and affiliated mutual funds, for which they received higher commissions than other funds. The contests and higher commissions were not disclosed to investors – material omissions that constitute fraud under the Massachusetts Securities Act.

These enforcement actions are only two examples of the deep problems in the industry. Mutual funds violate investor trust in a number of ways:

- when mutual funds allow marketing timing for their employees;
- when mutual funds allow market timing for certain outside investors, perhaps as an incentive to generate or retain business;
- when mutual funds allow late-trading in a fund's shares;
- when mutual funds pay higher commissions to brokers or offer other incentives to sell proprietary, or in-house, funds to investors rather than funds that may be more suitable to an investor's needs; and
- when breakpoint discounts are ignored or concealed.

State securities regulators are often first to identify investment-related problems and to bring enforcement actions to halt and remedy these problems. Any suggestion that

state regulators have hindered federal enforcement of securities laws is completely false. Any effort to restrict or preempt state enforcement must be called what it clearly is – anti investor.

HR 2420 is a positive response to some of the many problems investors in mutual funds now face. And I endorse its objectives. This bill can be improved however. The original language of section 1, regarding fund operating expenses should be restored. Each individual investor should be notified of the actual costs they are paying and instead of disclosing soft dollar costs – they should be banned.

Prompt passage of this bill is important to bring the regulation of mutual funds to the level of regulation that their role in our financial system demands. But laws alone are not enough – they must be vigorously enforced.

I again want to commend the Subcommittee for focusing attention on this situation. With strengthened laws and vigorous enforcement we can give our nation's investors the fairness and honesty they seek and the protection they deserve.

Thank you.

State of New York Attorney General
Eliot Spitzer

Before the United States Senate
Governmental Affairs Committee
Subcommittee on Financial Management,
the Budget and International Security

Washington, D.C.
November 3, 2003

The Investment Company Act requires that mutual funds be organized, operated and managed in the interests of the funds' shareholders and not the funds' directors, officers and investment advisors. Despite that express instruction, too many funds have abandoned the interests of their shareholders and instead permitted and indeed fostered an environment that promotes the interests of their managers at the expense of their shareholders.

It has been only two months since my office announced its settlement with Canary Partners. Our investigation into Canary's investment practices revealed that some of the nation's largest mutual fund companies permitted hedge funds to take advantage of after-market information by buying and selling mutual fund shares at the Net Asset Value that had been set earlier that day when the markets closed. That practice, which is known as "late trading," is illegal.

Hedge funds were also permitted to engage in "market timing" activities. "Market timing" permits a trader to take advantage of market information that develops during the lag between the last quoted price for securities held by the mutual fund and the time the funds' Net Asset Value is set. Permitting market timing is contrary to the interests of a funds' long-term investors. As the Financial Analysts Journal observed last summer: "Because the gains [of market timers] are offset by losses to other investors in the fund, the funds clearly have a fiduciary duty to take some preventive action. All the gains are being offset, dollar-for-dollar, by losses incurred by buy-and-hold investors."

Indeed, mutual funds recognize that market timing works to the detriment of funds' long-term shareholders, which is why their prospectuses convey to shareholders the impression that market timing is not permitted. Despite these assurances and the requirements of the Investment Company Act, the funds ignored their promises to -- and the interests of -- their shareholders, and market timing was widespread.

More recently, we have learned that many fund insiders themselves engaged in market timing and late trading activities, directly profiting at the expense of the long-term investors in their funds. This tension – between the interests of the fund managers and those of its investors – is nothing new.

It was evident more than thirty-five years ago, when the Senate was considering legislation affecting the mutual fund industry. This is how Nobel Prize laureate Professor Paul Samuelson explained how the interests of shareholder and managers had diverged:

> I decided that there was only one place to make money in the mutual fund business -- as there is only one place for a temperate man to be in a saloon, behind the bar and not in front of the bar. So I invested in a [mutual fund] management company.

Today, matters have only gotten worse. The extent to which the mutual fund industry has come to devalue shareholder interests was highlighted last year by its vigorous opposition to a proposal that would have required them to report to their shareholders how they voted their proxies. The industry argued that providing the information would cost too much and return little value to shareholders. The refusal to provide even this minimal level of transparency provides us with an important perspective into the industry's thinking. When managers object to informing shareholders how they voted their shares, something is truly wrong.

As the investigations continue, it is important for us to focus not only on what happened but also on why it happened. As more details emerge, I believe that it will become clear that a large part of the problem – and thus an issue that must necessarily be addressed when formulating solutions – is the conflict of interest facing mutual fund directors.

Mutual funds are owned by their shareholders and are led by a board of directors. But the funds tend not to have any employees, instead contracting out for advisory, management, marketing and investment services. Funds that manage tens of billions of dollars operate without a single, full-time employee. The directors are supposed to be the stewards of their shareholders' investments, but too often act at the behest of the advisory and management companies that run the funds' day-to-day operations.

Mutual fund directors are supposed to negotiate lower fees for their shareholders, but there is little evidence of that. And they are even less likely to replace the advisors managing the fund. After all, the Chairman of the fund's Board of Directors is almost always affiliated with the management company. And fund directors sometimes serve on dozens or more fund boards simultaneously – often joining the fund board after retiring from a job at the management company.

In fact, there are some striking parallels between our investigation into the mutual fund industry and our earlier probe of Wall Street analysts.

Some Wall Street analysts ignored their duty to investors by instead giving priority to the interest of their investment banking colleagues. Some mutual fund directors ignore their duty to shareholders by instead giving priority to the interests of the fund advisors and managers.

Wall Street analysts rarely if ever issued a "sell" recommendation, because that would be contrary to the interests of the bankers. Mutual fund directors rarely if ever negotiated lower fees or changed advisors, because that would be contrary to the interests of the fund advisors and managers.

Why did analysts behave the way they did? Because of conflicts of interest, with their compensation often being tied to investment banking business. Why do mutual fund directors act the way they do? Because of conflicts of interest -- the Board chairman is almost always affiliated with the management company, and board members too often have personal and professional ties to the fund advisors and managers.

Some will say that I am being too tough on the mutual fund directors and demand to see evidence of their dereliction of duty. Exhibit A is obviously last week's revelation about the Strong funds. But even beyond that case of gross malfeasance, there was evidence available to fund directors that something was terribly wrong at their funds. Here's why directors were on notice that their funds were being mismanaged:

Fund directors could and should have suspected that their funds were permitting market timing by simply comparing the fund's average net assets -- the amount, on average, that a fund's shareholders have invested in a fund, with the fund's total redemptions -- the amount that the fund paid out to shareholders cashing out their shares. Since most fund shareholders are relatively long-term investors, total redemptions are on average a <u>percentage</u> of its net average assets. A red flag should therefore have been raised if a fund's total redemptions are <u>several times</u> its average net assets. While not the only possible explanation, it strongly suggests that the fund is permitting rapid-fire, in-and-out market timing and trading.

While they had this information available to them, fund directors apparently didn't act on it. For example, at least several of the funds in the Alger family of funds exhibited total redemptions that were many, many times the funds' average net assets – in one case, redemptions totaled more than <u>17 times</u> the funds' net average assets. And yet the directors didn't ask any questions. The same was true at some of the other funds that permitted Canary to engage in market timing.

A red flag should also be raised when there is a very close correlation between a fund's total sales and total redemptions. Since market timers cycle large amounts of money in and out of the funds they are timing, those funds are likely to report that total sales - which represents money flowing into the fund, and total redemptions - which represents money flowing out of the fund, are close to equal. At a minimum, directors who were doing their jobs would give a fund that has an almost 1:1 ratio of sales to redemptions some added scrutiny. Yet sales and redemptions were almost equal in several Alger funds during 2002, and nobody thought to ask why this was so.

Frankly, it wasn't even necessary to analyze financial data to know that there was a market timing problem. The market timers were so brazen about what they were doing, and so unconcerned that the mutual funds would put a stop to a practice that cost their long-term investors an enormous amount of money, that they openly advertised the fact that they were engaged in market-timing. In fact, a study published by four N.Y.U. professors in the summer of 2002 noted that they "know of at least 16 hedge fund companies covering 30 specific funds whose stated strategy is 'mutual fund timing'."

Why didn't the publication of that study cause directors to closely examine whether their funds were permitting timing? Why didn't fund directors make the inquiries that could have protected their shareholders? Because the directors were beholden to the fund managers and advisors.

Permitting market timing and late trading were not the only examples of the failure of fund directors to protect their shareholders' interests. Perhaps most costly to shareholders is the directors' total abdication of any meaningful effort to negotiate lower advisory and management fees. In 2002, it is estimated that mutual funds paid advisory fees of more than $50 billion and other management fees of nearly $20 billion. That does not even include the tens of billions that the funds spend on trading costs – costs that are no doubt significantly increased by the heavy trading of market timers.

And the fees paid by the mutual funds – or, more precisely, the fees that are paid by mutual fund shareholders -- seem to defy the laws of economics. As my good friend Jack Bogle has pointed out, mutual fund shareholders do not benefit from the economies of scale in the industry: mutual fund assets grew by sixty times between 1980 and 2000, but the funds' fees and expenses grew by ninety times during that same period.

Studies have revealed the extent to which mutual fund investors pay advisory fees that are simply too high -- too high because the fund directors are compromised and do not negotiate hard for their shareholders. A study published in 2001 exposed the fact that mutual funds pay significantly higher advisory fees than pension funds. Mutual funds often pay more than 25 basis points more for advisory services than pension funds pay, even when it is the same advisory company providing the identical advisory service to both the pension and mutual funds.

Why the higher fee? Because fund directors do not -- and can not -- negotiate hard on the fees. Why not? What else would you expect when the chairman of the mutual fund is also the chairman of the advisory company?

And make no mistake about it, 25 basis points matters. A couple that invested their $100,000 retirement nest egg for ten years and received an 8% annual return would receive an increase of almost $6,000 if their advisory fees were reduced by 25 basis points.

A 25 basis point reduction in the advisory fees that all mutual fund shareholders pay would result in a staggering savings to investors of more than $10 billion annually!

The fact is that in no other industry would a board of directors be permitted to issue billions of dollars in no-bid contracts annually. Yet that is par for the course in the mutual fund industry, where the fund directors essentially contract out for all of the fund's operations. We must not permit this to continue.

Mutual funds that permitted improper market timing and illegal late trading must be required to provide restitution to their investors and to disgorge all profits that they earned in connection with those activities. The managers also must disgorge the advisory fees received during the time that they were mismanaging the funds by permitting timing and late trading.

In addition, as with our investigation of conflicts in Wall Street research, any resolution of the inquiries into the mutual fund industry must require structural reforms that will realign the interests of the funds with the interests of their shareholders.

We must require mutual funds to maintain truly independent boards of directors -- with an independent chairman -- that take an active role in overseeing the trillions of dollars that shareholders have entrusted with them. The boards can begin to demonstrate that they have earned that trust by negotiating hard for lower fees from the advisory and management companies. The managers must know that if they do not lower their fees and improve their performance, they will be replaced. That is what happens in every other sector of the economy, and that is what must happen in the $7 trillion mutual fund industry.

While this is by no means an exhaustive list, some of the steps necessary to achieve these reforms are:

1. Requiring mutual funds to demonstrate that they have negotiated advisory and management fees that are in the best interest of their shareholders. This can be done by obtaining multiple bids, an independent evaluation or appraisal, or by some other means that ensures that shareholders are getting the best deal possible.

2. Requiring mutual funds to obtain most-favored nations clauses in their contracts. This will prevent advisory and management companies from charging them fees in excess of those paid by pension funds.

3. Requiring mutual funds to have an independent Board chairman with no relationship to the advisory and management company, and providing that chairman with the authority and ability to demand and receive any and all information from the fund advisory and management company.

4. Requiring independent directors to be truly independent of the advisory and management company.

5. Requiring mutual funds to provide their directors with the staff and data necessary to ensure that shareholder interests are being protected. This may require moving the compliance function from the management companies to the mutual funds themselves.

6. Requiring mutual funds to provide a uniform, complete and categorized disclosure of the fees that they pay for advisory services, management and marketing services, and trading costs.

These reforms would begin the process of restoring the rights and interests of shareholders and vindicating the Investment Company Act's promise to shareholders that mutual funds will be organized, operated and managed in the interests of the funds' shareholders and not the funds' directors, officers and investment advisors.

They can be achieved in a variety of ways – through legislation in Congress, regulation by the S.E.C. or other regulatory bodies, or as the terms of a settlement of current and future investigations. Our investigations are continuing, and we may turn up other abuses as well. Questions have already been raised about 12b-1 fees, soft dollar transactions, and undisclosed financial incentives for brokers to sell particular funds and particular classes of shares to investors. Some of these issues are addressed in H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act.

The S.E.C. enforcement staff does a terrific job. They are aggressive, tough, smart prosecutors. I remain committed to working together with them and others as we continue our investigations and think about solutions. But there must be a fundamental change of mindset that invigorates those who formulate policy and regulations at the S.E.C. to more actively and aggressively prevent mutual funds from acting against their shareholders' interests.

All of us here today -- lawmakers, regulators and industry officials -- have a duty to make sure that happens.

Testimony

of

Mary L. Schapiro

NASD Vice Chairman and President
Regulatory Policy and Oversight

Before
the
Subcommittee on Financial Management,
the Budget and International Security
Senate Committee on Government Affairs

Hearing on Mutual Fund Trading Abuses

United States Senate

November 3, 2003

Mr. Chairman and Members of the Subcommittee: NASD would like to thank the committee for the invitation to submit this written statement for the record.

NASD

NASD, the world's largest securities self-regulatory organization, was established in 1939 under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. Every broker/dealer in the U.S. that conducts a securities business with the public is required by law to be a member of NASD. NASD's jurisdiction covers nearly 5,400 securities firms that operate more than 92,000 branch offices and employ more than 665,000 registered securities representatives.

NASD writes rules that govern the behavior of securities firms, examines those firms for compliance with NASD rules, MSRB rules, and the federal securities laws, and disciplines those who fail to comply. Last year, for example, we filed a record number of new enforcement actions (1,271) and barred or suspended more individuals from the securities industry than ever before (814). Our investor protection and market integrity responsibilities include examination, rulewriting and interpretation, professional training, licensing and registration, investigation and enforcement, dispute resolution, and investor education. We monitor all trading on The NASDAQ Stock Market -- more than 70 million orders, quotes, and trades per day. NASD has a nationwide staff of more than 2,000 and is governed by a Board of Governors at least half of whom are unaffiliated with the securities industry.

NASD's involvement with mutual funds is predicated on our authority to regulate broker/dealers. NASD does not have any jurisdiction over investment companies or the fund's investment advisor; rather, we regulate the sales practices of broker/dealers who sell the funds to investors. Our investor education efforts also place special emphasis on mutual funds due to their widespread popularity with investors.

Our examination and enforcement focus in this area has concentrated on five main areas: first, the suitability of the mutual funds that brokers are selling; second, broker sales practices; third, the disclosures provided to investors; fourth, the compensation arrangements between the funds and brokers; and, fifth whether brokers are delivering to their customers the benefits to which they are entitled, such as breakpoint discounts. We have brought some 60 enforcement cases this year in the mutual fund area, and more than 200 over the last three years. We also have a number of ongoing examinations and investigations involving mutual fund issues, including late trading and market timing.

Recent Enforcement Efforts

NASD has several rules that govern the relationship between broker/dealers and fund companies. For example, our rule governing cash and non-cash compensation, Rule 2830, generally prohibits the award of non-cash compensation, such as lavish trips and entertainment, to brokers for the sale of mutual fund shares. The rule thus prohibits contests that encourage brokers to steer their customers into unsuitable investments. The

rules are designed to prevent the conflicts of interest that may arise for the broker when faced with such a choice.

Cash and Non-Cash Compensation Cases

In September, we brought a case under this rule against Morgan Stanley that resulted in a $2 million fine against the firm. Morgan Stanley had been conducting prohibited sales contests for its brokers and managers to push the sale of Morgan Stanley's own proprietary mutual funds. In addition to censuring and fining the firm, NASD also censured and fined a senior member of the firm's management – the head of retail sales.

Between October 1999 and December 2002, the firm had conducted 29 contests and offered or awarded various forms of non-cash compensation to the winners, including tickets to Britney Spears and Rolling Stones concerts, tickets to the NBA finals, tuition for a high-performance automobile racing school, and trips to resorts.

The obvious danger of such contests is that they give firm personnel a powerful incentive to recommend products that serve the broker's interest in receiving valuable prizes, rather than the investment needs of the customer. And one of the most troubling things about this case is Morgan Stanley's failure to have any systems or procedures in place that could detect or deter the misconduct.

In January 2003, NASD censured and fined IF Distributor, Inc., and VESTAX Securities Corp. a total of $150,000 for failing to disclose special cash compensation they paid to their sales force in the sale of mutual fund shares. Prior to disclosing this special cash compensation, the reps sold over $20 million in Class A shares to over 200 customers. Brokers selling these shares received approximately $220,000 in special cash compensation.

Shelf-Space

We also are conducting an examination sweep where we are looking at more than a dozen broker/dealers, specifically with a view to determine how investment companies pay for inclusion on firms' featured mutual fund list or why they receive favored promotional or selling efforts. We are looking at different types of firms, including full-service, discount and online broker/dealers. Thousands of funds are presented to investors through discount and on-line broker-dealer "supermarkets." In addition, we are examining a similar number of mutual fund distributors, who are also our members. Mutual fund sponsors and distributors that once marketed exclusively through a single, traditional distribution channel often now compete head-to-head in the same distribution channels vying for visibility and valuable "shelf space." We want to see what the distributors' role may be in these types of practices.

At issue in this sweep is NASD Rule 2830, which expressly prohibits members from directly or indirectly, favoring or disfavoring the sale of shares of any investment

company or group of investment companies on the basis of brokerage commissions received or expected by that member from any source. In short, an NASD member cannot seek brokerage commissions from a fund or investment company as a condition to the sale or distribution of investment company securities. Exchanging prominent placement of a fund or family of funds on a firm's Web site or in the firm's marketing material or placing a fund on a "featured" or "preferred" list of funds in exchange for brokerage commissions from the fund may be misleading to investors and a violation of NASD rules.

Class B Shares

Many mutual funds offer different classes of the same investment portfolio. Each class is designed to provide brokers and their customers with a choice of fee structure. Class A mutual fund shares charge a sales load when the customer purchases shares. Class B shares do not impose such a sales charge. Instead, Class B shares typically impose higher expenses that investors are assessed over the lifetime of their investment. Class B shares also normally impose a contingent deferred sales charge (CDSC), which a customer pays if the customer sells the shares within a certain number of years. In addition, investors who purchase Class B shares cannot take advantage of breakpoint discounts available on large purchases of Class A shares.

NASD has found that some brokers have unscrupulously recommended Class B shares in such large amounts that the customer would have qualified for breakpoint discounts had the broker recommended Class A shares instead. Some brokers also have recommended transactions in Class B shares that are so frequent as to cause the customer to incur CDSC charges. In both cases, the broker may receive higher compensation for the Class B recommendations. NASD has vigorously prosecuted these violations, and we are continuing a comprehensive review of Class B shares sales practices. Over the last two years, NASD has brought more than a dozen enforcement actions against firms and individual brokers for these types of violations.

For example, in May the SEC affirmed a disciplinary action NASD took against Wendell D. Belden, who was found to have violated NASD's suitability rule by recommending that a customer purchase Class B mutual fund shares in five different mutual funds within two fund families instead of Class A mutual fund shares. Because of the size of his customer's investment ($2.1 million) and the availability of breakpoint discounts for Class A shares, Belden's recommendations caused his customer to incur higher costs, including contingent deferred sales charges.

Belden tried to justify his recommendations to customers that they purchase the Class B shares instead of the Class A shares because he received greater commissions on the sales of these shares. He stated that he "couldn't stay in business" with lower commissions. Belden was fined, suspended, and ordered to pay more than $50,000 back to his customers.

In June we announced a settled action against McLaughlin, Piven, Vogel for violations in this area. The firm was fined $100,000 and ordered to pay restitution of approximately $90,000 to 21 customers. In August we announced five more actions for unsuitable sales of Class B shares.

Breakpoints

Mutual funds typically offer discounts to the front-end sales load assessed on Class A shares at certain pre-determined levels of investment, which are called "breakpoints." The extent of the discount is based on the dollar size of the investor's investment in the mutual fund. For example, breakpoint discounts may begin at dollar levels of $25,000 (although, more typically, at $50,000) and increase at $100,000, $250,000, $500,000, and $1,000,000. At each higher level of investment, the discount increases, until the sales charge is eliminated.

An investor can become entitled to a breakpoint discount to the front-end sales charge in a number of ways. First, an investor is entitled to a breakpoint discount if his single purchase is equal to or exceeds the specified "breakpoint" threshold. Second, mutual funds generally allow investors to count future purchases toward achieving a breakpoint if the investor executes a letter of intent that obligates him to purchase a specified amount of fund shares in the same fund or fund family within a defined period of time. Similarly, mutual funds generally grant investors "rights of accumulation," which allow investors to aggregate their own prior purchases and the holdings of certain related parties toward achieving the breakpoint investment thresholds (including reaching investment thresholds necessary to satisfy letters of intent).

Mutual fund families began to offer these breakpoint discounts to make their funds more attractive to investors. Over time, funds expanded the rights of accumulation they offered by expanding the categories of accounts that could be linked or aggregated for the purpose of obtaining breakpoint discounts. Mutual funds view their aggregation rules as important competitive features of their products. Accordingly, these rights of accumulation can vary from fund family to fund family, and many fund families define the related parties that can aggregate their holdings to determine breakpoint discount eligibility differently. For instance, one fund family may allow parents to link their accounts with a "minor child," while another fund family may allow parents to link their accounts with any child residing at home.

During routine examinations of broker-dealers by our Philadelphia District Office, NASD discovered that broker-dealers selling front-end load mutual funds were not properly delivering breakpoint discounts to investors. Following this discovery, in November and December 2002, the SEC and New York Stock Exchange joined us for an examination sweep of 43 firms selling front-end load mutual funds. We found that most of those firms didn't give investors all the breakpoint discounts they should have and the average dollar amount of the discount not provided was $364. Failures to give the discounts stemmed from a variety of different operational problems, including a failure to

link share classes and holdings in other funds in the same fund family and a failure to link accounts of family members.

NASD issued a *Notice to Members* on December 23, 2002, reminding firms to explain and deliver breakpoints. And, we issued in January 2003 an Investor Alert to advise customers of breakpoint opportunities.

Also in January 2003, the SEC asked NASD to lead a task force to find breakpoint solutions. The task force had 24 members, including representatives from broker/dealers, mutual funds, transfer agents, clearing facilities, academia, the SEC staff, other SRO's and trade associations.

The Task Force issued its report in July 2003, in which it recommended a number of technological and operational changes, as well as modifications to mutual fund prospectus and other disclosure and sales practices, to ensure that customers are not overcharged. Working groups, consisting of knowledgeable representatives of the mutual fund and securities industries, are currently engaged in implementation of the Task Force recommendations. NASD and the SEC receive periodic reports from these Working Groups and are monitoring progress as implementation moves forward.

As for the transactions that should have received discounts, NASD supplemented its referenced examination effort with a survey of every NASD member to learn more about each member's overall mutual fund activities. The survey, in turn, provided NASD with information that helped us frame a self-assessment. Specifically, NASD directed firms to perform a self-assessment of their own of breakpoint discounts delivery. These self-assessments were carried out through use of a carefully constructed sample of transactions, which permitted NASD to extrapolate each firm's performance to its entire universe of transactions. NASD has concluded that, during the 2001 to 2002 period covered by the self-assessments, investors were overcharged in about one out of every five transactions in which they were eligible for breakpoint discounts. Those overcharges, in our view, total at least $86 million, and the average overcharge was $243. When the assessments were complete, firms were directed to refund overcharges to investors, with interest. In addition, NASD will require that most of the firms involved undertake further action, including contacting their customers individually to alert them to possible overcharges. Disciplinary or enforcement proceedings will be brought against certain of the firms.

Late Trading and Market Timing

Investment Company Act Rule 22(c)(1) generally requires that mutual fund shares be sold an redeemed at a price based on the net asset value (NAV) of the fund computed after the receipt of the order. In practice this requirement means that mutual fund shares are priced according to the value of their securities portfolio, computed at the next close of the national securities exchanges. For example, if a mutual fund receives an order to purchase shares before the close of the securities exchanges, 4 p.m. EST, the investor should receive a price based on that 4 p.m. close. If, however, a mutual fund receives an

order to purchase shares after the 4 p.m. close, the investor should receive a price based on *the next day's* 4 p.m. close. This "forward pricing" requirement represents a fundamental principle of the Investment Company Act, for it prevents investors who might have access to the NAV of the portfolio from trading on that information.

The failure to meet the forward pricing standard has become known as "late trading." Late trading, however, should be distinguished from the practice, followed by many broker/dealers and other intermediaries of transmitting orders after 4 p.m. because they require additional processing time. For example, some intermediaries may net out transactions by pension plan participants in order to simplify their order to the mutual fund company. In these instances, the participants entered their orders before 4 p.m., but the orders of the plan were not processed and transmitted until after 4 p.m.

The frequent trading of mutual fund shares in order to take advantage of pricing inefficiencies or market movements has become known as "market timing." Market timing is not per se illegal. Market timing activities become illegal when they violate the fiduciary duty of the fund's investment adviser; they also are problematic when they violate a stated policy of the fund as disclosed in the fund's prospectus. Many mutual funds police market timing by their shareholders, because market timing can increase fund expenses and harm fund performance for the other shareholders. When a mutual fund has disclosed a policy of protecting investors from market timers, a broker/dealer may not knowingly or recklessly collude with the fund in order to effect a market timing transaction. Broker/dealers must have in place policies and procedures reasonably designed to detect and prevent this collusion.

In response to prevailing issues concerning mutual fund execution, in September NASD sought information from roughly 160 firms regarding late trading and impermissible market timing.

As a preliminary matter, we have determined that numerous firms' conduct warranted a referral to NASD's Enforcement Department for further investigation and possible disciplinary action. Another group of firms are being examined by our Member Regulation Department for potential late trading and impermissible market timing misconduct.

Specifically, a number of firms disclosed that they had, or probably had, received and entered mutual fund orders after U.S. markets closed for the day. Some of these firms disclosed specifically that they had accepted and entered late trades; other firms disclosed that they "probably" accepted and entered late trades. This imprecision in the latter group indicates separate issues of poor internal controls and record keeping; we will also pursue these areas. These matters, too, have been referred to NASD's Enforcement Department for action.

NASD also has identified a number of firms that were involved in market timing and it remains to be determined whether their activities were impermissible under our rules or applicable statutes. These firms appear to have facilitated a customer's market

timing strategy in mutual funds or variable annuities, had employees who agreed with a mutual fund or variable annuity to market time the issuer's shares, or had an affiliate involved in some form of market timing of mutual funds or variable annuities. We are investigating any broker/dealer that made any of these disclosures in our investigations. We will investigate whether these firms simply allowed market timing, which is not per se illegal, or whether they colluded with the mutual fund companies to evade the fund's state policies against market timing.

Proposed Disclosure Rules

In August, NASD proposed greatly expanded disclosure of mutual fund compensation arrangements. The proposal is designed to alert investors to the financial incentives that a brokerage firm or its registered representatives may have to recommend particular funds.

The proposal would ensure that investors receive timely information about two types of compensation arrangements. The first consists of cash payments by fund sponsors to broker/dealers to induce fund sales. Typically, these payments are made in order to gain "shelf space" at the broker, or to secure a place for a fund on a preferred sales list. The second is the payment by a broker/dealer of a higher compensation rate to its own registered representatives for selling certain funds. The proposal would require firms to disclose these compensation arrangements in writing when the customer first opens an account or purchases mutual fund shares. The proposal also would require member firms to update this information twice a year and make it available on their Web sites, through a toll-free number, or in writing.

The comment period on the proposal ended October 17, 2003. NASD has received approximately 40 comment letters on the proposal, which the staff is reviewing.

Investor Education

Mutual funds have been a particular focus of NASD's investor education efforts. This year alone, we have issued Investor Alerts on:

- Mutual fund share classes
- Mutual fund breakpoints
- Principal protected funds
- Class B mutual fund shares

Each of these Investor Alerts educates investors about the wide variety of mutual fund fee structures that exist and urges investors to scrutinize mutual fund sales charges, fees, and expenses.

Research has shown that many investors are unaware of how much they pay to own mutual funds and that even small differences in fees can result in thousands of dollars of costs over time that could have been avoided. To help investors make better

decisions when purchasing mutual funds, we have unveiled an innovative "Mutual Fund Expense Analyzer" on our Web Site. Unlike other such tools, the Expense Analyzer allows investors to compare the expenses of two funds or classes of funds at one time, tells the investor how the fees of a particular fund compare to industry averages, and highlights when investors should look for breakpoint discounts. To make this tool more widely available to investors, we are developing a version of the Expense Analyzer for broker/dealer Web sites.

Conclusion

NASD will continue its vigorous examination and enforcement focus on the suitability of the mutual fund share classes that brokers are selling, the compensation practices between the funds and brokers, and the question of whether brokers are delivering to their customers the benefits offered to them, such as breakpoint discounts. And as we continue our examinations and investigations into late trading and market timing issues, we will enforce NASD rules with a full range of disciplinary options--which include stiff fines, restitution to customers and the potential for suspension or expulsion from the industry. While NASD cannot alone solve all the problems revealed in recent months in the mutual fund industry, we have jurisdiction over all broker/dealers that sell these products to investors and will rigorously exercise our authority to take actions against violators as part of our overall efforts to protect investors and to restore investor confidence.

Statement of
Representative Richard H. Baker
Hearing Before the Senate Governmental Affairs Committee:
Subcommittee on Financial Management, the Budget and International Security
"Mutual Funds: Trading Practices and Abuses That Harm Investors"
November 3, 2003

Chairman Fitzgerald, Ranking Member Akaka, and members of the Subcommittee, I am very appreciative and honored to appear before you today. I want to applaud you, Chairman Fitzgerald, for holding this important hearing and for your exemplary leadership in the Senate on mutual fund regulation. As you know, ninety-five million Americans invest in mutual funds. Pooled investment products like mutual funds provide access to millions of Americans to our nation's stock markets. It is therefore imperative that all of us in Congress – both the House and Senate – seek to ensure that there is fairness and integrity in the mutual fund industry. Again, I commend the Chairman and Ranking Member for stepping up to this challenge on behalf of mutual fund investors. It is also my understanding that Senator Shelby, a member of this Subcommittee and the esteemed chairman of the Banking Committee, will be turning that Committee's focus toward these important issues later this month.

As chairman of the Capital Markets Subcommittee of the House Financial Services Committee, I held a hearing in March on the state of the mutual fund industry. This was many months before the major fund scandals were uncovered by the good work of New York Attorney General Eliot Spitzer and Massachusetts Secretary of State William Galvin. Regrettably, at the hearing we heard boastful testimony from the fund industry. Let me quote a representative statement – again this is a quote from an industry witness –

> "In these challenging times that we all face – where public confidence has been shaken and weak market performance continues – it is clear that investors have benefited from the stringent regulation of mutual funds. The disclosure and substantive regulatory requirements imposed upon mutual funds have enhanced competition and helped the industry avoid major scandal."[1]

I would expect that you will be receiving slightly different testimony from the industry today.

Perhaps the most critical component for healthy capital markets is investor confidence. Quite simply, if investors feel the game is rigged, they will avoid the playing field and park their money on the sidelines. Chairman Oxley and I have made investor protection the cornerstone of the House Financial Services Committee's agenda, and more specifically, the agenda of the Capital Markets

---

[1] Testimony of Mr. Paul G. Haaga, Jr., Executive Vice President, Capital Research and Management Company, and Chairman, Investment Company Institute, *Hearing on Mutual Fund Industry Practices and Their Effect on Individual Investors Before the House Committee on Financial Services*, 108th Cong. 21 (Mar. 12, 2003).

Subcommittee. Our hearings on the conflicts that plagued the Wall Street analyst community were the first major examination – by any committee in any legislature – of that issue, and planted the seeds that would ultimately become the historic Sarbanes-Oxley legislation. Our investigation of accounting fraud and Wall Street practices, including IPO allocation abuses, predated the WorldCom scandal and the events that led to the global settlement between investment banks, the states, and the Securities and Exchange Commission ("SEC").

But while passage of Sarbanes-Oxley was an important event, it was only a first step. Earlier this year I introduced H.R. 2575, a bill to provide a new regulator for Fannie Mae and Freddie Mac. The introduction of this bill occurred before the full revelation of the problems at Freddie Mac and the recent accounting problems at Fannie Mae. Members of the Senate, specifically Senators Hagel, Sununu, and Dole, have shown exceptional leadership on this issue as well. I mention these legislative efforts not to convince the Members of this Subcommittee that I possess precognitive skills but to make an important point: history teaches us that it is not ideal and often unwise for Members of Congress to ignore early warning signs and wait for a major scandal to erupt before considering legislation. On June 11, 2003, I introduced H.R. 2420, the *Mutual Fund Integrity and Fee Transparency Act of 2003.* At that time, there were no major scandals in the fund industry and several Members questioned the need for legislation, one going so far as to suggest that "all of us are rushing around as part of a bucket brigade to put out sometimes phantom fires." Well, the recent disclosures involving egregious acts by fund executives and portfolio managers entrusted with investors' money have proven these fires to be quite real and, like any dangerous blaze, prone to spreading. It is now obvious that the problems within the industry are not isolated. Sadly, they appear to be widespread.

State and Federal Investigations of the Mutual Fund Industry

As you know, at the beginning of September, Attorney General Spitzer filed formal charges against a hedge fund, Canary Capital Partners ("Canary"), for engaging in improper trading arrangements with four mutual fund companies: Bank of America, Bank One, Janus Capital, and Strong Capital Management. The State of New York's complaint alleged that Canary established special relationships with the mutual fund companies to engage in improper late trading and market timing trading practices that allowed Canary to reap benefits at the expense of mutual fund investors. The complaint outlines Bank of America's effort to go as far as installing an electronic trading platform at Canary's office so the firm could conduct trades with a range of mutual funds after trading had closed for the day. Canary benefited from this arrangement by reaping up to $40 million in profits and Bank of America, in turn, earned substantial commissions from Canary's trades. Canary agreed to pay $40 million to settle the charges.

The allegations of mutual fund trading abuses were a shock to millions of Americans who invested in what was previously considered a reputable industry and had been assured by industry claims that, "[t]he extensive regulatory scheme that applies to mutual funds has been effective in protecting investors and helping the

industry avoid major scandal."[2] The investigation of Canary was the tip of the iceberg and the New York state investigation has since expanded to include other hedge funds, mutual funds, and financial management companies. Just last week investigators revealed that Richard Strong, the Chairman and Founder of Strong Funds – a man with a net worth of approximately $800 million – was engaged in market timing of mutual funds managed by his firm and profited $600,000 over several years. In addition, there is evidence that some fund managers have been aware of irregular trading practices at mutual funds. These revelations are particularly appalling because it shows company executives and fund managers are turning their back on their fiduciary duty to investors to protect their interests in mutual funds.

Along with Mr. Spitzer, Mr. Galvin and the SEC have initiated their own investigations of mutual fund trading practices. Last week, Mr. Galvin filed the first formal complaint against a mutual fund company, Putnam Investments, for trades resulting from Putnam's failure to stop members of a New York union retirement plan from market timing funds. According to Mr. Galvin, the ten most active union members made almost 3,000 trades over the past three years garnering profits of $4.1 million. Two executives are also alleged to have been involved in self-dealing by taking advantage of inside knowledge about the international funds they managed to generate quick profits for themselves. One executive made at least thirty-eight market-timing trades in at least four of the seven funds he managed from 1998 until this year, and at least twenty trades were made after he was warned by superiors to stop. Mr. Galvin credited a whistleblower, a Putnam call center employee, who came to his office in September with allegations that Putnam was knowingly allowing market timing trades. The whistleblower claims he repeated warnings to his superiors that rapid trading was harmful to other fund investors from 2001 until earlier this year. It has been reported that the whistleblower had gone to the SEC in March but inexplicably the Commission's Boston office never acted upon the tip.

For its part, the SEC has launched its own investigation of the mutual fund industry on the heels of Mr. Spitzer's revelations of trading abuses. In September, the SEC sent a letter to one hundred financial institutions to inquire whether they are involved in the abusive trading practices outlined by Mr. Spitzer. So far, the SEC has filed charges against Fred Alger Management for improper trading of mutual funds and imposed a fine on Prudential Securities for improperly overseeing mutual fund trading practices. In addition, the SEC has sent two notices about potential charges to Morgan Stanley for failure to adequately disclose compensation that the firm received from fund companies for selling their products and sales practices related to certain share classes of funds. The SEC is also expected to propose regulations next month intended to halt late trading and market timing practices.

Explanation of Late Trading and Market Timing

---

[2] Testimony of Mr. Paul G. Haaga, Jr., Executive Vice President, Capital Research and Management Company, and Chairman, Investment Company Institute, *Hearing on Mutual Fund Industry Practices and Their Effect on Individual Investors Before the House Committee on Financial Services*, 108th Cong. 20 (Mar. 12, 2003).

Late trading and market timing are detrimental to the interests of long-term mutual fund investors. Late trading is a practice prohibited under SEC regulations whereby traders are allowed to purchase mutual fund shares at that day's closing price after the market closes at 4 p.m. in New York. SEC regulations require an investor placing an order after four o'clock to pay the next day's closing price. A late trader is able to profit by making trades based on news disclosed after the market closes when ordinary investors are not allowed to trade. When a trader is allowed to purchase shares at a price lower than the closing price, the trader receives a profit that would have otherwise gone completely to the fund's other investors. One study estimates the harm to long-term shareholders at $400 million per year.

Market timing, on the other hand, is a form of arbitrage that exploits the market inefficiencies when the "net asset value"[3] price of a mutual fund share does not reflect the current value of the stocks held by the mutual fund. The practice of trading "in and out" of funds, using delays between time zones, dilutes the value of shares held by long-term investors. For example, market timers could buy shares of international funds late in the day and lock-in the fund price. The prices of individual international stocks are set on their home exchanges which follow sharp movements on the U.S. exchanges. Therefore, if U.S. markets have a strong day, a U.S. mutual fund with international stocks might be underpriced because the Asian markets have not yet opened by the close of trading in New York, but the fund's value is likely to rise the next day. A trader could invest in that fund before the markets close in New York and quickly sell the next day when the fund's value increases. While not illegal, most fund prospectuses discourage or prohibit market timing because it harms long-term mutual fund investors by (1) diluting the value of the shares; and (2) raising trading costs. An independent academic study published last year estimated that market timing costs long-term investors $5 billion each year. Many funds claim to discourage market timing in their prospectuses by charging extra fees to investors who try to take advantage of pricing anomalies.[4]

Mutual Fund Scrutiny by the House Financial Services Committee

As I mentioned earlier, my Subcommittee held hearings in the spring and summer examining the need for reforms to strengthen corporate governance and management accountability at mutual fund companies. As a follow up to these hearings, I sent the chairman of the SEC a letter expressing concern about mutual fund fees, transparency, governance, and performance. At the end of July, under the leadership of Chairman Oxley, H.R. 2420 was marked-up and favorably reported by the full Financial Services Committee on a unanimous vote. To date, I have been urging my colleagues to support H.R. 2420 and I await Floor action on the legislation.

---

[3] Mutual fund companies sell and redeem its shares at net asset value – a price that is computed once a day by calculating the value of their holdings at 4 pm – the close of trading in New York.

[4] Prospectuses from Janus, Strong, and Bank One make statements similar to Bank of America's prospectus which states, "market timing . . . may interfere with portfolio management and have an adverse effect on all shareholders."

The purpose of H.R. 2420 is to (1) improve transparency of mutual fund fees and costs and (2) improve corporate governance and management integrity of mutual funds under the premise that better fee disclosure will promote robust industry competition and will help investors make better informed decisions about which mutual fund is most appropriate for them. While mutual funds have brought the benefits of professional management, portfolio diversification, and securities ownership to millions of individuals, numerous studies and commentators noted in our hearings that equity mutual fund fees have continued to increase while fund returns have lagged those of relevant indexes and investors are often unaware of these fees. I believe mutual fund investors should be the direct beneficiaries of greater fee-based competition among mutual funds, more accessible and understandable information about mutual fund fees, stronger oversight by independent fund directors, and enhanced firewalls against a variety of conflicts of interest raised by the way mutual funds are operated and sold. H.R. 2420 provides all of these critically important reforms for mutual fund investors.

The Legislative Reforms of H.R. 2420

H.R. 2420 strengthens the influence of independent directors, who have a greater inclination to protect the interests of fund shareholders than those directors who are tied to the success of the mutual fund's management company. The bill further promotes investor protection by directing the SEC to promulgate rules requiring enhanced disclosure and director scrutiny of directed brokerage, soft dollar and revenue sharing arrangements. H.R. 2420 also codifies the SEC rule requiring mutual funds to disclose both policies and procedures with respect to proxy voting and the actual votes cast, thus enabling shareholders to monitor their funds' involvement in the governance of portfolio companies. Finally, the bill codifies a pending SEC rule requiring mutual funds to implement internal audit procedures, including appointing a chief compliance officer to administer these procedures.

Specifically, H.R. 2420 contains the following provisions:

Fee Disclosure. H.R. 2420 generally codifies a pending SEC proposal that would require disclosure in a fund's semi-annual and annual report to include a dollar example of the fees an investor would have paid on a hypothetical investment. The dollar example must be based on a hypothetical $1,000 investment and account statements are required to include a legend prominently stating that the investor has paid fees on the mutual fund investment, the fees have been deducted from the amount shown on the statement, and the investor can find more information by referring to documents disclosing the amounts of such fees.

Portfolio Transaction Expenses. Portfolio transaction expenses are the costs funds incur when they buy and sell securities. In some cases, these costs exceed the fund's operating expenses. The bill directs the SEC to promulgate a "concept release" seeking input on portfolio transaction costs that will provide more useful information to investors about these significant mutual fund costs. H.R. 2420 requires mutual fund companies to improve portfolio turnover disclosure (a proxy for fund transaction costs) that funds currently provide by including this disclosure in a

document that is more widely read than the prospectus or Statement of Additional Information, and by requiring a textual explanation of the impact of high portfolio turnover rates on fund expenses and performance.

Portfolio Manager Compensation and Holdings. Mutual funds are not required to disclose the structure of compensation of portfolio managers or their fund ownership. H.R. 2420 directs the SEC to (1) issue rules requiring disclosure of the structure of fund manager compensation and (2) require that fund managers disclose their holdings in the funds they manage.

Breakpoint Discounts. Many mutual funds sell funds with front-end loads that may be reduced based on the amount of an investor's holdings. Many investors, however, are unaware that they may be eligible for these breakpoint discounts and have overpaid front-end sales loads when they were actually entitled to a reduced rate pursuant to the fund's breakpoint policy. H.R. 2420 requires the SEC to mandate improved disclosure of breakpoint discounts to help investors determine whether they are eligible for a discount.

Revenue Sharing Arrangements. Revenue sharing is generally not disclosed to investors, thus leaving investors unaware of the incentives a broker may have for recommending one fund over another. Under a revenue sharing arrangement, the adviser of a fund uses its own profits to pay a broker or other party to sell shares of the fund. Accordingly, the legislation requires fund directors to review revenue sharing arrangements consistent with their fiduciary duty to the fund.

Directed Brokerage Arrangements. Funds increasingly use a portion of brokerage commissions to compensate broker-dealers for distribution of fund shares or certain classes of fund shares. Directed brokerage arrangements are not clearly disclosed to investors. Accordingly, the bill directs the SEC to require enhanced disclosure of these arrangements, as well as enhanced oversight by the board of directors of these arrangements, consistent with their fiduciary obligations to the fund. The bill also requires the SEC to issue a rule requiring disclosure of any conflicts of interest that the broker may face due to such financial incentives, such as a "point of sale" disclosure, or an after-the-fact disclosure such as in an order confirmation that is provided to investors after execution of the transaction.

Soft Dollar Arrangements. A soft dollar arrangement is one in which an investment adviser directs client brokerage transactions to a broker and, in exchange, receives research or other services from the broker or a third party. Soft dollar arrangements have been subject to criticism because of the potential for conflicts of interest between a fund and the investment adviser. There is also an inadequate incentive for the adviser to keep trading costs low.

H.R. 2420 addresses the inherent conflicts of interest with respect to soft dollar arrangements by (1) requiring the SEC to issue rules mandating disclosure of information about soft dollar arrangements; (2) requiring fund advisers to submit to the fund's board of directors an annual report on these arrangements, and requiring the fund to provide shareholders with a summary of that report in its annual report to shareholders; (3) imposing a fiduciary duty on the fund's board of directors to

review soft dollar arrangements; (4) directing the SEC to issue rules to require enhanced recordkeeping of soft dollar arrangements; and (5) ordering the SEC to conduct a study of soft-dollar arrangements, including the trends in the average amounts of soft dollar commissions, the types of services provided through these arrangements, the benefits and disadvantages of the use of soft dollar arrangements, the impact of soft dollar arrangements on investors' ability to compare the expenses of mutual funds, the conflicts of interest created by these arrangements and the effectiveness of the board of directors in managing such conflicts, and the transparency of soft dollar arrangements.

Independent Fund Directors. Mutual funds are distinct from the fund management and are, in fact, owned by their investors, not mutual fund advisers. In practice, many mutual fund investors have very little power over the company they own. Thus, H.R. 2420 strengthens the influence of independent directors on fund boards by requiring that independent directors comprise at least two-thirds of the board, thereby ensuring that directors represent the interests of the millions of investors who put their trust in mutual funds and not the interests of fund management.

Audit Committee Requirements. H.R. 2420 extends provisions to enhance the independence and authority of mutual funds' audit committees. The bill strengthens the audit committees by requiring that all of its members be independent. To further the objectivity of financial reporting, the bill charges the audit committee with direct responsibility for the appointment, compensation and oversight of the mutual fund's accountant. The bill also requires the audit committee to establish procedures for handling complaints regarding accounting matters.

Use of the term "no-load." Under current NASD rules, only funds that charge a 12b-1 fee of twenty-five basis points or less can call themselves no load funds. This misleads investors who are led to believe that "no-load" means the fund is not charging any 12b-1 fee at all. The bill directs the SEC to clarify rules relating to the use of the term "no-load" by mutual funds, so that investors may better understand what they are actually paying when they choose such a fund.

Proxy Voting Disclosures. Recent business scandals have created renewed investor interest in issues of corporate governance, underscoring the need for mutual funds to focus on this issue. Despite the fact that millions of American investors own the underlying securities of mutual funds, funds have been extremely reluctant to disclose how they exercise their proxy voting power with respect to portfolio securities. H.R. 2420 codifies an SEC rule that requires investment companies to disclose their policies and procedures with respect to proxy voting as well as the actual votes cast.

Informing Directors of Significant Deficiencies. The SEC staff regularly inspects mutual funds. In practice, the staff generally informs the fund's adviser of any significant deficiencies that are discovered. H.R. 2420 includes a new requirement that the fund's board of directors be provided with a report of any such deficiencies, to ensure that they will be able to take any necessary corrective action.

Ethics Compliance. H.R. 2420 codifies aspects of a SEC proposal to strengthen the corporate governance practices of mutual funds that would require investment companies to implement internal audit procedures to promote compliance and detect violations of federal securities laws. Specifically, H.R. 2420 requires investment companies to designate a chief compliance officer to administer the internal audit program.

Study of Arbitration Claims Involving Mutual Funds. This provision directs the SEC to study the dramatic increase in arbitration claims involving mutual funds since 1995. Arbitration cases involving mutual funds have increased ten-fold in just the past few years, skyrocketing from 121 in 1999 to 1,249 in 2002. The study will identify the reasons for this troubling trend and will therefore help the SEC to enact measures to reverse it.

Independent Chairman. Regrettably, I was not able to garner enough support from my colleagues to block an amendment at the full committee mark-up to strike a requirement that would require a mutual fund's board of directors to have an independent chairman. This provision was significant because independent directors do not oversee all board matters involving conflicts of interest between advisors and funds. Instead, review of these transactions typically occurs in a meeting with all of the directors that is overseen by the board's non-independent chairman. Fund boards need to have an independent chairman because fund directors and management are not accountable to the same interests: fund directors are accountable to fund shareholders – i.e. the ninety-five million Americans who invest in mutual funds and have an interest in keeping fund fees low – whereas fund management has a fiduciary obligation to maximize profits and increase the amount of fees collected.

H.R. 2420 and the Future of Mutual Fund Governance

As I have discussed, H.R. 2420 is an important first step toward improving accountability and integrity of mutual fund companies. In light of the events that have occurred since the Committee on Financial Services reported the bill on July 23rd, it is clear to me that my legislation needs to be strengthened. The Subcommittee on Capital Markets will be holding two hearings this week on this subject, at which I look forward to hearing the ideas of a variety of distinguished witnesses regarding how best to strengthen the bill. At a minimum, though, I believe there are several areas that call for legislative attention, which I plan to add to the bill.

First, while the Financial Services Committee voted to remove the bill's original provision mandating that the chairman of the board of all mutual funds be independent, I believe, as I stated earlier in this testimony, that provision absolutely must be reinstated. Investors need to be assured that the fund's board chairman is looking out for *them*, and not themselves or the management company. If we are to avert a more severe crisis of confidence by mutual fund investors, we must start by making this fundamental change at the very top and send a message that the

"business as usual" that has been exposed as, in too many cases, corrupt, simply will be tolerated.

In addition, we must act to fight the conflicts of interest that arise when management and portfolio managers are able to steal money from investors by timing their own funds. While existing insider trading laws might already ban this activity, I believe the prohibitions should be made stronger and clearer. Management and portfolio managers simply should not be permitted to market time their own funds. Certainly, their holdings in funds they manage should be disclosed.

Another conflict of interest that is simply unacceptable is that of a portfolio manager managing both a mutual fund and a hedge fund. This arrangement creates opportunities for unfair allocation of securities transactions. It has been widely observed that such an arrangement might create incentives for a manager to allocate the best investment ideas to the hedge fund, because hedge fund managers collect lucrative fees – typically twenty percent of total profits – based on performance. Even worse, it apparently provided at least one manager with the opportunity to market time the very mutual fund he was managing, on behalf of the hedge fund! Such joint portfolio management should be banned.

Market timing is a practice that raises questions about whether any mutual fund – which by nature is a vehicle generally designed for long-term investors – should permit it. However, there are funds that do permit this practice and are even marketed as such. The problem arises where fund investors are told the fund does not permit market timing, or the policy is not clear, and they are disadvantaged by the fund permitting certain select investors to do so. This problem can be solved by forcing funds to make a choice – they either permit market timing or not, and the rules must be the same for everybody. Making this policy "fundamental" under the Investment Company Act of 1940 will improve the disclosure that shareholders receive about a fund's market timing policy and also ensure that funds cannot change this policy without a shareholder vote. It would also help discourage market timing if funds are able to charge more than the current limit of two percent of assets as a short-term redemption fee. I believe that limit should be raised to at least four percent. Finally, the SEC needs to act to clarify the rules that apply to fair value pricing. Market timing would be difficult to engage in if funds were required to value their shares according to their real market value, rather than according to a "stale" market close price.

With regard to late trading, insider trading, and other flagrant violations of the securities laws that appear to be pervasive in the fund industry, it is clear to me that internal compliance at many fund companies is woefully inadequate. Not only do funds need to appoint a chief compliance officer, as H.R. 2420 would require, but I believe that that person should report directly to the independent directors in the chain of command so there are no concerns about repercussions from fund management for whistleblowing.

I also believe that more disclosure of executive and portfolio manager compensation is critical. Mutual funds are simply not as transparent in this regard

as other public operating companies. Just as investors have the right to know how much the executives at Ford and GE are paid for their services, they should be better informed about the compensation of fund managers and executives.

Finally, I believe that investors should have confidence in the primary regulator charged with protecting them from those who would abuse their trust. It seems to me that steps to improve the SEC's use of external tips, and to strengthen communication between the divisions that oversee enforcement and mutual fund regulation, could help in this regard.

These are just a few of the changes that would strengthen the *Mutual Funds Integrity and Fee Transparency Act* and help to restore the confidence of fund investors, which has been so shaken by the shocking allegations of recent weeks.

Thank you again for this opportunity to share my views on this critical issue. I look forward to responding to any questions or comments you may have.

Statement of John C. Bogle

Founder and Former Chief Executive of the Vanguard Group and
President of the Bogle Financial Markets Research Center
Before the United States Senate Governmental Affairs
Subcommittee on Financial Management, the Budget,
and International Security
November 3, 2003

Good morning, Chairman Fitzgerald and members of the Subcommittee. Thank you for inviting me to speak today.

I hope that my experience in the mutual fund industry will be helpful in considering the issues before you. I have been both a student of, and an active participant in, the mutual fund industry for more than half a century. My interest began with an article in the December 1949 issue of *Fortune* magazine that inspired me to write my Princeton University senior thesis ("The Economic Role of the Investment Company") on this subject. Upon graduation in 1951, I joined Wellington Management Company, one of the industry pioneers, and served as its chief executive from 1967 through January 1974. In September 1974, I founded the Vanguard Group of Investment Companies, heading the organization until February 1996, and remaining as senior chairman and director until January 2000. Since then I have served as president of Vanguard's Bogle Financial Markets Research Center.

Vanguard was created as a *mutual* organization, with its member mutual funds as the sole owners of the management company, Vanguard Group, Inc. The company operates the funds on an "at-cost" basis. Essentially, we treat our clients—the fund shareholders—as our owners, simply because they *are* our owners. We are the industry's only *mutual* mutual fund enterprise.

At the conclusion of my remarks, I hope that you'll have a better understanding of what

---

Note: The opinions expressed in this statement do not necessarily represent the views of Vanguard's present management. Much of the material in this statement was included in a presentation before the Society of American Business Editors and Writers on October 27, 2003.

today's mutual fund industry is all about—that you'll see our industry as it is, and not as virtually every industry leader sees it. The gift, in the words of Robert Burns, "to see ourselves as others see us."

In a speech I delivered in the autumn of 1996, I warned that the "spirit of trusteeship, professional competence and discipline, and a focus on the long term, are rapidly losing their role of the driving force—in the long run, the *life* force of this industry." Today, the three principal points I made seem almost prescient:

- "The industry's traditional focus on trusteeship, implying placing the interest of fund shareholders as our highest priority and charging a reasonable price for our services, is being supplanted by a focus on asset-gathering—on distribution—as we worship at the shrine of the Great God Market Share, the exorbitant cost of which is borne by our own fund shareholders.

- "The industry's traditional focus on professional competence and discipline has moved from long-term investment to what is really speculation, with rapid turnover in our investment portfolios (*averaging* almost 100% per year!), funds concentrating on ever-narrowing segments of the stock market, and far too many gunslinger portfolio managers.

- "And the industry's traditional focus on the eminent suitability of mutual funds for long-term investors is quickly becoming a focus on investing in fund portfolios for the short-term (a second level of speculation) and, even more baneful, a focus on enticing fund shareholders to use their mutual funds as vehicles for rapid switching, either for the purpose of market timing or for the purpose of jumping on the bandwagon of the latest hot fund (and that's called speculation, too)."

Shocked, Shocked

What we now know, of course, is that the consequences of these three baneful trends have come home to roost in the most painful sort of way: in damage done to the pocketbooks of the shareholders who placed their trust in mutual funds.

The recent market timing scandals are but a midget manifestation of the problem. But the industry's response can be best characterized by a classic line spoken by the police chief in the film *Casablanca,* Claude Rains: "I am shocked, *shocked* to find (timing) going on here." We've already been told that the misdeeds are akin to "parking at a meter and not paying. Nobody is being bankrupted by this." And we'll doubtless be told (if we haven't already been told) that these breaches of fiduciary duty are attributable to only "a few bad apples," although as these scandals continue to come to light, we may need to liberalize our definition of "few."

Even as the spotlight that shined on the specific acts that brought notoriety to corporate America's bad apples—the Ken Lays, the Dennis Kozlowskis, the Sam Waksals, the Jack Welches, the Richard Scrushys, to name just a few—illuminated all the nibbling around the edges of proper and ethical conduct that, absent the intrusive spotlight, could otherwise have persisted for another decade or more, so the spotlight that shines on the scandals perpetuated by the bad apples of the mutual fund industry reflect the frequent willingness—nay, the eagerness—of fund managers to build their own profits at the expense of the fund owners whom they are honor bound to serve.

"It's an ill wind that blows no good." By illuminating the inherent conflict of interest between fund managers and fund investors, these scandals will ultimately prove a blessing for fund owners. This conflict is hardly a secret. Indeed in that very 1996 speech, I urged this industry to move to a system in which "the focus of mutual fund governance and control is shifted . . . to the directors and shareholders of the mutual funds themselves, and away from the executives and owners of mutual fund management companies (where it almost universally reposes today), who seek good fund performance to be sure, but also seek enormous personal gain."

If such a shift of control and governance had taken place, the market-timing scandals detailed in the Spitzer-Canary settlement may well never have occurred. The Attorney General's seemingly airtight case was built, not only on covert *practices*, but on open *motivations*—on the receipt of payola, for the want of a better word. The managers received that payola in the form of side banking deals, lending money at high interest rates; large investments in other funds on which the manager earns high fees ("sticky assets" in the vernacular of the trade); and the like.

One manager's e-mail could hardly have made the motivation clearer. "I have no interest in building a business around market timers, but at the same time I do not want to turn away $10-$20m[illion]!" (Yes, the exclamation point was there.) The writer emphasized that allowing the timing trades would be in the manager's "best interests." Lest his colleagues be complete nincompoops and fail to get the point, he explained in a parenthetical aside what that meant: "increased profitability to the firm." Another e-mail (God bless e-mail!) also told the truth: "Market timers are a big problem . . . it's very disruptive to the operation of the funds. (But) obviously, your call from the sales side."

A Study in Corporate Incest

It can be little surprise that the mutual fund industry has not escaped the same kinds of scandals that have faced Wall Street and Corporate America. For in no other line of business endeavor is the conflict between *owners* capitalism and *managers* capitalism more institutionalized, and therefore more widely accepted. Yet by its very structure, this industry, for all its protestations about its dedication to Main Street investors, seems almost preordained to give the managers total control over the fund shareowners.

Consider how the typical fund organization operates. Even when their assets are valued in the scores of billions of dollars, *fund complexes do not manage themselves.* They hire an external management company—with its own separate set of shareholders—to manage their affairs. The management company runs the fund's operations, distributes its shares, and supervises and directs its investment portfolio. It decides when to create new funds, and it decides what kinds of funds they will be. When the funds are badly run, the company replaces the portfolio manager . . . but with one of its own employees. And when a fund outlives its usefulness, it is the management company that decides how to dispatch it to its well-deserved reward: simply liquidating it, or, much more likely, merging it into another fund with a better past record. . . but a fund that it also just happens to manage.

What's more, this typical management company graciously provides all of the fund's officers, who are employees of the *company*, not the *fund.* And while the executives of the manager usually have a miniscule investment in the funds they run, they select themselves for the fund board, and until recent years, also selected most of the funds' "independent" directors, who by law must now compose at least a majority of the board. In the typical case, furthermore, the

chairman of the board of the *management company* also serves as, you guessed it, the chairman of the board of the *mutual funds*.

Given the Gordian knot on the rope that binds the fund and the manager together, it is impossible to imagine that at one of the fund's four annual board meetings the less-well-informed independent directors can stand up to the steeped-in-the business management company minority. Small wonder that an early law review article about this industry's structure was, as I recall, entitled: "Mutual Funds: A Study in Corporate Incest."

The Emperor's Clothes

How can it be that the industry takes this bizarre governance structure as the natural order of things? How is it that its leaders couldn't see that this structure was an accident waiting to happen? It must have something to do with what Hans Christian Andersen wrote about in 1837 in *The Emperor's Clothes*:

> "When the little child said 'But he has nothing on,' and the whole people agreed, the emperor shivered, for they were right. But he thought 'I must go through with this procession.' And he carried himself still more proudly, and the chamberlain held on tighter than ever, and carried the train, which did not exist at all."

But the ability to ignore the reality of our industry's existence goes back even further than that. Hear Descartes in 1650: "A man is incapable of comprehending any argument that interferes with his revenue." And even 1000 years before *that*, in 350 B.C., hear Demosthenes: "Nothing is easier than self-deceit. For what each man wishes, that he also believes to be true."

The fund industry, in the vernacular of the day, "just doesn't get it." So I urge you not to be persuaded by the self-aggrandizing comments offered by the Investment Company Institute's president to the audience at this year's General Membership Meeting: "Your unshakable commitment to putting mutual fund shareholder interests first has served our shareholders and our companies well. In a nutshell, we have succeeded because the interests of those who manage funds are well aligned with the interests of those who invest in mutual funds."

But the interests are *not* well aligned. And to ignore—indeed, to deny—the obvious and profound conflicts that are manifest in this industry is hardly the beginning of wisdom. The fact is that whatever alignments of interest may exist are far outweighed by the misalignments. Consider just four of the major areas in which what is good for the managers is bad for the shareholders:

1) Market timing, which brings in temporary assets that provide higher fees to managers, but only at the cost of dilution in the returns for fund owners.
2) Management fees, which are—unarguably—*inversely* related to fund performance. The higher a fund's management fees and expenses the lower the returns earned by its shareowners.
3) Growth in a fund's assets to elephantine size, which enriches managers but destroys the fund's ability to repeat the performance success that engendered that very growth. The bigger the fund, the bigger the fee, and the more likely the fund's reversion to the market mean.
4) The industry's marketing focus, which seems inevitably to demand the creation of new and often highly specialized funds to meet the heated investment passions of the day, creating huge capital inflows, huge fees for managers, and—far more often than not—huge losses to investors.

1. Market Timing Becomes Rife

In view of its topicality, the market timing issue is the first obvious conflict of interest I'll discuss. I've already laid bare the obvious conflict in the "late trading" scandal, the brazenness of which astonished even an industry reformer like me. But late trading is only the small tip of a big iceberg. "Time-zone trading" is likely even larger in its negative impact on fund shareholders. Yet the shocking thing about time-zone trading—usually, taking advantage of a free (to the timer!) arbitrage between an international fund net asset value calculated at 4 PM in New York, but based on closing prices across the Pacific 14 hours earlier—is that it has been going on for so long, without significant defenses being erected by managers. It has hardly been a secret; academics have been publishing papers about it at least since the late 1990s.

A prescient article in the *Financial Analysts Journal*[1] carefully described the time-zone trading strategy, quantified its effectiveness, and showed, with specific examples, how easy it was to make money by gaming the system. It also berated the industry for its benign neglect of the market-timing issue: "When the gains from these strategies are matched by offsetting losses incurred by buy-and-hold investors in these funds . . . why haven't more funds taken stronger actions to restrict short term trading?" What is more, the four authors cited fully 20 other academic studies on the same point, and, especially prescient the light of the Canary hedge-fund settlement, noted that 30 hedge funds had blatantly listed their investment strategy as "*mutual fund timing*." If industry participants were fast asleep before, that article sounded the alarm, and it surely answered the question: "What did we know and when did we know it?" Fund shareholders, if not fund managers, owe these four academics a major debt of gratitude.

Yet the sole published response to the revelation was a screed from a representative of the manager whose funds were mentioned in the article. He berated the *Journal:* "Publishing such a piece in a publication that is aimed solely at financial professionals is a bad idea in the best of times, but is abhorrent when investor confidence is already shaken by corporate greed . . ." Nonetheless, just nine months later, the very firm that employed the respondent initiated a 2% redemption fee on its international funds. At long last!

"General" Market Timing in Funds

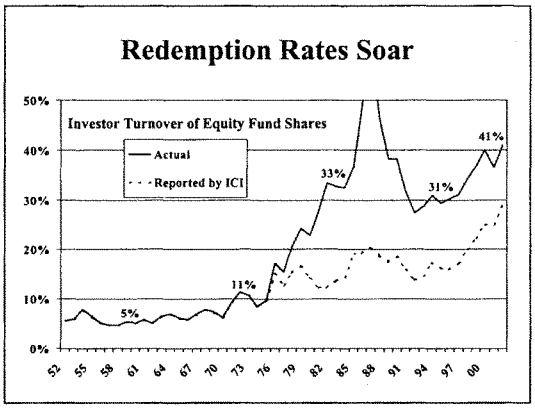
But general market timing—*not* the illegal late trading, *not* the unethical time-zone trading—suggests that investors, using the finest vehicle for long-term *investing* ever designed, are doing too much short-term speculation in mutual funds. *There's a lot of money sloshing around the mutual fund system.* How much market timing is there? We simply don't know. But we do know a great deal about what is going on.

First, there is *much* more timing activity than the industry acknowledges. By failing to acknowledge that redemptions whose proceeds are invested in another fund within the same family—so-called "exchanges out"—are actually, well, *redemptions*, the ICI substantially understates fund redemption rates. Such intra-family redemptions are the clearest—though hardly the *only*—example of a market timing strategy; i.e., frequent moves back and forth

[1] "Stale Prices and Strategies for Trading Mutual Funds," by NYU Professors Boudonkh, Richardson, Sulrahmanyam, and Whitelaw. *The Financial Analysts Journal*, July/August 2002.

between a stock fund and a money market fund in the same family. While the ICI *reported* an equity fund redemption rate equal to 29% of assets in 2002, the *actual* rate, including exchanges-out, was 41%, *half* again higher.

Next, we also know the (true) redemption rate has soared—from 5% to 15% in the 1950s through the mid-1970s, to the 30%-35% range into the late 1990s (excepting a 60% rate in the turbulence of 1987), and to the 40%-50% range thereafter. The average fund investor, who not all that long ago held fund shares for an average of more than ten years (the reciprocal of, and proxy for, a 10% redemption rate), now holds shares for less than two and one-half years (proxy for a 41% redemption rate).



Robust Timing by the Minority

Interestingly, industry studies of investor behavior show that the typical (i.e., median) fund investor doesn't do much trading. During 1998, according to an ICI survey, fully 82% of equity fund owners made not a single redemption. Even if that figure is accurate (and assuming that the ratio holds for 2002), however, consider what it implies: the 41% *total* redemption rate, spread over only the remaining 18% of investors, indicates that this small segment of investors

has an average holding period of just 160 days. And if we assume, arbitrarily, that one-half of these investors maintained, say, a ten-year holding period, the remaining half would have an *average* holding period of about 90 days—a redemption rate of an astonishing 446%.

When we look at fund objectives, it's easy to see what is going on. International funds win the prize, with an average redemption rate rising from 94% a year in 2000 to 97% in 2002. During the same period, sector funds redemptions averaged 57%, and aggressive growth funds 51%. While the ICI's major understatement of redemptions requires us to do our own calculations, these data are all actually reported, so it takes little effort to observe where the worst investor behavior is going on.

What is more, the annual report of each mutual fund is required to report total redemptions. It is a revelation to examine some of the funds involved in one aspect or another of the recent timing scandals, where the numbers approach the brazen. The Alger equity funds, with total assets averaging $2 billion in 2002, reported redemptions for the year totaling $9 *billion(!)*—a 440% redemption rate. Bank of America's Emerging Markets Fund had a 295% annual redemption rate, and Janus Adviser International Growth fund had a 372% redemption rate.

The dollar amount of redemptions (but not the turnover rate) are clearly set out in each fund's financial statement without comment, and sent to shareholders (and, we must assume, to directors as well). This redemption activity, then, is not only going on with the tacit knowledge of the managers, directors, and regulators, it is happening right under the noses of the shareholders, the press, and the public as well, fully disclosed for anyone interested enough to look. Yet I have *never* seen it questioned or challenged.

The solution to the problems of excessive market timing by fund traders is straightforward: 1) Close the funds' transaction window at 2:30 PM instead of 4:00 PM for *everybody*. If the assets for 401(k) plans can't meet the deadline, they'll just have to execute the orders on the *next* day. 2) Impose a redemption fee of 2% for shares held for less than, say, 30 days. Alas, with the fierce competition to attract assets, few firms will have the courage to take these two steps on their own. It would cost them business! So, I urge the Securities and Exchange Commission to impose these standards on this reluctant industry. I also urge a firm like Morningstar to regularly publish and comment on the redemption rates of individual funds.

As it almost invariably does, the sunlight of disclosure would quickly modify the behavior of both managers and traders.

2. The Conflict of Interest in Fund Fees

I have no trouble in postulating that both the fund directors and the management company share a common interest in providing good returns to the fund shareholders. But when it comes to *how* good, their interests diverge. Why? Simply because the higher the management fees and other fund expenses, the lower the fund's return.

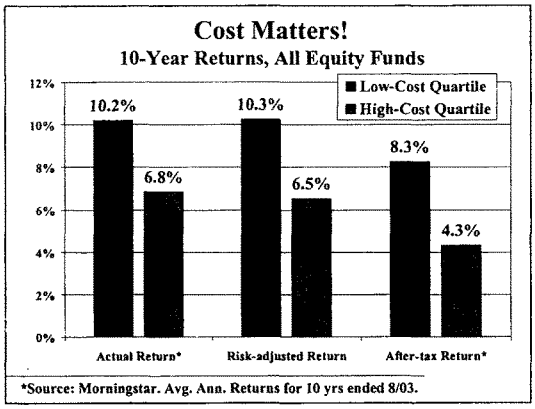
Sometimes, this relationship exists on a virtual dollar-for-dollar basis. For example, the correlation between the yields that money market funds deliver to their shareholders and the expense ratios of these funds is an inverse –0.98, almost, well, perfect. When money market yields are 3%, for example, a high-cost fund will deliver as little as 1¼% to its owners; a low-cost fund will deliver as much as 2¼%—fully 50% more. Indeed, whenever fund gross returns are commodity-like (for example, in stock index funds and bond index funds), the same kind of "locked-in" relationship of returns to costs prevails.

But even in actively managed funds, costs clearly differentiate the superior performers from the inferior performers over the long run. Consider a study we recently prepared quantifying the relationship between the *total* costs of equity funds and their returns. Using all 803 diversified U.S. equity funds in the Morningstar database in existence over the full ten-year period ended August 30, 2003, we compared each fund's investment returns with its costs. The average expense ratio for these funds was 1.3%, and their average portfolio transaction costs were estimated at 0.7%, for a total of 2.0%. (We conservatively assumed that transaction costs totaled 1% of turnover, equal to only ½% on each side of the trade.)

Results? The high-cost quartile of funds, with all-in expenses of 3.4%, provided an average annual return of 6.8%.[2] The low-cost quartile, with expenses of 1.0%, provided an average annual return of 10.2%, earning an advantage of 3.4 percentage points per year. On a

[2] We omitted the impact of initial sales charges, and few of these established funds have 12b-1 fees, so the expense ratios of this select group were significantly below industry norms. Further, since we made no adjustment for survivor bias, the average return was also overstated.

fund-by-fund basis, the inverse correlation between cost and return was remarkable: *minus* 0.60%. So yes, *cost matters*.

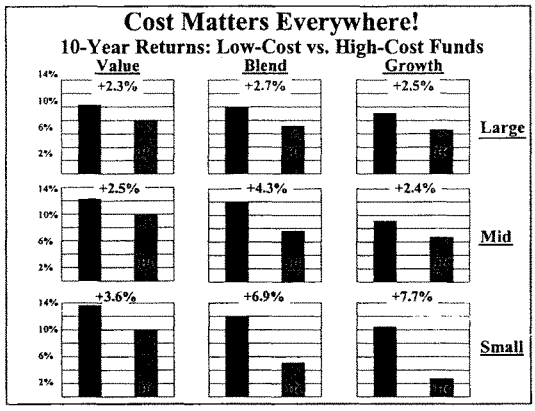


What's more, the funds with the highest costs also assumed the highest risks (a standard deviation 30% higher than the lowest-cost funds); generated the highest turnover (160% vs. 22%); and produced the poorest tax-efficiency. As a result, the low-cost group had an even greater advantage (3.8% per year) in risk-adjusted return, and an amazing advantage of 4.0% per year in after-tax return. It's hard to imagine presenting a more persuasive case about the relationship between fund costs and fund returns.

Reinforcement of the Low-Cost Thesis

But, of course, I'll present a more persuasive case anyway. For when we sort the funds into their nine Morningstar style boxes, the consistency of the performance margin (even without risk-adjustment and tax-adjustment) was little short of astonishing. The low-cost quartile provided a consistent edge in the remarkably narrow range of 2.3% to 2.7% per year among the nearly 500 large-cap funds, and in two of the three mid-cap styles. In the remaining (smaller and therefore less statistically reliable styles; the small-cap value group had a total of only 28 funds), the excess returns achieved by the low-cost funds were even higher (averaging 5.6% per year). With this reinforcement from the segment data, it is simply impossible to argue that the link

between lower costs and higher return isn't about as strong as the suspension cables on the Golden Gate Bridge. Cost matters, and it matters *everywhere*.



The establishment of a fair cost structure—including management fees, portfolio turnover expenses, operational expenditures and sales loads—must be the categorical imperative of the fund board. Given the circumstances of fund governance, however, the directors affiliated with a management company have a compelling interest in the reverse. They seek the highest fees that public opinion and traffic will bear. The manager not only places a high priority on its own profitability; but it's arguable that it has a fiduciary duty to its own shareholders to do *exactly that*. And the independent directors seem reluctant to challenge that interest. (Hear Warren Buffett: "When the managers care about fees and the directors don't, guess who wins? Negotiating with oneself seldom produces a barroom brawl.") Fee negotiation is a myth, and the fund shareholders suffer, not only accordingly, but as the data make clear, both measurably and substantially.

3. Let the Asset Growth Roll

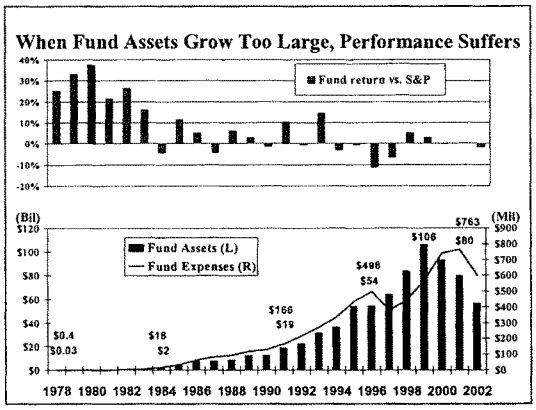
It must be obvious that as the assets of actively-managed funds grow, the challenges of implementing their investment strategies increase. And when the assets grow exponentially, so too do the challenges. The number of stocks available for the portfolio manager to choose from

shrinks, and portfolio transaction activity tends to either become more expensive as average trade size increases or, for better or worse, to diminish. Further, as the fund grows, investment returns have a powerful tendency to revert to the market mean—three negatives, at least for the investors who chose the fund because of its demonstrated ability to generate superior returns. But exceptional growth generates exceptional fees, and the managers are enriched accordingly.

Yet it is only in rare cases that managers summon the courage to close funds to investors, which suggests that the pressures to let funds grow beyond their ability to be effectively managed exist. Fund closings are the exception that proves the rule: Only ten of the 3,363 domestic equity mutual funds in existence today have completely closed, although another 127 are closed to new investors. In an industry where average assets of the fifty largest equity funds have burgeoned from $4.6 billion to $23.3 billion in a decade, why have the closings been so rare? It seems reasonable to assume that it is because the manager's interest in ever-higher fees carries the day, and outweighs the shareholder's interest in sustaining superior returns.

Let's consider a single (extreme!) example of how the interaction of these trends works in practice. I'll call it Fund X. During its early years, it turned in an astonishingly successful record, outpacing the Standard & Poor's 500 Stock Index by an *average* of 26 percentage points per year from 1978 through 1983. With such success, its assets burgeoned from a mere $22 million to $1.6 billion during that period. While its performance then reverted *toward* the mean, its excess return from 1984 through 1993 remained a healthy four percentage points per year. By then, its assets had grown to a staggering $31 billion, and the excess returns came to an abrupt halt. Four years of losing to the S&P followed, and then three small gains and two small losses. Since 1993, it has fallen an average of almost two percentage points per year behind the 500 Index—a far cry from the success of its earlier years.

With soaring management fees leading the way, the expenses borne by the shareholders of Fund X kept growing. And growing, and growing. From $400,000 in 1978 to $17 million in 1984, to $166 million in 1991, and $500 million in 1996, expenses peaked at $763 million in 2001. *At the outset of the period, small fees for large returns. At the period's conclusion, awesome fees for mediocre returns.* Obviously, the fund's asset growth was wonderful for its managers, but the exact opposite was true for its owners.



Further, of course, the larger the fund grew, the more it became like an index fund. Reversion to the market mean strikes again! In 1978-1982, the S&P return explained 82% of the return of Fund X, but in 1998-2002 fully 97%. I'm *not* arguing that is bad. (After all, I'm an indexer!) But I *am* arguing that fees and costs totaling $3 billion dollars during that five-year period are, well, absurd. Absurd, I quickly add, when looked at from the vantage point of the investors who are paying them. From the standpoint of the managers who are receiving them, they are the soul of rationality. "We made the fund large, and we deserve to be paid for that success." If that argument appeals to you, welcome to the mutual fund industry.

4. The Marketing Focus—We Make What Will Sell

A recent article[3] in *The New Yorker* described Hollywood as exemplifying, "the most joyless aspects of capitalism. The 'industry,' as it insists in calling itself, packages ideas and images as 'products,' and then values them according to how they 'penetrate' markets, support 'platforms' of ancillary products, and 'brand' a company as a reliable purveyor of similar products." If that makes Hollywood sound like what the mutual fund industry has become, you are paying attention to the march of our history.

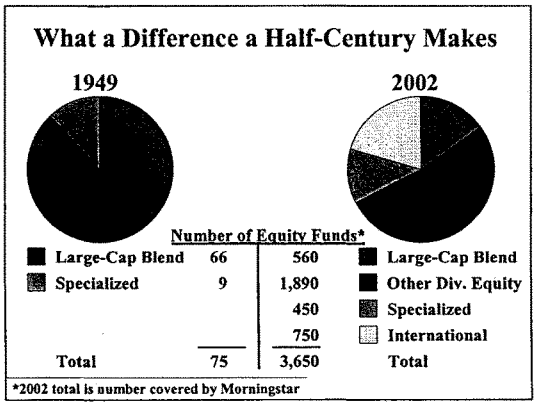
When I came into this business 52 years ago, fund management companies were relatively small, privately-held professional firms, and we focused on stewardship. Marketing had

[3] "Remake Man" by Tad Friend; June 2, 2003. The word "products" read "commodities" in the original article.

yet to rear its ugly (in the context of fund management) head. Those managers provided their services to just 75 mutual funds, of which 66 were essentially what today we would call "large-cap blend funds," holding a widely diversified portfolio of blue-chip stocks and providing returns that generally paralleled the returns of the stock market itself, as measured by the Standard & Poor's 500 Index. Most of these fund managers ran but a single stock fund. In short, we sold what we made. *We sold what we made.*

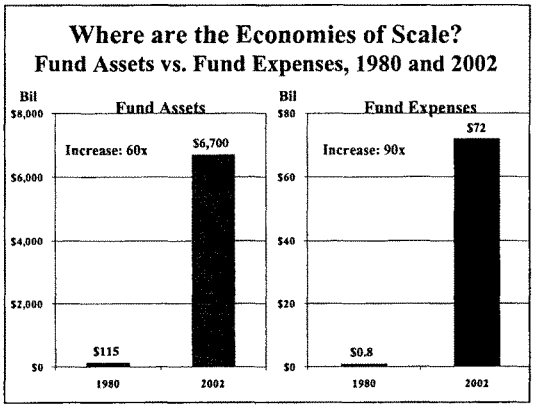
What a difference a half-century makes! Today, the industry is dominated by giant financial conglomerates that focus on salesmanship. There are 3,650 equity funds large enough to be tracked by Morningstar, and only 560 of them closely resemble their blue-chip forebears. What are these other funds? 1,890 funds are diversified equity funds investing in one of the eight remaining "style boxes," that make bets away from the total market—bets on large-cap growth stocks, or small-cap value stocks, and mid-cap blend stocks. Another 450 funds invest in specialized industry segments—technology, telecommunications, and computers, are (or were!) the most popular examples. And 750 are in "international" funds, an odd locution that applies largely to funds that invest in foreign markets (albeit sometimes with a seasoning in U.S.-based companies).

In general these other fund categories assume higher risks than the market-like funds of yore. In 1951, an investor could throw a dart at the (tiny!) fund list and have *nine chances out of ten* of picking a fund whose returns would parallel the return of the market itself. Today, the investor's chances of doing so are just *one out of eight*! For better or worse, selecting mutual funds has become an art form, and "choice" rules the day.



"Penetrating Markets"

The fund industry has become a business school case study in marketing—packaging new ancillary products in order to penetrate new markets and to expand penetration of existing markets. Modern marketing has played a major role in the burgeoning profitability of investment managers, and, in that sense, it has worked. The hundreds of billions of dollars poured into these "new products," along with appreciation in the value of "existing products" during the great bull market, created a bonanza for fund managers. From 1980 to 2002, total mutual fund assets rose 60 times over—from $115 billion to about $7 trillion. Yet despite the staggering economies of scale in this industry,[4] fund management fees and expenses rose far faster—90 times over, from $800 million to $72 billion.



Why? Because rather than creating sound investment choices, our Great God Market Share, to repeat an earlier phrase, demanded that we create funds that the investing public wanted to buy. And what the public wanted to buy—and was willing to pay higher fees for—was the hot idea of the day. In the late bubble, of course, it was the "new economy" internet funds and technology funds and telecommunications funds, and the aggressive growth funds that

[4] The average expense ratio of the Vanguard funds, which are operated on an "at cost" basis, declined 54% during the same period, from 0.59% to 0.27%.

concentrated in those stocks. Indeed, these risky sectors also dominated the portfolios of even the more diversified traditional growth funds. The public had little interest in the more sedate value funds. So we created these risky new funds, promoted them, and sold them. Why? We made what would sell. *We made what would sell.*

The trends are easily measured: From 1998 through 2000, the public bought $460 billion(!) of high price-earnings-ratio growth funds, at ever ascending prices and redeemed a net total of $100 billion in lower price-earnings ratio value funds. Then, after the market neared its lows, investors switched gears, and in 2001-2002, these growth funds experienced net redemptions of $46 billion, and value funds took in $89 billion of additional capital—proving, once again, that this is a market-sensitive industry.

Managers Win, Investors Lose

This sensitivity worked to the advantage of fund managers. That huge flow of additional capital to new-economy-oriented funds produced some $30 *billion*(!) of additional management fees and costs during 1998-2000, and, even though these costs tumbled as the bubble burst, an additional $20 *billion* during 2001-2002—total revenues of $50 billion, accompanied by only modest incremental expenditures by the managers. The focus on marketing was a remarkably profitable strategy for *managers*.

Investor Returns, For Funds, for Shareholders

But not so for *investors*. That same marketing strategy cost our shareholders hundreds of billions of dollars. Aided and abetted by the aggressive sales promotion of the managers, investors moved their money into the most vulnerable areas of the market and withdrew money from the least vulnerable areas, as we now know, *precisely* the reverse, of what they should have been doing. And we now have the tools to recognize just how badly these investors fared. For in my 1996 speech, I talked about the need for mutual funds to report not only their "time-weighted" returns (our standard measure for the return a mutual fund earns on each *share*), but their "dollar-weighted" returns (the measure of what the fund earns for its *shareholders* as a group).

While that suggestion for a second measurement never materialized, it is instructive to consider the dollar-weighted returns earned by the shareholders of a whole variety of the largest

and most popular growth funds during the past five years. Roughly speaking, the $460 billion that investors poured into this group of "new-economy"-oriented funds resulted in a loss of some $300 billion in the decline that followed.

It's fair to say that (a) fund managers made huge profits by their willingness, indeed eagerness, to make what would sell, and (b) fund investors absorbed huge losses from (literally) buying into that strategy. Put another way, the change in the mutual fund industry, in which the managers have come to consider money management a *business* focused on their desire for profits, rather than a *profession* focused on the interests of their fund shareholders, could itself well be considered a certain kind of scandal.

Summing up: Earning a Fair Share of Stock Market Returns?

What has been described as "a pathological mutation"[5] in corporate America has transformed traditional owners capitalism into modern-day managers capitalism. In mutual fund America, the conflict of interest between fund managers and fund owners is an echo, if not an amplification, of that unfortunate, indeed "morally unacceptable"[5] transformation. The blessing of our industry's market-timing scandal—the good for our investors blown by that ill wind—is that it has focused the spotlight on that conflict, and on its even more scandalous manifestations: the level of fund costs, the building of assets of individual funds to levels at which they can no longer differentiate themselves, and the focus on selling funds that make money for managers while far too often losing money—and lots of it—for investors.

The net results of these conflicts of interest is readily measurable by comparing the long-term returns achieved by *mutual funds*, and by mutual fund *shareholders*, with the returns earned in the *stock market* itself. During the period 1984-2002, the U.S. stock market, as measured by the S&P 500 Index, provided an annual rate of return of 12.2%. The return on average mutual fund was 9.3%.[6] The reason for that lag is not very complicated: As the trained, experienced investment professionals employed by the industry's managers compete with one another to pick the best stocks, their results average out. Thus, the average mutual fund *should* earn the market's

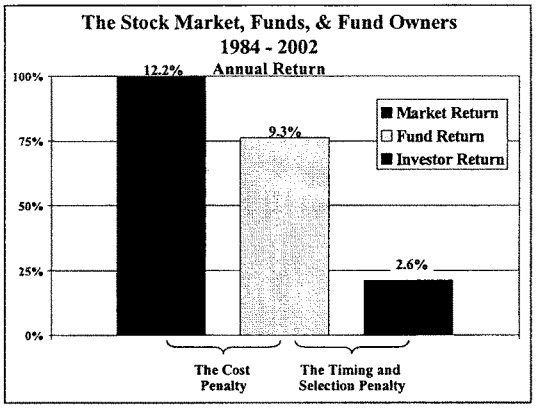
---

[5] William Pfaff, writing in *The International Herald-Tribune* on September 9, 2002.

[6] Lipper data show that the funds that were in business throughout the period earned an annualized return of 9.8%. We estimate that survivor-bias reduced those returns by at least 0.5% per year, to 9.3%. Even that number *overstates* the fund record, because it ignores the impact of sales charges.

return—*before* costs. Since all-in fund costs can be estimated at something like 3% per year, the annual lag of 2.9% in after-cost return seems simply to confirm that eminently reasonable hypothesis.

But during that same period, according to a study of mutual fund data provided by mutual fund data collector Dalbar, the average fund shareholder earned a return just 2.6% a year. How could that be? How solid is that number? Can that methodology be justified? I'd like to conclude by examining those issues, for the returns that fund managers actually deliver to fund shareholders serves as the definitive test of whether the fund investor is getting a fair shake.



Is the Dalbar Study Accurate?

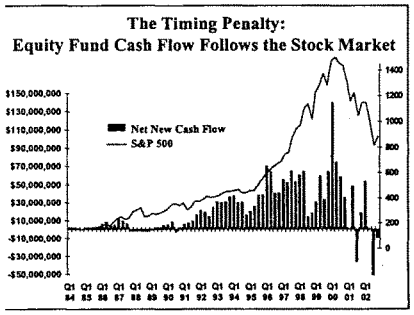
Let's begin by using some common sense. It is reasonable to expect the average mutual fund investor to earn a return that falls well short of the return of the average fund. After all, we know that investors have paid a large *timing* penalty in their decisions, investing little in equity funds early in the period and huge amounts as the market bubble reached its maximum. During 1984-1988, when the S&P Index was below 300, investors purchased an average of just $11 billion per year of equity funds. They added another $105 billion per year when the Index was still below 1100. But after it topped the 1100 mark in 1998, they added to their holdings at an $218 billion(!) annual rate. Then, during the three quarters before the recent rally, with the Index

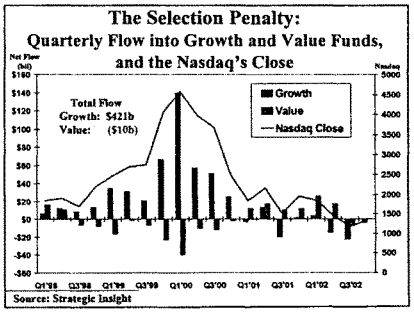
below 900, equity fund investors actually *withdrew* $80 billion. Clearly, this perverse market sensitivity ill-served fund investors.

The Dalbar study calculates the returns on these cash flows as if they had been invested in the Standard & Poor's 500 Index, and it is that simple calculation that produces the 2.6% annual investor return. Of course, it is not entirely fair to compare the return on those *periodic investments* over the years with initial *lump-sum* investments in the S&P 500 Stock Index and in the average fund. The *gap* between those returns and the returns earned by investors, then, is somewhat overstated. More appropriate would be a comparison of *regular* periodic investments in the market with the *irregular* (and counterproductive) periodic investments made by fund investors, which would reduce both the market return and the fund return with which the 2.6% return has been compared.

But if the gap is overstated, so is the 2.6% return figure itself. For investors did *not* select the S&P 500 Index, as the Dalbar study implies. What they selected was an average *fund* that lagged the S&P Index by 2.9% per year. So they paid not only a *timing* penalty, but a *selection* penalty. Looked at superficially, then, the 2.6% return earned by investors should have been *minus* 0.3%.

Worse, what fund investors selected was *not* the *average* fund. Rather they invested most of their money, not only at the wrong *time*, but in the wrong *funds*. The selection penalty is reflected by the eagerness of investors as a group to jump into the "new economy" funds, and in the three years of the boom phase, place some $460 billion in those speculative funds, and pull $100 billion out of old-economy value funds—choices which clearly slashed investor returns.





Dollar-Weighted Returns: How Did Fund Investors Fare?

Now let me give you some dollars-and-cents examples of how pouring money into the hot performers and hot sector funds of the era created a truly astonishing gap between (time-weighted) per-share fund returns and (dollar-weighted) returns that reflect what the funds actually earned for their owners. So let's examine the astonishing gap between those two figures during the recent stock market boom and subsequent bust.

Consider first the "hot" funds of the day—the twenty funds which turned in the largest gains during the market upsurge. These funds had a compound return of 51% per year(!) in 1996-1999, only to suffer a compound annual loss of –32% during the subsequent three years. For the full period, they earned a net annualized return of 1.5%, and a cumulative gain of 9.2%. Not all that bad! Yet the investors in those funds, pouring tens of billions of dollars of their money in *after* the performance gains began, earned an annual return of *minus* 12.2%, losing fully 54% of their money during the period.

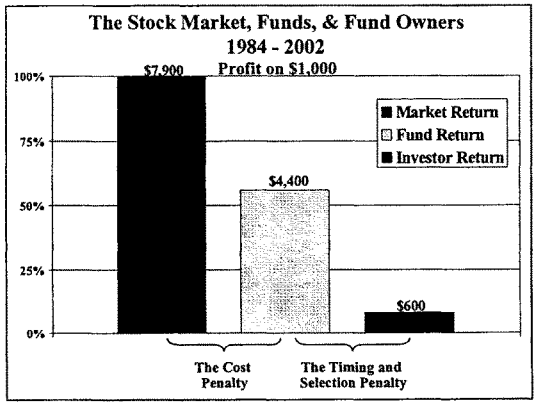
Now consider sector funds, specific arenas in which investors can (foolishly, as it turns out) make their bets. The computer, telecommunications, and technology sectors were the favorites of the day, but only until they collapsed. The average annual returns of 53% earned in the bull market by a group of the largest sector funds were followed by returns of minus 31% a year in the bear market, a net annual return of 3% and a cumulative gain of 19.2%. Again, not too bad. Yet sector fund *investors*, similar to the hot fund investors I described earlier, poured billions of dollars in the funds as they soared, and their annual return averaged –12.1%, a cumulative loss of 54% of *their* capital, too.

While the six-year annual returns for these *funds* were hardly horrible, both groups did lag the 4.3% annual return of the stock market, as measured by the largest S&P 500 Index Fund, which provided a 29% cumulative gain. But the investors in that index fund, taking no selection risk, minimized the stock market's influence on their timing and earned a positive 2.4% return, *building* their capital by 15% during the challenging period. Index investor +15%; sector fund and hot fund investor –54%. Gap: 69 percentage points. It's a stunning contrast.

How Selection and Timing Can Destroy Investor Returns

	Time-Weighted Returns			Dollar-Weighted Returns
	Avg. Ann. Return		Cum. Return	Cum. Return
	97-99	00-02	97-02	97-02
Hot Funds	51.4%	-32.0%	9.2%	-54.0%
5 Major Sector Funds	53.3%	-30.8%	19.2%	-54.0%
S&P 500 Index Fund	27.5%	-14.6%	29.2%	15.3%

Given these caveats about methodology, and these actual examples of how shareholders actually invested their dollars, the 2.6% return cited by Dalbar certainly *overstates* the annual return earned by the typical fund shareholder during a period in which the stock market return of 12.2% was virtually there for the taking. But let's assume that their figure is accurate, and wrap up the issue by calculating the *cumulative* compound return earned during the period: $1000 invested in the S&P Index at the outset would have grown by $7,900, $1000 in the average *fund* would have grown by $4,400; and $1000 for the fund shareholder would have grown by just $600—less than it would have grown in a savings account. No, most fund investors have *not* been given a fair shake.



It is the myriad conflicts between the interests of fund managers and the interests of fund owners that exist in this industry that bear so much of the responsibility for this staggering gap between the stock market's return and the returns earned by fund investors, and even the returns earned by the funds themselves. While the unacceptable, and partly illegal, market timing scandal has gained a great deal of well-deserved attention, it pales in significance when compared with the powerful impact of high costs on reducing fund returns, on the force of fund size in diminishing fund returns, and on the marketing focus that tempted too many investors to purchase funds that they now wish they had never bought.

These conflicts are severe, and unacceptable. They can be resolved only by implementing reforms in fund structure that create a governance model that puts the shareholders in the driver's seat, where all those years ago the Investment Company Act of 1940 insisted that they belong. Such structural reform must be our highest priority, and the sooner we get about the task, the better.

What's to be Done?

The current market timing scandals present an opportune moment for Congress to require serious reforms in the mutual fund industry, reforms that will enhance the information that fund investors receive, and reforms that will reduce the profound conflicts of interest that I've catalogued. Investors need Congress to help in dismantling today's incestuous conflict between managers and shareholders and building a shareholder-oriented board structure for mutual funds.

Before I turn to these governance issues, however, I'd like to take this opportunity to endorse House Bill H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act of 2003. The changes proposed in this bill represent a good first step. However, I believe that in some cases the bill does not go far enough. Specifically, I would recommend that the bill mandate that mutual fund companies provide their shareholders with a better estimation of the fees they pay each year for the funds they own. If mutual fund companies are able to multiply the fund's most recent expense ratio by $1,000 to provide a hypothetical cost figure (as H.R. 2420 currently proposes), they certainly have the technological capability to multiply that expense ratio by the shareholder's actual year-end balance. Such personalized disclosure would give shareholders a much better illustration of exactly how much their investment costs. I also endorse the full disclosure of soft-dollar arrangements and portfolio turnover rates.

But H.R. 2420 does not adequately address the conflicts that are inherent in the very structure of the mutual fund industry. To seriously reform the industry, we must amend the Investment Company Act of 1940 to require an independent board chairman (presently, that post is usually filled by a director affiliated with the fund's manager); we must limit the fund's manager to a single board seat; and we must enable the board to retain its own staff to provide information that is independent and objective. Further, we must have full disclosure of all compensation, including each individual's share of the management company's profits paid to senior executives and portfolio managers. It is also high time that the Congress demands an economic study of the mutual fund industry, showing the sources of management company revenue and the uses of management company expenditures. "Follow the money" is a necessary rule if regulators and investors are to come to grips with solutions to the conflicts I've recounted.

We also must establish a federal standard of fiduciary duty that requires fund directors to place the interest of the fund's shareholders first. The 1940 Act's preamble declares that funds must be "organized, operated, and managed" in the interest of their shareholders, rather than in the interests of fund "directors, officers, investment advisers, underwriters, or distributors." That is *not* the way the industry works today. Adding a requirement that "fund directors have a fiduciary duty" to carry out that noble purpose would be a major step forward for fund shareowners.

The preamble to the 1940 Act stated that investment companies are affected by a national public interest. Some 63 years later, that public interest is staggeringly large. Today, some 95 million Americans own mutual funds. The interests of those investors have indeed been "adversely affected" by the fund industry's structure and the behavior of its managers, precisely what the 1940 Act was designed to preclude. It is high time to put investors in the driver's seat of fund governance, and give them a fair shake.

Testimony of Mercer E. Bullard

President and Founder

Fund Democracy, Inc.

and

Assistant Professor of Law

University of Mississippi School of Law

before the

Subcommittee on Financial Management, the Budget,

and International Security

Committee on Governmental Affairs

United States Senate

November 3, 2003

Chairman Fitzgerald, Ranking Member Akaka, members of the Subcommittee, thank you for the opportunity to appear before you today to discuss alleged trading abuses in the mutual fund industry and actions needed to mitigate such practices in the future. It is an honor and a privilege to appear before the Subcommittee today.

I am the Founder and President of Fund Democracy, a nonprofit advocacy group for mutual fund shareholders, and an Assistant Professor of Law at the University of Mississippi School of Law. I founded Fund Democracy in January 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments. Toward this end, Fund Democracy has filed petitions for hearings, submitted comment letters on rulemaking proposals, testified on legislation, published articles on regulatory issues, educated the financial press, and created and maintained an Internet web site.

I. Introduction

Last June, I introduced my testimony before a House subcommittee with the following statements:

> More than 95 million Americans are shareholders of mutual funds, making mutual funds America's investment vehicle of choice. These shareholders have made the right decision. For the overwhelming majority of Americans, mutual funds offer the best available investment alternative.[1]

[1] Testimony of Mercer Bullard, Fund Democracy, Inc., before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, at p. 2 (June 18, 2003) at http://financialservices.house.gov/media/pdf/061803mb.pdf.

More than 95 million Americans still own mutual funds today, but they are no longer certain that they made the right decision, or that mutual funds offer the best available investment alternative.

Recent allegations of fraud have fundamentally altered Americans' perception of mutual funds. These allegations do not involve isolated instances of individual wrongdoing by low-level employees – the proverbially "few bad apples." These allegations appear to involve the majority of mutual fund complexes, and wrongdoing by a large number of employees, including, in some cases, the executives at the highest levels of management.

The usual ways in which we respond to such crises do not apply here. When frauds occur that could not reasonably have been anticipated, perhaps because of some previously unidentified legal loopholes, we can close the loopholes and forgive the stewards of the industry. Structural reform generally is not needed.

The alleged frauds in this case, however, were open and notorious and violated express legal requirements. Fund stewards were on notice and failed to take action. There are no significant legal loopholes to close or grounds to excuse a fundamental failure of compliance. These systemic frauds have exposed a compliance system that is not working and is in dire need of structural reform.

In this testimony, I have described the recently alleged frauds – stale pricing, late trading, market timing, and commission overcharges -- in Section II. Section III discusses the systemic nature of these frauds and explains why structural reform in the way mutual funds are regulated is necessary. Section IV describes specific actions that I

believe are necessary to protect investors and restore Americans' confidence in the mutual fund industry.

II. Description of the Alleged Frauds

A. Stale pricing

Stale pricing refers to the practice of pricing a fund's shares based on prices of portfolio securities that no longer reflect their market value. For example, consider a Hong Kong fund that holds securities traded on the Hong Kong Exchange. The Exchange closes at 3:00 am EST, but the fund prices its portfolio securities at 4:00 pm EST, at the close of the U.S. markets. If the fund manager prices the fund using closing prices on the Hong Kong Exchange, and nothing has affected the value of the securities during the 13 hours since the Exchange closed, then the fund's price reflects current market value. If events have occurred that affect the value of those securities, however, then the price will not reflect current market value.[2]

A number of academic studies have shown that such events often occur after the close of foreign exchanges, and that the effect of these events is very predictable.[3] The effect is so predictable, in fact, that professional and retail investors alike routinely

---

[2] Stale pricing also can occur in domestic funds that hold illiquid or infrequently-traded securities whose most recent trading price may be hours or days old.

[3] See, e.g., Conrad Ciccotello, Roger Edelen, Jason Greene & Charles Hodges, Trading at Stale Prices with Modern Technology: Policy Options for Mutual Funds in the Internet Age, 7 Va. J.L. & Tech. 6 (Fall 2002); Jacob Boudoukh, Matthew Richardson, Marti Subrahmanyam & Robert Whitelaw, Stale Prices and Strategies for Trading Mutual Funds, 58 Financial Analysts Journal (July/August 2002) at http://www.aimrpubs.org/faj/issues/v58n4/full/f0580053a.html; Eric Zitzewitz, Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds (October 2002) at http://faculty-gsb.stanford.edu/zitzewitz/Research/arbitrage1002.pdf; and William Goetzmann, Zoran Ivkovich & Geert Rouwenhorst, Day Trading International Mutual Funds (October 2000) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=217168.

purchase shares of foreign funds in the knowledge that the funds are undervalued and that their share prices will rise the next day when the higher value of the securities is reflected in closing prices on foreign exchanges.[4]

This is precisely what occurred, for example, in October 1997, when a sharp drop in Asian markets was followed by a rebound in the U.S. market. According to the Securities and Exchange Commission ("SEC"), "fairly large numbers of investors attempted . . . to take advantage [of stale prices] which promised potential gains in double digits."[5] The SEC has not disclosed the results of its investigation of the effect of stale pricing on this occasion, but Fund Democracy has estimated, applying the methodology used by the SEC, that some funds lost in excess of 2% of net assets.[6] This means that a shareholder with a $100,000 account would have lost more than $2,000 to traders ***in a single day***.

Stale pricing is a violation of the Investment Company Act. The Act expressly requires that when market quotations are not readily available, funds' portfolio securities must be fair valued "in good faith by the board of directors."[7] Market quotations are not readily available, for example, when events occurring after the close of a foreign

---

[4] Although prices that are too high can also be exploited by selling fund shares and then buying them back the next day, this is less frequent because traders typically prefer to have cash available to exploit trading opportunities as they arise, and therefore prefer not to have cash tied up in a single fund that can be used to exploit trading opportunities only in that fund.

[5] Address by Barry Barbash, Director, Division of Investment Management, Securities and Exchange Commission, before the ICI Securities Law Procedures Conference, Washington, D.C. (Dec. 4, 1997).

[6] Mercer Bullard, Your International Fund May Have the Arbs Welcome Sign Out, TheStreet.com (June 10, 2000); see also Mercer Bullard, International Funds Still Sitting Ducks for Arbs, TheStreet.com (July 1, 2000).

[7] Investment Company Act Section 2(a)(41)(B); see Investment Company Rule 2a-4(a)(1).

exchange have affected the value of the securities.[8] In that event, funds must update the value of the affected securities. Some fund firms routinely update their portfolio securities' prices, but as evidenced by the pervasive exploiting of stale prices uncovered by recent investigations, many do not.

B. Late Trading

Late trading refers to purchase and sales that occur after the fund has been priced, which is typically at 4:00 pm EST. It is similar in effect to exploiting stale prices. After a fund has been priced, that price may quickly become stale as events occur that affect the value of the fund's portfolio. For example, companies often announce their quarterly results after the close of the U.S. markets at 4:00 pm EST. If the announcements are positive and they involve companies held in a fund's portfolio, the 4:00 pm EST price will then be lower than the actual value of the portfolio after the announcements are made.

The Investment Company Act prevents traders from exploiting post-4:00 pm EST information by requiring that all purchases of fund shares be executed at their next calculated net asset value.[9] An order received by a fund at 3:59 must receive that day's 4:00 price. An order received by a fund at 4:01 must receive the next day's price.

The SEC has permitted orders to be received after 4:00 pm EST in certain situations. As a practical matter, brokers, pension administrators and other intermediaries

[8] See Investment Company Institute, SEC No-Action Letter (Apr. 30, 2001) ("If the fund determines that a significant event has occurred since the closing of the foreign exchange or market, but before the fund's NAV calculation, then the closing price for that security would not be considered a 'readily available' market quotation, and the fund must value the security pursuant to a fair value pricing methodology.").

[9] Investment Company Act Rule 22c-1.

often receive orders before 4:00 pm EST but are unable to transmit the orders to the fund until after 4:00 pm EST. In these cases, the fund receives the order after legal deadline.[10] Of course, the SEC has permitted such "backward pricing" on the condition that orders received by the fund after 4:00 were received by the intermediary before that time.[11]

Further, the SEC position assumes that orders received before 4:00 cannot be cancelled after 4:00. Otherwise, a trader could exploit positive information released after 4:00 by placing an order every day and then canceling the order each day that there was no post-4:00 information affecting the value of the portfolio or the post-4:00 information was negative.

Recent investigations have found that traders, in direct contravention of existing rules and SEC positions, have routinely submitted orders and/or cancelled fund orders after the time the fund was priced.

C. Market Timing.

Market timing is a term of art that, with respect to mutual funds, refers to frequent purchases and redemptions based on the trader's views about the relative short term performance of certain market sectors, asset classes or other broad categories of investments.[12] For example, there are market timing newsletters that make

---

[10] According to a complaint filed by the New York Attorney General, some funds have given the same day price to orders received as late as 9:00 pm EST, State of New York v. Canary Capital Partners, LLC (Sep. 3, 2003), and some press reports suggest that some funds do so for orders received as late as 11:00 pm EST.

[11] Charles Schwab & Co., Inc., SEC No-Action Letter (July 7, 1997).

[12] Recent news reports have used the term "market timing" to describe frequent trading conducted for the purpose of exploiting stale prices. This use of the term is inaccurate and risks confusing and thereby improperly limiting the ultimate responsibility of fund managers for using stale prices. For example, some fund managers have stated that they intend to compensate funds for any harm resulting from "market timing" but have said nothing about compensating funds for dilution resulting from stale pricing. See, e.g., Letter from Richard M. DeMartini to Nations Fund Shareholders (Sep. 19, 2003) (promising restitution for harm caused by "discretionary market-timing agreements") at http://www.bankofamerica.com/nationsfunds/pdf/press_release.20030919.pdf.

recommendations regarding which categories are expected to outperform in the short-term, and there are mutual fund families that cater specifically to market timers.[13]

Traders who exploit stale prices and engage in late trading also are market timers, but there is no necessary connection between market timing and the two frauds. Such traders are market timers, that is, frequent traders, because trading in and out of the fund promises them the greatest profit for the least risk. Their goal is to remain invested in a fund only as long as necessary to collect their risk-free profits and to minimize their exposure to fluctuations in the value of a fund's portfolio.

Permitting market timing is, by itself, legal. Permitting market timing in contravention of a fund's stated trading policies, however, violates the federal securities laws. Some fund prospectuses state, for example, that the fund does not permit frequent trading in fund shares.[14] The purpose of these policies is to hold down fund costs; they are not required by law. Market timers can increase fund costs because a fund must spend more on processing transactions in fund shares and investing fund assets. Market timing also can adversely affect a fund's investment performance by disrupting the management of its portfolio. Another benefit of market timing restrictions is that they limit the ability of traders to exploit stale prices or engage in late trading, although the best protection against these frauds is, of course, to accurately price the fund and to reject trades that were placed after the fund was priced.

---

[13] Two examples are the ProFunds and Rydex fund complexes.

[14] See , e.g., Prospectus for the Vanguard U.S. Stock Index Funds at 52 (July 3, 2003) (limiting round trips to two per 12-month period and requiring 30 days between round trips).

Recent allegations have revealed that many fund complexes, perhaps even a majority, have permitted market timing and have even entered into market timing arrangements with selected traders. These arrangements can violate the securities and general antifraud laws to the extent that they are not consistent with the fund's stated policies. They also can be illegal if the special treatment afforded to the traders violates the fund manager's or another participant's fiduciary duty to the fund.[15]

D. Commission Overcharges

Another fraud that was uncovered prior to the current mutual fund scandal is the systematic withholding of discounts on commissions from qualified investors. Mutual funds frequently offer discounts on sales commissions that are based on volume, which are known as "breakpoints." For example, a $10,000 purchase might incur a full 4% sales commission, whereas a $100,000 purchase might be charged only 2%. A $1,000,000 purchase typically would not be charged any commission.

Funds often permit purchases by different accounts, by different family members, and in different funds in the same fund complex to be aggregated for purposes of calculating the breakpoint. Some funds also permit purchases made over time to be aggregated for breakpoint purposes. Other, more complex circumstances in which shareholders are entitled to breakpoints are summarized in a joint SEC/NASD/NYSE report released earlier this year.[16] The calculation of breakpoints can thus require fairly

[15] There is not, however, a general duty to treat all shareholders equally. Fund shareholders are routinely treated differently based on, for example, the size of their accounts, the size of their initial investments, and, as indicated by market timing policies, the frequency of their trading.

[16] Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds (March 2003) at http://www.sec.gov/news/studies/breakpointrep.htm.

complex monitoring systems in order to ensure that investors actually receive the breakpoints to which they are entitled.

Between November 2002 and January 2003, the SEC, NYSE and NASD conducted a joint inspection of 43 broker-dealers to determine whether shareholders had received the breakpoints to which they were entitled. The regulators found that shareholders were systematically overcharged by the broker-dealers. They found that shareholders were overcharged with respect to 32% of transactions that were eligible for discounts. Of the 43 firms, only two were found not to have overcharged any shareholders. Three broker-dealers were found to have overcharged shareholders in every single instance in which discounts should have been applied. The average amount by which shareholders were overcharged was $364.

III. A Systemic Compliance Failure

The frauds described in the immediately preceding section represent a systemic compliance failure in the fund industry. Each of these frauds reflects a failure to ensure that there are compliance procedures in place that are reasonably designed to protect shareholders, and that steps are taken to ensure that the procedures are working. None of these frauds is surprising in the sense that the fraud reflects an unknown vulnerability in the operation or regulation of mutual funds. Each of these frauds was predictable and could and should have been prevented simply by enforcing minimal compliance standards.

A. Stale Pricing

The use of stale prices is so widely known that many retail investors routinely exploit international and other funds by buying shares after upswings in U.S. markets. In one case, 28 members of the Boilermakers Local Lodge No. 5 of New York each executed 150 to 500 trades in Putnam funds over a three-year period.[17] They realized profits ranging from $100,000 to $1,000,000 by exploiting stale prices. These profits came directly out of the pockets of the other 916 members of their union who were invested in the funds and other fund shareholders.

The opportunities offered by stale prices have been discussed in Internet bulletin boards and personal finance magazines.[18] A stream of academic studies have demonstrated that U.S. mutual funds lose hundreds of millions, if not billions, of dollars each year as a result of stale prices.[19] In 2000, I published two articles describing the stale pricing problem in which I estimated that stale prices could cost a fund in excess of 2% of its assets in a single day.[20] In 1997, the SEC examined a number of funds that had used stale prices and found that "fairly large numbers of investors attempted . . . to take advantage [of stale prices] which promised potential gains in double digits."[21]

The problem of stale pricing has been successfully addressed by some fund firms. Vanguard, Fidelity and other fund complexes regularly fair value their portfolios when

---

[17] In the Matter of Putnam Investment Management, LLC, Docket No. E-2003-061.

[18] See, e.g., Jill Andresky Fraser, Short Term, Long Enough, Bloomberg Personal Finance at 95 (Sep. 2000) (describing how to exploit stale prices).

[19] See supra note 3.

[20] See supra note 6.

[21] Barbash, supra note 5.

events occurring after the close of foreign markets affect the accuracy of closing prices on foreign exchanges. For some years, independent pricing firms have offered services to funds that enable them to update their prices to reflect such events. The SEC staff has on two occasions described the tools that funds can use to ensure that their portfolios are accurately valued.[22]

Despite the fact that the problem of stale pricing has been widely recognized and, by some fund complexes, successfully addressed, it is clear based on recent revelations that traders have routinely exploited stale prices to the detriment of shareholders of a large number of funds. These funds' managers have been aware that their funds' prices were stale, as further evidenced by aggressive market timing by some fund shareholders. In some cases, fund management allegedly colluded with traders to take advantage of stale prices and even loaned traders the money they used to cheat the fund's shareholders. In at least one case, the portfolio managers themselves alleged exploited stale prices of the very funds that they managed.[23] In another case, the chief executive officer of the fund manager allegedly exploited the stale prices of funds of which he was the chairman.[24]

Further, these funds' directors failed to satisfy minimum standards of compliance oversight. These directors should, at a minimum, have regularly reviewed funds' pricing policies to ensure that they were designed to prevent stale pricing and required periodic spot checks to determine whether the procedures were working. These spot checks

---

[22] Investment Company Institute, SEC No-Action Letters (Dec. 8, 1999 & Apr. 30, 2001).

[23] See supra note 17.

[24] Tom Lauricella, Probe Hits Strong's Chairman: Investigators Say Firm's Founder Engaged in Improper Trading, Wall Street Journal (Oct. 30, 2003).

would include, for example, comparing prices of the complex's international funds to prices of similar funds in other complexes or prices calculated by outside pricing services, and monitoring fund inflows and outflows to determine whether market timers were exploiting stale prices. Although fund directors cannot reasonably be expected to detect individual instances of fraud, their primary responsibility is to detect and prevent the kind of widespread abuses uncovered in recent investigations.

B. Late Trading.

The potential problems of late trading were even more obvious than stale pricing. For years, funds have routinely received orders after 4:00 pm EST. There is no basis for claiming, nor have any fund managers attempted to claim, that they were unaware that orders were received after 4:00 pm EST. Fund managers expressly authorized this practice.

In view of fund managers' and directors uncontradicted knowledge of the receipt of orders after 4:00 pm EST, it was incumbent upon them to ensure that there were procedures in place that were reasonably designed to detect and prevent orders from being placed or cancelled after 4:00 and to take steps to ensure that these procedures were working. It is self-evident that, given the opportunity, some traders will attempt to take advantage of opportunities to profit from late trading (as evidenced by ongoing investigations).

Some fund executives have suggested that protecting fund shareholders against late traders is not the fund manager's or director's responsibility when trades are executed through omnibus accounts. In this situation, an intermediary is responsible for processing fund transactions, and the only trade with the fund is a single order that nets

all of the trades of persons who invest through the omnibus account.[25] Although the presence of an omnibus account may create an additional layer of compliance for a fund manager and fund board, it in no way relieves them of their fundamental responsibility to protect fund shareholders.

Fund managers and fund boards must take steps to ensure post-4:00 pm EST trades are placed before 4:00 and cannot be arbitrarily cancelled. The SEC has permitted funds to receive orders after 4:00 pm EST on the condition that the fund's directors ensure that the orders originate before 4:00. In a letter to Charles Schwab & Co., Inc., in which the SEC authorized Schwab to submit orders after 4:00, the SEC stated that the fund's "board of directors should consider whether Schwab has adopted and implemented internal controls reasonably designed to prevent customer orders received after the Fund's Pricing Time from being aggregated with the orders received before the Fund's Pricing Time."[26] The SEC also stated that the fund directors also should consider whether third parties designated by Schwab to receive orders have internal controls designed to ensure that late trades originated before the fund is priced.

C. Market Timing.

The problem of market timing is so notorious that many funds have adopted trading policies that are designed to combat market timing and have disclosed these policies in their prospectuses. It cannot have been a surprise to fund managers or directors that many investors would seek to trade in and out of their funds.

---

[25] Such omnibus accounts would include employee benefit plans, such as 401k plans, accounts held in street name by a broker-dealer, and accounts held by fund supermarkets, such as Schwab's Mutual Fund OneSource service.

[26] See supra note 11.

Nor can fund managers or directors have been ignorant of the prevalence of frequent trading in their funds. Funds have direct knowledge of daily cash flows in and out of their funds, and it is difficult to imagine, in light of the high profile of the market timing problem, how such cash flows could not have been the subject of constant and careful analysis by fund managers and directors. At a minimum, fund managers and directors must ensure that there are procedures in place that are reasonably designed to protect shareholders against inappropriate market timing and to conduct regular checks to ensure that these procedures are working. Reports that half of the 80 fund complexes subpoenaed in connection with ongoing investigations may have market timing arrangements with some investors and that half of those complexes have anti-market timing policies is evidence that the most fundamental elements of effective compliance -- standardized procedures and periodic verification -- were routinely ignored.

Some have suggested, as similarly suggested with respect to late trading, that fund managers and directors should not be held accountable for frequent trading conducted through omnibus accounts. For the same reasons discussed above, these arguments are incorrect. Further, omnibus accounts are permitted to invest in funds only with the funds' permission, and such investments should not be permitted on the condition that the beneficiaries be allowed to trade in and out of the fund to the detriment of other shareholders.

Further, patterns of frequent trading in omnibus accounts are, in fact, detectable. For example, Putnam was able to detect frequent trading by a deferred compensation plan for which a third party acted as the administrator. As indicated in exhibits to the Mass. Secretary of State's complaint, the deferred compensation plan resisted Putnam's request

to eliminate frequent trading, thereby illustrating that ultimate responsibility for protecting fund shareholders does and must lie with fund managers and directors.

D. Commission Overcharges.

It is fundamental to a fund manager's or director's duty to protect fund shareholders that he take steps to ensure that shareholders are not overcharged. Nowhere is the potential for fraud or embezzlement greater than when persons are able to collect their fees or commissions directly from the amount of a purchase or a shareholder's account. This is especially true in the context of mutual fund purchases, where, unlike virtually every other type of securities transaction, the SEC has exempted brokers from disclosing to shareholders they amount that the broker was paid in connection with the transaction.[27]

It is incumbent upon fund managers and directors to establish procedures that are reasonably designed to ensure that investors are not overcharged, and to require periodic checks to ensure that the procedures are working. The procedures might include regular, independent audits of fees charged to shareholders and occasional sampling to determine whether the audits were effective. It is precisely this kind of sampling that was conducted by regulators and revealed an extraordinary record of overcharges.[28] Regulators cannot police every fund and every broker; effective compliance must begin at individual firms.

E. A Systemic Compliance Failure

The frauds discussed above demonstrate a systemic breakdown in compliance systems in the mutual fund industry. This is not intended to suggest that fund managers

[27] SEC Report at 80.

[28] See supra discussion at pp. 9 -- 10.

and directors should be expected to catch every fraud, to detect every frequent trader, to price every foreign security perfectly, day in and day out. This is not the standard to which fund managers and directors are or should be held. Indeed, when brokers process millions of fund transactions, it is to be expected that shareholders will occasionally be overcharged, and in some cases they may be overcharged intentionally. But the extraordinary incidence of overcharges found by regulators exceeds the inevitable glitches that any complex system will produce. For example, investors entitled to breakpoints would almost have had a better chance of not being overcharged if they had flipped a coin. In some cases, such investors had a 100% chance of being overcharged. The overcharges, along with the failure to detect and protect the other alleged frauds, demonstrate a systemic failure of compliance.

The frauds described above have been shown not to be isolated incidents. They reflect widespread abuses occurring at a large number of fund complexes that in a number of cases involve upper level management. Fund managers and directors knew or should have known that their funds were using stale prices, and some even assisted investors in exploiting these prices. They knew or should have known that late trading was occurring, and some even helped late traders process their transactions. They knew or should have known that traders were market timing their funds, and some even negotiated deals to facilitate this practice. They created a system of awarding breakpoints that was complex and plainly susceptible to abuse, yet in some cases investors had a 0% chance of receiving the breakpoints to which they were entitled.

IV. Mutual Fund Reform

These frauds necessitate prompt and forceful action by Congress. In this section, I propose certain measures that are needed to strengthen the independence and authority of fund directors. Strengthening measures, however, are not sufficient. These frauds reflect a systemic compliance failure in the sense that the current structure of fund oversight is not resulting in fund shareholders receiving the most fundamental and obvious forms of protection from actual and potential abuses that have been known to regulators and the fund industry for years. If shareholders are not being protected from the most obvious frauds, they cannot have any confidence that they are being protected from frauds that we have yet to or may never discover. I therefore strongly recommend that Congress create a Mutual Fund Oversight Board, as also described in Section IV below.

Finally, Congress should adopt long overdue reforms to ensure that fund fees and expenses are fully disclosed. These reforms, which already have been passed by the House Financial Services Committee, are critical to restoring investors' confidence and promoting competition in the mutual fund industry. Mutual funds have historically maintained a higher standard of ethics and professionalism than any other financial services provider. This high standard is attributable, in part, to the relative transparency of their fees and the strict regulatory regime under which they operate. The current scandal, however, has severely damaged their reputation, perhaps irreparably. Congress should take immediate steps to restore Americans' trust in this once proud industry.

A. Independent Fund Directors

As discussed above, recent frauds demonstrate systemic weaknesses in mutual fund compliance. These systemic weaknesses require immediate steps to strengthen the independence and authority of independent mutual fund directors, and the creation of a regulatory structure designed to ensure that fund boards of directors fulfill their responsibility to protect shareholders.

As this subcommittee is aware, virtually all mutual funds are essentially a board of directors that oversees a nexus of contracts with different service providers. Recent frauds have implicated a variety of different legal requirements applicable to these service providers, but all of the frauds share a common element: the failure of mutual fund boards to satisfy fundamental standards of compliance oversight. I strongly recommend that Congress adopt the following requirements to restore Americans' confidence in mutual funds and ensure that the industry never again engages in frauds of the kind and scope that have recently been brought to light.

1. Independent Chairman

Congress should require that the chairman of a fund's board of directors be independent. As often noted by the Commission, a mutual fund is effectively dominated by its adviser,[29] and this fact necessarily compromises the control normally exercised under state law by a board of directors. To compensate for this imbalance, it follows that additional requirements, beyond those provided under state law, are necessary for the board to effectively police the adviser's conflicts of interest and protect shareholders.

[29] See, e.g., Role of Independent Directors of Investment Companies, Investment Company Act Rel. No. 24082, at Part I (Oct. 15, 1999) ("investment advisers typically dominate the funds they advise").

These additional requirements have become especially important in light of recently alleged frauds perpetrated, in part, by fund managers and, in one case, the chairman of the fund's board. It is self-evident that, where such frauds may be perpetrated by a service providers to a fund, an executive of that service provider cannot provide objective leadership to the fund's board. There is an inherent conflict between the board's duty to evaluate the adviser's conflicts of interest on the one hand, and the appointment of an employee of the adviser as the board's chairman on the other. Requiring that the chairman be independent will remove this conflict and ensure that the fund's independent directors have complete control over the board.

The Commission staff has suggested that an independent chairman is unnecessary because the independent directors already can "influence the agenda and the flow of information to the board."[30] It is not enough, however, that the independent directors "influence" the information they receive; nor is the staff's position consistent with the principle underlying directors' affirmative statutory duty to "request and evaluate" the information necessary to evaluate the advisory contracts.[31] Indeed, the staff's suggestion that fund boards designate a "lead independent director" acknowledges the need for independent directors to exercise authority beyond that afforded by their numerical superiority. Formally appointing an independent director as chairman would better fill that need.[32] There can be no better demonstration of this fact than recent allegations that

[30] Memorandum from Paul Roye, Director, Division of Investment Management, to William Donaldson, Chairman, Securities and Exchange Commission, at 50 (June 9, 2003) ("SEC Report").

[31] See Investment Company Act Section 15(c).

[32] For further discussion of the reasons that an independent board chairman is necessary, see Letter from Mercer Bullard, Fund Democracy, Inc., to the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Enterprises, U.S. House of Representatives, at pp. 8 – 11 (July 9, 2003).

the chairman of the board of the Strong fund complex, who is also the chief executive officer of the fund manager, personally engaged in market timing the funds whose boards he commanded for the purposes of exploiting stale prices.

The Commission's position also contradicts current trends in corporate governance. Recent corporate scandals have caused leaders in corporate law and practices to reconsider common assumptions about corporate governance. In June 2002, for example, The Conference Board convened the Commission on Public Trust and Private Enterprise to "address the causes of declining public and investor trust in companies, their leaders and America's capital markets."[33] In its report, the Commission on Public Trust specifically recommended that the position of board chairman not be held by a member of management.[34]

If we are to learn anything from alleged frauds in the fund industry, it is that accepted standards of conduct for funds' boards of directors need to be reexamined. I recognize that requiring that a chairman be independent in law will not guarantee that he or she will be independent in fact, but it is beyond dispute that -- all things being equal -- a legally independent chairman is more likely to be truly independent than a person with ties to management.

[33] Findings and Recommendations, The Conference Board Commission on Public Trust and Private Enterprise (Jan. 9, 2003).

[34] Id. at 21.

2. Authority and Representation of Independent Directors

Congress also should take steps to ensure that independent directors have the authority and representation necessary to counter the domination of the fund's manager. As discussed immediately above, mutual funds have a uniquely conflicted structure that necessitates an especially strong and independent board. Congress should take five steps to improve the effectiveness and independence of independent fund directors

The first two steps are related. First, Congress should increase the minimum percentage of independent directors on a fund board from 40% to 75%.[35] Second, Congress should prohibit any fund from requiring that board action necessitate the approval of a non-independent board member. This second step is necessary to prevent the circumvention of the independent directors' 75% control, for example, by adopting a provision that requires the approval of 80% of the board for any board action. These measures, in tandem, will ensure that independent fund boards have the authority to act when necessary to address conflicts of interest and detect and prevent fraud.

Third, Congress should ensure that fund directors actually "represent" fund shareholders in a meaningful way. Many current fund directors have never been approved by shareholders. Mutual funds normally do not have annual shareholders meetings, and fund directors typically are appointed for an indefinite term. Congress should prohibit any person from counting as an independent director unless that person has been approved by shareholders at least once every five years.

---

[35] As a practical matter, SEC rules virtually require that all funds have a majority of independent directors. See Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001). This is not, however, a statutory minimum.

Fourth, Congress should require that independent directors be found annually by a majority of the other independent directors, after reasonable inquiry, not to have any material business or familial relationship with the fund or any significant service provider to the fund that is likely to impair the independence of the director.[36]

Finally, Congress should require that independent directors form a committee of their peers that shall have responsibility for selecting and nominating independent directors.[37] This committee should be required, at a minimum, to adopt qualification standards for the selection of nominees that are disclosed in the fund's registration statement.[38]

3. Definition of Independent Director

Without an adequate definition of independence, no law can ensure that independent directors will be effective advocates for fund shareholders. In many respects, the current definition of independence permits persons with significant conflicts of interest to serve as independent directors.[39]

Congress should amend the standard for independent directors to disqualify the following persons:

- any natural person who has served as an officer or director, or as an employee within the preceding ten years, of an investment adviser or principal underwriter to the fund, or of any entity in a control group with

[36] See Amendment No. 2 to the NYSE's Corporate Governance Proposals (Oct. 8, 2003) at http://www.nyse.com/pdfs/amend2-10-08-03.pdf (recommending that corporate boards be required to find that independent directors have no material relationship with the company and to disclose these determinations).

[37] Id. (recommending that corporate boards be required to nominating committee that identifies director qualification criteria).

[38] Id.

[39] SEC Report at 47 – 48 (describing independent fund director relationships "that suggest a lack of independence from fund management").

the adviser or underwriter; and

- any natural person who has served as an officer or director, or as an employee within the preceding 10 years, of any entity that has within the five preceding years acted as a significant service provider to the fund, or of any entity in a control group with the service provider.[40]

Furthermore, Congress should authorize the SEC to prohibit any class of persons from serving as independent directors who the SEC determines are unlikely to exercise an appropriate degree of independence.

4. Mutual Fund Oversight Board

Although the proposals discussed above will strengthen fund boards, they will not be adequate to ensure that the kinds of frauds discussed above do not reoccur. These frauds reflect a failure by independent fund directors that cannot be explained solely by a lack of independence or authority. These frauds reflect systemic compliance failures that require structural changes in the way that fund boards are regulated.

Recent frauds demonstrate that the Commission staff has too many responsibilities and not enough resources to provide adequate oversight of fund boards. I strongly recommend that Congress create a Mutual Fund Oversight Board that would have examination and enforcement authority over mutual fund boards. The Board would be charged with identifying potential problems in the fund industry and ensuring that fund boards are actively addressing these problems before they spread.

The Board would be financed from assessments on mutual fund assets to provide an adequate and reliable source of funding. Board members would be persons with

[40] See SEC Report at 47 (noting that a former fund management executive can serve as an independent director two years after retiring from his position); Report of the Advisory Group on Best Practices for Fund Directors, Investment Company Institute, at 12 – 14 (June 24, 1999) (recommending that former officers and directors of a fund's investment adviser or principal underwriter not serve as independent directors).

specific expertise in the fund industry and would be appointed for five year terms by the Commission to ensure their independence. This model, which ideally combines the strengths of independent, expert oversight with the advantages of a reliable and adequate funding source, would do more to restore confidence in the fund industry and protect fund shareholders than any changes in the makeup, qualifications or authority of fund boards.

B. Fees and Expenses

Congress also should act promptly to eliminate two major gaps in mutual fund fee disclosure: portfolio transaction costs and compensation paid to brokers for selling fund shares. As discussed below, current SEC rules and positions provide investors with a misleading picture of the costs of fund ownership and the incentives of brokers from whom they buy fund shares. With America's investors experiencing a crisis in confidence in the mutual funds, fee disclosure reform is more important than ever.

1. Portfolio Transaction Costs

As stated by the Commission, "fund trading costs incurred in a typical year can be substantial."[41] The Commission cites studies that estimate that brokerage commissions alone cost about 0.30% of equity funds' net assets.[42] Other studies estimate that market spread, or the amount by which the price of a security is marked up or marked down, costs about 0.50% of equity funds' net assets, and that "opportunity costs may amount to 0.20% of value."[43]

---

[41] SEC Report at 19.

[42] Id. at 22.

[43] Id.

Another study found that the mean brokerage and market spread costs for a sample of equity funds was 0.75% of assets, or almost three-quarters of the mean expense ratio of 1.09%.[44] The brokerage and spread costs constituted an even larger percentage of the total costs of funds with the highest trading costs, with mean brokerage and spread costs equaling 1.54% of assets and the mean expense ratio equaling only 1.24%.[45] Thus, portfolio transaction costs can be the single largest fund expense, exceeding all other fund expenses combined. These costs are not, however, included in fee information provided in the prospectus. Transaction costs vary greatly among funds, and full disclosure of these expenses will help hold fund advisers accountable for their trading practices.

Fuller disclosure of portfolio transaction costs also will provide a collateral benefit in connection with funds' soft dollar practices. In short, transaction cost disclosure will subject fund expenditures on soft dollar services to market forces, and thereby provide a practical solution to the problem of regulating soft dollar practices.[46] For some transaction costs, fashioning disclosure rules will be a relatively easy task. Fund brokerage commissions already are disclosed in the Statement of Additional Information as a dollar amount. Converting this dollar amount to a percentage of assets and including it with other expenses in the expense ratio in the fee table would be simple and inexpensive.[47]

---

[44] Chalmers, Edelen & Kadlee, Fund Returns and Trading Expenses: Evidence on the Value of Active Fund Management (Dec. 29, 2001).

[45] Id.

[46] For further discussion of this benefit, see Bullard Testimony, supra note 1, at pp. 10 – 13.

[47] Accord, SEC Report at 28.

Providing disclosure regarding other types of transaction costs will be more difficult, but no less necessary. There are no standardized methods for calculating spread costs, market impact or opportunity costs. Nor are these concepts, unlike fund brokerage, generally understood by the investing public. Nonetheless, the Commission has been able to develop effective, standardized, quantitative disclosure tools in other contexts, such as funds' investment performance and expense ratios. There are a number of private companies that already provide fund advisers with quantitative assessments of their funds' transaction costs for self-evaluative and board review purposes.[48] The SEC's inspection staff routinely considers these quantitative assessments when evaluating a fund adviser's obligation to obtain best execution of fund transactions. It should not be difficult, over time, to develop quantitative tools to measure fund transaction costs and disclosure formats that will provide this information in a way that helps investors understand these costs.

The Commission has objected to the disclosure of fund portfolio transaction costs on the grounds that the disclosure of brokerage commissions, while easily comparable and verifiable, would be incomplete, and the disclosure of other components of transaction costs, while completing the transaction cost picture, would not lack comparability.[49]

This objection misunderstands the purpose of fee disclosure rules. The purpose of fee disclosure rules is to ensure that investors have the information they need to make informed investment decisions. Thus, the issue is not whether the disclosure is

---

[48] Id. at 21-22

[49] Id. at 20-22 & 28-35.

theoretically perfect or complete, but rather whether it provides information that facilitates better investment decisions.

For example, Commission-mandated standardized investment performance is imperfect and incomplete in a number of ways. It is calculated net of fees, notwithstanding that this does not accurately portray a fund adviser's pure stock picking ability before expenses. It arbitrarily measures performance at 1-, 5-, and 10-year intervals, and not periods in between. It is based on only one of a number of different methods of calculating an internal rate of return. In advertisements, it is permitted to show the returns of a single class, even though the performance of other classes may have been different.

Similar observations could be made about imperfections in the fee table. Indeed, one drawback of the expense ratio is that it is incomplete, and including commissions would make it a more complete measure of the cost of fund investing. Both standardized performance and the fee table have provided an undisputed net benefit to shareholders, notwithstanding their theoretical inadequacies.[50]

The fact that there is more than one way to calculate the different components of fund transaction costs is not a reason to deprive shareholders of useful information about these costs. The Commission has suggested enhanced disclosure of funds' turnover ratios as an alternative to disclosure of actual transaction costs. Using the turnover ratio

[50] Indeed, the same observations could be made about the SEC's preference for turnover rates as a proxy for portfolio transactions costs. Chalmers, supra note 44 (demonstrating that fund turnover is not a reliable proxy for fund trading expenses). If an imperfect, indirect measure of transaction costs such as portfolio turnover is to be used, it is unclear why a direct measure, such as commissions, spread costs, market impact or opportunity costs would not be preferable.

as a proxy for transaction costs, itself an imperfect measure, would be an inferior and inadequate substitute for disclosure of actual transaction costs.[51]

2. Brokers' Compensation

The purpose of prospectus disclosure is to inform investors about the cost of investing in a fund. In contrast, the purpose of disclosure made at the point-of-sale is to inform investors about the economic motives of the person (referred to herein as the "broker") recommending the fund. Rule 10b-10 under the Securities Exchange Act accordingly requires that brokers disclose, to purchasers of securities, "the source and amount of . . . remuneration received or to be received by the broker in connection with the transaction." This disclosure is known as the "trade confirmation" or "confirm." The Commission has, ill-advisedly, taken the position that Rule 10b-10 does not apply to sales of mutual fund shares.[52]

The prospectus does not disclose all of the compensation that may be paid to brokers for selling fund shares.[53] Even the compensation that is disclosed has no necessary relationship to the amount paid to a broker in a particular transaction. For example, the prospectus for two different mutual funds may show that an investor will pay the same front-end load of $500 on a $10,000 investment, but the broker selling the funds may be paid more for selling one fund over another.[54] The broker payout for both of these funds may be lower than for a fund with a 1.00% 12b-1 fee, for which brokers

---

[51] Id.

[52] SEC Report at 80.

[53] For further discussion of the disclosure of disclosure of compensation paid to brokers in the registration statement, see Bullard Testimony, supra note 1 at pp. 13 – 15.

[54] See Lauricella, Investment Firm's Portfolios Get Priority Despite Rules: 'The Home Field Advantage,' Wall Street Journal (May 22, 2003).

often receive a flat, upfront payment substantially in excess of the amount of 12b-1 fees that the shareholder will pay in the course of a single year. The broker also may receive payments directly from the fund adviser or compensation in the form of fund portfolio brokerage commissions.

If an investor buys shares of IBM or Dell, his broker must send a confirm that shows how much the broker was paid in connection with the transaction. In contrast, if an investor buys shares in a mutual fund, the confirm is not required to provide this information. For a number of years, the Commission has stated that it recognizes this problem and is studying possible solutions.[55] It is time for Congress to overrule the SEC's position that Rule 10b-10 does not apply to sales of fund shares and require that all compensation received by brokers in connection with sales of fund shares be disclosed on fund confirmations, as well as any information necessary to direct investors' attention to incentives that a broker may have to prefer the sale of one fund over another. Further, in light of regulators' discovery that brokers routinely fail to credit investors with commission breakpoints, see supra p. 16, Congress it should consider whether fund confirms should include a separate box that shows the breakpoint schedule and how it was applied to the purchase.

[55] In February 2000, the Commission conceded that current rules fail to require disclosure of payments received by brokers for recommending fund shares and stated that it had directed its staff to make recommendations on how to fix this problem. See Brief of the Securities and Exchange Commission, Amicus Curiae, in Donald Press v. Quick & Reilly, Inc. (2d Cir.)(Feb. 2000). Almost four years later, the Commission has taken no action to remedy this gap in fund disclosure. In a report issued by the Commission on June 9, 2003, the staff restated that it had been "directed . . . to make recommendations" but provided no indication that it was any closer to making recommendations than it was in early 2000. SEC Report at 80.

C. Portfolio Manager Compensation

Congress should require that the amount and structure of portfolio managers' compensation be disclosed ("portfolio manager" hereinafter includes the portfolio management team). In many cases, the frauds described above have involved the portfolio managers of the affected funds. No one stands in a stronger fiduciary relationship with a fund than the person responsible for the actual management of the fund's portfolio. Portfolio managers often have conflicts of interest, however, and these conflicts of interest may be specifically related to their compensation.

The SEC staff has noted that whether a portfolio manager's compensation turns on short-term or long-term, or pre-tax or after-tax performance may indicate whether the manager's and the shareholder's interests are aligned.[56] Whether a portfolio manager is compensated for services provided to other mutual funds or other fund or non-fund clients, or for providing other outside services generally, also is highly relevant to shareholders who wish to evaluate the manager's commitment to a fund and the presence of conflicts of interest that the manager may have as a result of outside duties.[57] Disclosure of portfolio managers' compensation will cause fund managers to minimize such conflicts and enable shareholders to judge for themselves whether portfolio managers' are aligned with their interests.

---

[56] SEC Report at 43.

[57] See Remarks by Paul Roye, Director, Division of Investment Management, before the ALI/ABA Investment Company Regulation and Compliance Conference (June 14, 2001)("As many mutual fund managers look to generate revenues by expanding into other areas of the investment management business such as offering private accounts or sponsoring and advising hedge funds and other alternative investment vehicles, they should be mindful that certain of these new opportunities raise conflict of interest issues and the potential for abuse.").

Requiring disclosure of portfolio manager compensation is not a novel concept. Indeed, for years publicly held companies have been required to disclose the compensation of their highest paid executives. Many mutual fund managers have been exempt from this requirement because the managers' executives work for a separate entity from the fund that is not publicly held. Nonetheless, the policies favoring disclosure of executive compensation by operating companies apply equally to mutual funds.

Executive compensation rules need to be adapted, however, to reflect the particular structure of mutual funds. Mutual funds typically do not pay their executives, as these executives are employed and compensated by funds' managers. In addition, the manager's highest paid executives usually are not the personnel who have the greatest impact on the fund's performance. Thus, the executive compensation most relevant to mutual fund shareholders is that compensation received by the fund's portfolio manager or portfolio management team.

STATEMENT OF MATTHEW P. FINK

PRESIDENT

INVESTMENT COMPANY INSTITUTE

BEFORE THE

SUBCOMMITTEE ON FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY

COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

ON

"MUTUAL FUNDS: TRADING PRACTICES AND ABUSES THAT HARM INVESTORS"

NOVEMBER 3, 2003

EXECUTIVE SUMMARY

- The bedrock principle of the mutual fund industry is that the interests of investors always come first. Consequently, the industry has reacted with shock and outrage to recent allegations of abusive mutual fund trading practices.

- Forceful steps must be taken immediately to restore and reinforce investor confidence. SEC Chairman Donaldson has laid out a blueprint for regulatory reform. The Institute has formed task forces to provide the SEC with a range of possible options to address the alleged abusive mutual fund trading practices.

- ***Late Trading.*** The Institute believes that the most effective solution to protect against the possibility of late trading would be to require that all purchase and redemption orders be received by a fund (or its transfer agent) before the time the fund prices its shares (*e.g.*, 4:00 p.m. Eastern time). This approach would significantly limit opportunities for late trading and enhance compliance oversight by funds and regulators.

- ***Market Timing.*** Market timing is not inherently illegal or improper, but because it can be disruptive to portfolio management and can increase trading and administrative costs, funds often employ methods to deter such activity. It has been alleged that some funds were not applying their market timing policies fairly and consistently, and even worse, that some fund insiders may have engaged in market timing, reaping personal benefits at the expense of other shareholders.

    - The SEC is considering various regulatory measures in this area, including (1) requiring funds to have more formalized market timing policies and procedures and to explicitly disclose those policies and procedures, (2) emphasizing the obligation funds have to fair value their securities under certain circumstances and (3) reinforcing board oversight of market timing policies and procedures. The industry supports all of these measures.

    - With respect to personal trading activities of senior fund personnel, the Institute is urging its members to clarify or amend their codes of ethics to require oversight of trades by such persons in any mutual funds offered or sponsored by the company.

    - Funds and their shareholders also would benefit if funds had additional "tools" to combat harmful market timing activity. These could include redemption fees higher than the 2% limit currently imposed by the SEC staff and measures that would enable funds to better enforce their market timing restrictions on short-term trading activity within omnibus accounts, such as a mandatory minimum 2% redemption fee on fund shares redeemed within a minimum of 5 days of their purchase.

- *Selective Disclosure.* It also has been alleged that some funds may have provided information about their portfolio holdings to certain investors to enable those investors to trade ahead of the funds. One way to address this conduct would be to require funds to adopt board-approved, written policies in this area and to publicly disclose those policies.

- *Other Initiatives.* Other current initiatives also will reinforce the protection and the confidence of mutual fund investors, including a proposal to require funds to have compliance programs, changes to the fund advertising rules, proposals concerning portfolio holdings and expense disclosure, measures to ensure that investors benefit from sales charge discounts to which they are entitled and proposed disclosure of revenue sharing arrangements. The industry supports these initiatives.

- The industry pledges its commitment to take any steps necessary to make sure that its obligation to place the interests of fund shareholders above all others is understood and fulfilled.

Table of Contents

I. INTRODUCTION

My name is Matthew P. Fink. I am President of the Investment Company Institute, the national association of the American investment company industry. The Institute's membership includes 8,664 open-end investment companies ("mutual funds"), 601 closed-end investment companies, 106 exchange-traded funds and 6 sponsors of unit investment trusts. The Institute's mutual fund members have assets of about $6.967 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders.

I appreciate the opportunity to appear before the Subcommittee today to discuss the issues of late trading and market timing of mutual funds, and the industry's commitment to take whatever steps are necessary to make sure that the interests of fund shareholders are fully protected.

The bedrock principle of the mutual fund industry is that the interests of mutual fund investors always come first. Consequently, the industry has reacted with shock and outrage to the allegations of late trading and market timing in the New York Attorney General's complaint in the Canary case[1] and other recent allegations of abusive mutual fund trading practices. There can be no excuse for knowingly permitting the buying and selling of fund shares at old prices after the market has closed. And while restricting market timing may be easier said than done,

[1] *State of New York v. Canary Capital Partners, LLC, Canary Investment Management, LLC, Canary Capital Partners, Ltd., and Edward J. Stern* (NY S. Ct. filed Sept. 3, 2003) (undocketed complaint) ("Canary Complaint").

silently selling to a select few the right to trade fund shares is deeply troubling. Even more abhorrent is the notion that, in some instances, fund insiders themselves may have engaged in market timing to reap personal benefits at the expense of other fund shareholders. The industry commends the New York Attorney General's office and the Securities and Exchange Commission for their investigative efforts and forceful responses to these alleged practices. It is imperative that the ongoing investigations by the SEC and others of these allegations are thorough and successful in rooting out trading activities that have compromised or harmed the interests of individual mutual fund shareholders.

We cannot wait until those investigations are complete, however, to take the steps necessary to restore and reinforce investor confidence in mutual funds. Investor confidence is every mutual fund's most precious asset. The industry earned the confidence of millions of Americans by serving their interests above all other considerations. Unfortunately, the business practices that have been alleged are inconsistent with this principle and are intolerable if mutual funds are to serve individual investors as effectively in the future as they have in the past. Forceful action will be the key to restoring and reinforcing investor confidence. The broad elements of what must be done to reassure investors are as follows:

- First, government officials must identify everyone who violated the law. Forceful and unambiguous sanctions must be delivered swiftly wherever punishment is warranted.
- Second, if shareholders were harmed because of illegal or deceptive business arrangements, these wrongs must be made right.
- Third, any gaps in the otherwise strict system of mutual fund regulation must be identified and effectively addressed.

With respect to the last point, SEC Chairman Donaldson has announced plans to propose tough new regulatory requirements addressing the late trading and abusive short-term trading of mutual fund shares.[2] The SEC also will consider whether additional requirements are necessary to address the issue of selective disclosure of portfolio holdings information. The industry pledges its full support of the SEC in whatever course of action it determines will best protect mutual fund shareholders.

To help advance this objective, the ICI's Board of Governors established two separate task forces to identify specific options to address the issues of late trading and abusive short-term trading involving mutual fund shares. The findings of the task forces are being provided to the SEC and other regulators and government officials.

Mutual funds themselves also have acted swiftly to determine whether wrongdoing occurred in their firms. They have initiated internal investigations, hired independent outside experts to investigate and judge the findings, and communicated their findings and responses to their boards and shareholders. In addition, some fund boards have retained independent third parties to conduct investigations. As a result of these investigations, several funds have terminated senior executives. Many funds have committed to taking remedial actions, including compensating fund shareholders for any detrimental impact that improper or illegal transactions may have had on their investments. These actions reinforce that funds take very seriously their obligations under the federal securities laws and the fulfillment of their responsibility to make sure that investors' interests always come first.

---

[2] *See* SEC Chairman Donaldson Releases Statement Regarding Initiatives to Combat Late Trading and Market Timing of Mutual Funds, SEC Press Release No. 2003-136 (Oct. 9, 2003) ("Donaldson Statement").

The remainder of my testimony will focus on the issues of late trading and abusive short-term trading of mutual fund shares. I also will discuss the practice of selectively disclosing information about fund portfolio holdings to shareholders, and oversight of hedge funds. Finally, I will discuss other initiatives to reinforce the protection and confidence of mutual fund investors.

II. LATE TRADING

A basic tenet of mutual fund investing is the concept of "forward pricing." Mutual funds are required to price their shares at least once each day, at a time or times designated by the fund's board of directors and disclosed in the fund's prospectus. Most funds price their shares as of 4:00 p.m. Eastern time, the close of regular trading on the New York Stock Exchange. All purchase and redemption orders received by a fund or its agents before 4:00 p.m. must receive that day's price. All orders received after 4:00 p.m. must receive the next day's price. The requirement that a purchase or redemption order be priced based on the fund's net asset value (NAV) next computed after receipt of the order is known as the "forward pricing" rule. The SEC adopted this rule in 1968 because it recognized that "backward pricing" (purchases and sales of fund shares at a previously determined NAV) could lead to dilution of the value of fund shares and could be susceptible to abuse in that it could allow speculators to take advantage of fluctuations in the prices of the fund's portfolio securities that occurred after

the fund calculated its NAV.[3] Unfortunately, the recent allegations of late trading appear to bear this out.

Under current SEC rules and staff interpretations, funds may treat the time of receipt of an investor's order by a person designated by the fund (such as a dealer) as the relevant time for determining which price the order will receive.[4] Thus, it is common industry practice for intermediaries such as broker-dealers, banks and retirement plan administrators to transmit their clients' purchase and redemption orders that were accepted before 4:00 p.m. to a fund for processing after 4:00 p.m. at that day's price.

Given the alleged abuses that recently have come to light, the Institute believes that existing regulations should be tightened to better protect against the possibility of late trading. The most effective solution to this problem would be to require that all purchase and redemption orders be received by a fund (or its transfer agent) before the time of pricing (*e.g.*, 4:00 p.m. Eastern time).[5] While such a requirement could have a significant impact on the many investors who own mutual funds through financial intermediaries,[6] the recent abuses indicate that the strongest possible measures are necessary to ensure investor protection. A 4:00 p.m.

---

[3] *See* Investment Company Act Release No. 5519 (October 16, 1968).

[4] *See, e.g.*, Investment Company Act Release No. 5569 (December 27, 1968).

[5] As noted above, most funds price their shares as of 4:00 p.m. Eastern time. Thus, for simplicity, the discussion below assumes that this is the case. A fund that prices its shares as of a different time should be required to cut off orders before that time.

[6] Institute data show that the vast majority (approximately 85-90 percent) of mutual fund purchases are made through such intermediaries, including both financial advisers and employer-sponsored retirement plans. *See* Investment Company Institute, 2003 Mutual Fund Fact Book, at 38. A 4:00 p.m. cut-off time at the fund will require intermediaries to apply an earlier cut-off time to the mutual fund orders they receive. This, in turn, will compress the time period during which investors conducting fund transactions through intermediaries could receive same-day prices. The precise impact likely will vary among different types of intermediaries, and among individual firms. In many cases, investors may no longer have the ability to obtain same-day prices.

cut-off time at the fund would significantly limit opportunities for late trading by narrowing the universe of entities responsible for applying a 4:00 p.m. cut-off time to funds and their transfer agents. In addition to limiting the number of entities involved, it would restrict them to SEC-regulated entities. This would simplify both funds' compliance oversight responsibilities and regulators' examination and enforcement efforts with respect to potential late trading. In doing so, it would likely enhance compliance.

We note that Chairman Donaldson has specifically asked the SEC staff to examine the feasibility of such a requirement.[7] The Institute believes that applying order cut-off requirements to funds and their transfer agents is the best way to address late trading abuses at this time.[8] We urge the SEC to proceed expeditiously to adopt this approach.[9]

III. MARKET TIMING

The ongoing investigations by the SEC and other governmental officials also involve issues relating to "market timing" of mutual funds. It is important to note that "market timing" is not a precisely defined term. Generally speaking, the term refers to a trading strategy involving frequent purchases and sales of mutual funds in an effort to anticipate changes in market prices. There is nothing inherently illegal or improper about such activity.

---

[7] Donaldson Statement, *supra* note 2.

[8] In the future, advances in technology may make it possible to devise systems (e.g., a system for "time stamping" mutual fund orders in a way that cannot be altered) that provide a high level of assurance regarding the time of receipt of an order by an intermediary. Nothing would prevent the SEC from revisiting this issue in that event.

[9] We note that a reasonable period of time will be needed to allow all affected entities to make the necessary systems changes to implement new cut-off requirements.

At some level, however, frequent trading activity can be disruptive to the management of a fund's portfolio. For example, frequent trading may compel portfolio managers either to hold excess cash or to sell holdings at inopportune times in order to meet redemptions. This can adversely impact a fund's performance, and increase trading and administrative costs. For this reason, many fund groups have sought to employ a number of methods to try to deter market timing, such as imposing redemption fees, limiting frequent trading, and restricting exchange privileges. Many funds disclose in their prospectus that they do not permit market timing or that they may take steps to discourage it.

Different types of funds are affected differently by short-term trading, and higher turnover of smaller accounts has little effect on portfolio management. Funds also may seek to serve different types of investors; some funds are designed specifically to accommodate short-term trading. Thus, there is no "one size fits all" solution with respect to market timing generally.

The specific concerns that have been raised about market timing are not that funds did, or did not, have certain policies in place. Rather, it has been alleged that some funds were not applying their market timing policies fairly and consistently. A number of different steps can be taken to address these concerns, which are discussed below.

A. Written Policies and Procedures

SEC Chairman Donaldson has outlined various regulatory measures that the SEC staff is considering to address the alleged practice of funds allowing certain investors to engage in market timing activities in a manner inconsistent with their policies.[10] These measures include new rules and form amendments to (1) require explicit disclosure in fund offering documents of market timing policies and procedures and (2) require funds to have procedures to comply with representations regarding market timing policies and procedures. The industry fully supports these measures.

While many funds already have market timing policies and procedures, requiring funds to adopt formal and detailed policies and procedures in this area will ensure that they have a system in place designed to address abusive market timing activity. Such a requirement will provide funds with an effective mechanism to implement and police compliance with their policies by, among other things, eliminating (except when expressly permitted) any discretion in dealing with market timers.

Another element of Chairman Donaldson's regulatory action plan is to reinforce the obligation of fund directors to consider the adequacy and effectiveness of fund market timing policies and procedures.[11] For example, fund boards could be required to receive regular reports on how these programs have been implemented. We strongly support reinforcing board oversight in this area.

---

[10] Donaldson Statement, *supra* note 2.

[11] *Id.*

Fund shareholders also will benefit from additional prospectus disclosure about a fund's market timing policies by gaining an understanding of how the fund will protect their interests from abusive market timing activity. Requiring that such disclosure be in a fund's prospectus could serve to enhance compliance with the policies. The disclosure also could have a deterrent effect by alerting market timers to the fund's policies.

Additional steps are needed to address alleged abusive market timing activity by fund insiders. As noted above, this conduct, if true, is especially reprehensible. Thus, with respect to personal trading in fund shares by portfolio managers or a fund's senior executives, the Institute is urging all mutual funds to clarify or amend their codes of ethics to require oversight of personal trading activity by these persons in any funds offered or sponsored by the company.

B. Fair Valuation

An issue related to market timing is the obligation of funds to determine the fair value of their portfolio securities under certain circumstances. Some market timing activity appears to be motivated by a desire to take advantage of fund share prices that are based on closing market prices established some time before a fund's net asset value is set. It has been suggested that one way to address this concern is to require funds to fair value their portfolio securities more often. As part of Chairman Donaldson's regulatory action plan to address detrimental market timing activity, the SEC staff is considering rules that would "emphasize the obligation

of funds to fair value their securities under certain circumstances to minimize market timing arbitrage opportunities."[12]

The Investment Company Act establishes standards for how mutual funds must value their holdings. Funds are required to use market prices when they are available. This is in recognition of the fact that market prices generally are objective and accurate reflections of a security's value. When market prices are not available, funds must establish a "fair value" for the securities they hold. The Investment Company Act places primary responsibility for fair valuation on a fund's board of directors. There is no definition of "fair value" provided in the Act, nor an established or required uniform method for fair value pricing inasmuch as it necessarily calls for professional judgment and flexibility.

In 2001, the SEC staff issued guidance that, among other things, discussed situations in which funds might need to utilize fair value pricing of foreign securities, even where those securities had closing prices in their home markets. In particular, the SEC staff said that, in certain circumstances, a significant fluctuation in the U.S. market (or a foreign market) may require a fund to fair value those securities.[13]

---

[12] *Id.*

[13] Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission, dated April 30, 2001 ("2001 Valuation Letter").

The rationale underlying the SEC staff's position is the same as that underlying the forward pricing rule discussed earlier in my testimony. To the extent that prices of foreign securities are correlated with changes in the U.S. market, a significant change in the U.S. market that occurs after the time that a foreign market closes can indicate that the closing prices on the foreign market are no longer an accurate measure of the value of those foreign securities at the time the U.S. market closes (*i.e.*, 4:00 p.m., Eastern time). Certain investors may attempt to exploit this situation by engaging in market timing activity. For example, a market timer might purchase shares of an international fund on days when the U.S. market is up significantly, and redeem shares of such a fund on days when the U.S. market is down significantly. Like late trading activity, this can hurt other shareholders in the fund by diluting their interests.

Unfortunately, knowing when and how to fair value foreign securities in these types of circumstances is not an exact science, as there is no way to know for sure at what price those securities would be traded as of 4:00 p.m. Eastern time. Consequently, funds must exercise their best judgment in valuing these securities. If funds fair value these securities too often, they may introduce too much subjectivity into the valuation process. If they don't fair value often enough, they run the risk of exposing their shareholders to losses from market timing activity of the type described above.[14]

In order to appropriately balance these concerns, funds must have in place rigorous, board-approved policies and procedures concerning fair valuation. Some fund groups have developed detailed fair value pricing methodologies in-house; others are utilizing third-party

[14] The potential for these losses can be mitigated by imposing restrictions on market timing.

service providers to assist them in valuing foreign and other securities. Either way, fair value policies and procedures can, and should, be updated as needed; as the 2001 SEC staff letter states, "funds should regularly evaluate whether their pricing methodologies continue to result in values that they might reasonably expect to receive upon a current sale."[15] The ICI has published two compliance papers for its members on valuation issues, which are intended to assist them in meeting their regulatory responsibilities and to ensure that fund share prices are fair to purchasing, redeeming and existing shareholders.[16]

It is important to note that, while fair valuation can reduce harmful market timing activity, it cannot completely eliminate it. Accordingly, as mentioned above and discussed further below, funds often employ additional methods to deter market timing activity.

C. Tools to Deter Market Timing

The government and regulatory investigations referred to above involved situations where funds allegedly granted exceptions from, or did not enforce, policies against market timing. It is important to note that many funds that are susceptible to market timing have devoted significant resources to efforts to combat such activity. Frequently, however, the various means that funds have employed to deter harmful market timing activity have not proved effective. Funds and their shareholders would benefit if funds had additional "tools" to restrict trading activity that they determine to be harmful to their shareholders. Last year, the

[15] 2001 Valuation Letter, *supra* note 13, at 7.

[16] *See* Investment Company Institute, *Valuation and Liquidity Issues for Mutual Funds* (February 1997) and Investment Company Institute, *Valuation and Liquidity Issues for Mutual Funds, 2002 Supplement* (March 2002).

SEC staff responded favorably to an Institute request to permit funds to delay exchange transactions, in an effort to deter some market timing activity.[17] There are additional methods for combating market timers that the SEC staff should consider permitting funds to employ. One such method would be to permit funds to impose a redemption fee (which is a fee paid directly to the fund to offset the costs resulting from short-term trading) greater than the 2% limit currently imposed by the staff.

A particular challenge that funds face in effectively implementing restrictions on short-term trading is that many fund investments are held in omnibus accounts maintained by an intermediary (*e.g.*, a broker-dealer or a retirement plan recordkeeper). Often in those cases, the fund cannot monitor trading activity by individual investors in these accounts. The Canary Complaint describes this practice as follows: "Timers . . . trade through brokers or other intermediaries . . . who process large numbers of mutual fund trades every day through omnibus accounts where trades are submitted to mutual fund companies en masse. The timer hopes that his activity will not be noticed among the 'noise' of the omnibus account."[18]

Steps clearly need to be taken to enable mutual funds to better enforce restrictions they establish on short-term trading when such trading takes place through omnibus accounts. One possible approach would be to require intermediaries to provide information about trading activity in individual accounts to funds upon request. Another approach would be to require most funds, at a minimum, to impose a 2% redemption fee on any redemption of fund shares

---

[17] Investment Company Institute, 2002 SEC No-Act. LEXIS 781 (November 13, 2003).

[18] Canary Complaint, *supra* note 1, at par. 46.

within 5 days of purchasing them. If most funds had a minimum redemption fee along these lines, it might be easier for intermediaries to establish and maintain the requisite systems to enforce payment of those redemption fees.[19]

We look forward to working with the SEC and other regulators and industry groups on these matters.

IV. SELECTIVE DISCLOSURE OF PORTFOLIO HOLDINGS

The SEC and other regulators are investigating allegations concerning the selective release by funds of their portfolio holdings to some but not all of a fund's shareholders. In particular, it has been alleged that some funds may have provided information about their portfolio holdings to certain investors in order to enable those investors to trade ahead of the fund, to the potential detriment of the other shareholders. Such conduct, if true, is deplorable. The industry is committed to working with the SEC to determine the best approach to deal with this matter.

One possible way to address this issue would be to require funds to adopt formal written policies in this area. The SEC could require that the policies be approved by the fund's

[19] Funds should retain the flexibility to impose more stringent redemption fee standards, either in the form of higher redemption fees or longer minimum holding periods. As noted above, different types of funds are affected differently by short-term trading; hence, flexibility remains important. In addition, certain types of funds (*e.g.*, money market funds and funds that are designed specifically for short-term trading) should not be required to assess redemption fees.

board and that reports of instances when the information was released be provided to the board on a regular basis. In addition, funds could be required to publicly disclose their policies for releasing portfolio information. This approach would have many benefits. Similar to market timing, requiring funds to adopt formal policies would ensure that they have a system to prevent disclosure that is not in the best interests of shareholders and to police compliance. Board oversight and public disclosure would further enhance compliance with the policies. At the same time, this approach would preserve some flexibility in how funds release information. This is important because many funds release portfolio information for purposes that benefit investors. For example, they may provide it to independent services that analyze mutual funds and to certain intermediaries that provide professional assistance to help investors make decisions such as which funds to invest in and how to allocate their assets among investments.

V. HEDGE FUND OVERSIGHT

The action brought by the New York Attorney General against Canary Capital also underscores the need for SEC oversight of hedge fund advisers. Currently, the Commission generally has access to records of trading on behalf of hedge funds through the records maintained by the brokers that the hedge fund advisers use and the markets on which they trade. The records, however, are dispersed and it is difficult to detect improper trading activities conducted by a particular hedge fund if such activities were effected through orders placed with multiple brokers and traded on multiple markets. The SEC recently issued a staff report on hedge funds[20] that included a recommendation to require hedge fund advisers to register under the Investment Advisers Act of 1940. The Institute supports this

[20] Staff Report to the United States Securities and Exchange Commission, *Implications of the Growth of Hedge Funds* (Sept. 2003) ("Staff Report").

recommendation. As the Staff Report indicates, by requiring hedge fund advisers to register, the Commission would be able to more comprehensively and effectively observe the trading activities of the funds managed by such advisers. As a result, the Commission would be in a better position to detect improper or illegal trading practices.[21]

VI. OTHER INITIATIVES

While the regulators have been actively involved in investigating and bringing enforcement actions relating to abusive mutual fund trading practices, as well as considering new regulatory requirements to prevent such practices in the future, it bears noting that these efforts are not the only current regulatory initiatives on behalf of fund investors. Other regulatory reforms, as well as voluntary industry actions, that are underway or have recently been completed also form an important part of overall efforts to reinforce the protection and the confidence of mutual fund investors.

Current initiatives include the following:

Fund Compliance Programs. In February, the SEC proposed a rule to require mutual funds to have compliance programs.[22] Generally speaking, the proposal would require (1) written compliance policies and procedures, (2) identification of persons responsible for administering the policies and procedures, (3) regular review of the policies and procedures,

---

[21] *Id.* at 92-95.

[22] *See* Investment Company Act Release No. 25925 (February 5, 2003).

and (4) board oversight of funds' compliance programs. Requirements along these lines could provide an effective way to enhance protections against late trading, abusive short-term trading, and selective disclosure. The Institute generally supports this proposal.[23]

Mutual Fund Advertisements. The SEC recently adopted amendments to the mutual fund advertising rules to require enhanced disclosure in fund advertisements, particularly advertisements containing performance information.[24] Under the new rules, fund performance advertisements will have to provide a toll-free or collect telephone number or a website where an investor may obtain more current performance information (current as of the most recent month-end). In addition, fund advertisements will be required to advise investors to consider the investment objectives, risks, and charges and expenses of the fund carefully before investing and that this and other information about the fund can be found in the fund's prospectus.

Portfolio Holdings and Expense Disclosure. The SEC is expected to adopt soon a proposal that would require funds to disclose their portfolio holdings on a quarterly (rather than semi-annual) basis, and that would improve disclosure in fund shareholder reports.[25] As part of this proposal, funds would be required to disclose in their shareholder reports the dollar amount of expenses paid on a $10,000 investment in the fund during the period covered by the report. This disclosure, which would supplement the detailed fee disclosure currently required

---

[23] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated April 17, 2003. In our letter we suggested certain modifications to ensure that the proposed requirement accommodates existing, effective compliance structures. In order for the proposal to achieve its objective of enhancing fund compliance, it is critical that the SEC have the benefit of the input from industry experts and other interested persons.

[24] *See* Investment Company Act Release No. 26195 (September 29, 2003).

[25] *See* Investment Company Act Release No. 25870 (December 18, 2002).

in fund prospectuses, would serve to remind investors about the impact of fund expenses and assist them in comparing the expenses of different funds. The Institute supports this proposal.

Sales Charge Breakpoints. Many mutual funds that are sold with front-end sales charges offer discounts to investors who invest specified amounts of money. The investment levels at which investors qualify for the discounts are called "breakpoints." In late 2002 and early 2003, regulatory investigations revealed instances in which broker-dealers did not give investors the benefit of sales charge reductions to which they were entitled. Most of these situations did not appear to involve intentional misconduct. These examination findings led to several important initiatives, including the formation of a Joint Industry/NASD Breakpoint Task Force, made up of high-level NASD, mutual fund and broker-dealer representatives. The Joint Industry/NASD Breakpoint Task Force recently issued a report making a series of recommendations designed to ensure that processes are in place to ensure that investors receive applicable discounts.[26] The recommendations include additional required disclosure concerning breakpoint discounts. The Institute is working with its members, other securities industry participants and regulators on the implementation of the Breakpoint Task Force's recommendations and is committed to resolving the problems that have been identified for the benefit of mutual fund investors.

Revenue Sharing Arrangements. "Revenue sharing" arrangements involve payments by a fund's investment adviser or principal underwriter out of its own resources to compensate intermediaries who sell fund shares. The principal investor protection concern raised by these

[26] Report of the Joint NASD/Industry Task Force on Breakpoints (July 2003).

payments is whether they have the potential for influencing the recommendations of the financial intermediary that is receiving them. Disclosure concerning revenue sharing payments is already required in fund prospectuses, and the Institute has long advocated additional, point-of-sale disclosure by broker-dealers to help investors assess and evaluate recommendations to purchase fund shares.[27] The NASD recently proposed new point-of-sale disclosure requirements in this area.[28] The NASD proposal also addresses differential cash compensation arrangements, in which a broker-dealer firm pays its registered representatives different rates of compensation for selling different funds. The Institute supports the NASD proposal.[29]

Fund Governance. The recent disturbing revelations have caused some to question the effectiveness of the fund governance system. We do not believe it is fair to place blame upon directors, or the fund governance system. Directors cannot be expected to unearth every instance of wrongdoing, especially if such wrongdoing took place at an unrelated entity. At the same time, it seems apparent that steps need to be taken to enhance the ability of directors to exercise their oversight responsibilities, and some of those steps are discussed above.

Overall, we continue to believe that the system of mutual fund corporate governance has served investors very well through the years. It has even served as a model for reforming the governance of corporate America. In recent years the fund governance system has

---

[27] *See, e.g.*, Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Ms. Joan Conley, Office of the Corporate Secretary, NASD Regulation, Inc., dated October 15, 1997.

[28] NASD Notice to Members 03-54 (September 2003).

[29] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Barbara Z. Sweeney, NASD, Office of the Corporate Secretary, dated October 17, 2003.

undergone several enhancements. For example, in June 1999, an Institute advisory group composed of investment company independent and management directors recommended a series of fifteen best practices – that went beyond legal and regulatory requirements – to enhance the independence and effectiveness of investment company directors.[30] Subsequently, the SEC adopted rule amendments designed to further strengthen the independence and effectiveness of investment company directors.[31] Last month, at the behest of the Institute's Executive Committee, the Institute's Board of Governors adopted a resolution recommending that Institute member companies adopt additional best practices with respect to (1) the treatment of close family members of persons associated with a fund or certain affiliates as independent directors and (2) the standards for investment company audit committees. The resolution also recommended that Institute members, to the extent they have not already done so, adopt the best practices set forth in the 1999 Best Practices Report.

VII. CONCLUSION

The alleged abusive late trading and market timing activities recently uncovered by the New York Attorney General and the SEC are deplorable. Swift and forceful responses are necessary to make clear that there is no place in the mutual fund industry for those who would put their own interests before those of fund shareholders. The industry pledges its commitment to take any steps necessary to make sure that its obligation to place the interests of fund shareholders above all others is understood and fulfilled.

---

[30] Report of the Advisory Group on Best Practices for Fund Directors (June 24, 1999) ("Best Practices Report").

[31] SEC Release No. IC-24816 (January 2, 2001).

Testimony of

E. Scott Peterson

Global Practice Leader of Defined Contribution Services

Hewitt Associates

Submitted for the Record

U. S. Senate Committee on Governmental Affairs

Subcommittee on Financial Management, the Budget, and International Security

Hearing on

Mutual Funds, Trading Practices and Abuses that Harm Investors

November 3, 2003

Summary

Hewitt Associates is the largest human resources outsourcing and consulting firm in the U.S. and the second largest such firm worldwide. We are the largest independent recordkeeper -- i.e., not an affiliate of an investment management organization -- for 401(k) retirement plans, serving more than 5 million plan participants.

As a 401(k) recordkeeper, we receive, record and communicate investment decisions made by plan participants. Current SEC rules require that orders to purchase or redeem fund shares must be received by the fund before the close of trading in fund shares if they are to receive that day's closing price. Typically this is by 4 p.m. Eastern Time (ET), which we will refer to in our comments as the closing time. We have very clear procedures and processes electronically and in writing about how participants' investment decisions are received, recorded and communicated. These processes and procedures are in adherence with regulatory standards. No exceptions are allowed. In order to completely perform these processes, Hewitt and other recordkeepers enter into agreements with mutual fund organizations whereby we become an agent of the fund. It is the absolute legal and contractual standard that Hewitt and other 401(k) recordkeepers impose a 4 p.m. ET cutoff by which participants must make their investment decisions in order to receive the current day's closing price.

Illegal After-Hours Trading: Given the importance of 401(k) plans to tens of millions of participants, any practice that undermines the fairness and trustworthiness of the system—such as illegal after-hours trading—must be promptly and appropriately remedied. Yet, it is also essential that the remedy not inadvertently undermine the 401(k) system. For example, if new rules were to mandate that 401(k) recordkeepers must complete all the needed processing before 4 p.m. ET, that would require the 401(k) plan to cut off participant transaction requests much earlier than 4 p.m. to get that day's price. 401(k) participants would be disadvantaged relative to other fund shareholders, and there would also be significant additional costs of needlessly re-engineering current systems and procedures. As an alternative, Hewitt suggests that enforcement of existing rules be reinforced by requiring recordkeepers that are fund agents to demonstrate that strict audit and review standards are in place to prevent after-hours trading. These strict audit and review standards would involve both design and practice. We ask that any remedy to curb illegal after-hours trading activity be weighed carefully given the large number of individual investors who are likely to be affected, and the fact that any solution is likely to require time -- and potentially material cost -- to implement.

Excessive Trading. Hewitt shares the concerns regarding excessive trading that has occurred within investment funds (particularly international funds). We believe it is in the best interest of 401(k) plan participants for an industry-wide standard to be adopted. The cost to administer unique rules for each individual fund manager can become prohibitive. This is a cost that will ultimately be absorbed by the plan sponsor and their participants. We have worked with many fund managers and 401(k) plan sponsors to find appropriate ways to curb this activity among a small group of market timers. Of critical importance, our research has found that redemption fees that are too low (e.g., 1 percent), are effective in slowing down this activity, but are often not very effective in stopping it. On days of wide swings in the market, a redemption fee may not be enough to remove the potential upside of a market timing strategy. One alternative remedy Hewitt has developed is "Aging of Monies," whereby money that is transferred into a restricted fund cannot be transferred out for a set period of days. While the number of days is variable, our research suggests that a limitation of seven days is sufficient to curb the activity.

Mr. Chairman and Members of the Committee:

On behalf of Hewitt Associates we thank you for holding this important hearing and we are pleased to submit this testimony for the record.

My name is Scott Peterson, I am Hewitt's Global Practice Leader for Defined Contribution Services. Headquartered in Lincolnshire, Illinois, Hewitt is the largest human resources outsourcing and consulting firm in the U.S., and the second largest firm worldwide. In North America alone, we employ about 13,000 associates, of whom approximately 7,000 are based in Illinois.

We are the largest independent recordkeeper (i.e., not an affiliate of an investment management organization) for 401(k) retirement plans, serving approximately 5 million employee participants. We would like to share with the Committee the experience of 401(k) participants and discuss how they might be affected under various approaches that may be considered by the Committee and/or the Securities and Exchange Commission.

The two broad issues we would like to address are:

- Illegal after-hours trading in mutual funds
- Market timing and excessive trading in mutual funds, particularly international funds

Tens of millions of workers rely on 401(k) plans as one of the cornerstones of their retirement security. In fact, in a 2003 Hewitt Associates survey of nearly 500 plan sponsors, a majority of plan sponsors (55 percent) described their 401(k) plan as the primary retirement vehicle available to their workers. 401(k) plans are popular because they offer certain tax advantages (and often company matching contributions) that encourage workers to voluntarily invest in the plan, saving part of their

current income for retirement. According to a recent Hewitt survey, 96 percent of plans offer employer contributions. Workers benefit from the ease of automatic deductions from their pay into the plan, and from plan sponsor oversight of the investment funds in which participants in 401(k) plans entrust their retirement money. 401(k) plans are also relied upon by workers as trustworthy, transparent, fair, and cost effective.

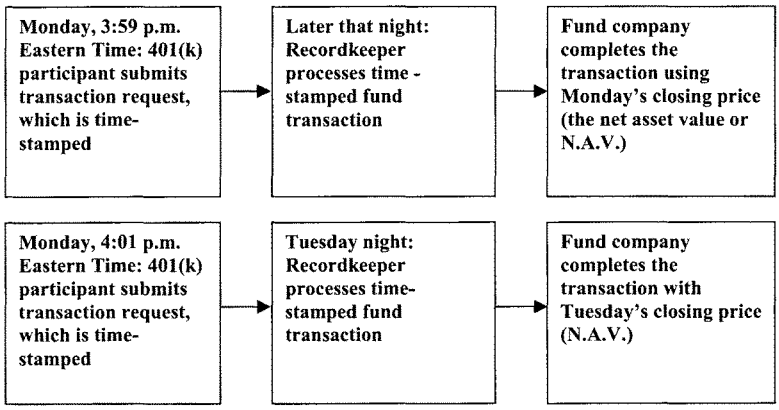
Illegal After-Hours Trading

Given the importance of 401(k) plans to so many U.S. workers, any practice that undermines the fairness and trustworthiness of the system—such as illegal after-hours trading—must be promptly and appropriately remedied. Yet, it is also essential that the remedy itself does not inadvertently undermine the 401(k) system. For example, attempts to curb illegal after hours trading by simply changing current trading rules outright could put at risk the fairness and potentially even the cost effectiveness of 401(k) plans for participants.

Role of the Recordkeeper

As background, it is important to understand the role of the defined contribution recordkeeper. Recordkeepers receive, record and communicate the investment decisions made by 401(k) participants. Current SEC rules require that orders to purchase or redeem fund shares must be received by the fund or its agent before 4 p.m. Eastern Time (ET) if they are to receive that day's closing price. Hewitt and other recordkeepers enter into agreements with mutual fund organizations whereby we become a designated agent of the fund. It is the absolute legal and contractual standard that Hewitt and other 401(k) recordkeepers impose a 4 p.m. ET cutoff by which participants must make their investment decisions (without exception) in order to receive the current day's closing price.

Once transaction requests are received by 4 p.m. from plan participants, the recordkeeper engages in the extensive processing and calculations that are required in order to complete daily processing. In addition to calculating the value of a single holding, the recordkeeper executes additional processes required to ensure compliance with retirement plan rules (e.g., vesting calculations, rules determining withdrawal amounts or other benefit payments) as well as regulatory requirements (e.g., regulatory caps on amounts that can be borrowed from participant accounts). Many of these processes require that account values be determined before specific calculations can be made. Once the processing has occurred, the recordkeeper communicates the transaction requests to fund companies, generally within several hours of the 4 p.m. cutoff. Here is an illustration of how it works.



Impact of Potential Rule Changes

One option reportedly under consideration would change the current regulations by requiring that *all* entities, including 401(k) recordkeepers, submit mutual fund trades to the mutual fund by 4 p.m. ET. For 401(k) plans, this would effectively mean that for 401(k) recordkeepers to complete their 401(k) processing, 401(k) investors would need to make their investment decisions several hours earlier than 4 p.m. ET. This would be a substantial change within the 401(k) system and place 401(k) mutual fund investors at a comparative disadvantage with respect to other fund shareholders. For 401(k) participants who do not meet the earlier transaction deadline, but who do trade prior to 4 p.m. ET, such a change in regulations would result in such participants' transactions being executed at the next day's price. Employees would have to submit their trades as early as the start of the business day on the West Coast to account for the time difference and the time needed to process the investment requests. Effectively, these 401(k) participants would be trading under different rules than other investors. An investor with money in Fund XYZ in the 401(k) plan who submitted his or her trade at 3:59 p.m. would receive a different price than an investor with money in Fund XYZ outside of the 401(k) plan who placed a trade directly with the fund at the same time. This different treatment could undermine the value of the 401(k) plan in the eyes of plan participants.

Such a change in the existing rules would also increase costs that are likely to be passed through to plan participants. It would result in significant re-engineering of existing defined contribution processing systems. According to Hewitt's recent survey, 93 percent of 401(k) plans offer daily pricing and transfers of existing balances. Over the past 15 years, highly efficient, automated processes have been developed to support these plans. The impact of a substantial, sweeping change in processing systems would affect the vast majority of plans, with the possibility that the cost of

implementing such substantial changes could increase the cost of administering—and therefore affect the offering—of plans to participants.

Alternative Solutions

Given the impact on 401(k) plans and participants, Hewitt believes that a reasonable alternative to a strict 4 p.m. cutoff for 401(k) recordkeepers would involve requiring recordkeepers to demonstrate that strict audit and review standards are in place to prevent after hours trading. These strict audit and review standards would involve both design and practice.

Design

The provider would need to demonstrate that its infrastructure includes the appropriate processes to ensure trades have been accepted prior to the 4 p.m. cutoff. For example, all trades entered into the provider's system would receive an automated time stamp. The provider then would apply the necessary calculations and requirements against the trade requests received by the cutoff, combine these requests and then send them to the fund company later in the day.

Practice

The recordkeeper would engage in regular audits of actual activity to verify that the relevant processes are being enforced in practice. Hewitt recommends regular audits of providers' processes in order to determine compliance within the existing rules. The SEC, mutual fund industry, or another third party working with fund transfer agents could be responsible for performing regular audits with these trading partners. And the audit results could be made available for inspection by the SEC. In fact, Hewitt is already registered as a transfer agent and is subject to the regulatory control of the SEC.

Conclusion on Illegal After-Hours Trading

To summarize: it is critical that any steps taken to remedy illegal after-hours trading take into account the impact on 401(k) plans central to the retirement income security of tens of millions of U.S. workers. Changing the regulations regarding the 4 p.m. cutoff will impact 401(k) plans adversely by creating a two-tier system of trading—one for investors who transact directly with mutual funds outside of 401(k) plans, and one for investors within 401(k) plans. In essence, the 401(k) investors would be put in the situation of being "second tier" under the proposed regulations. It could also create more costs for 401(k) plans.

In reviewing the history of abuses of after hours trading, it is clear that 401(k) investors—with median balances of $16,000—are not the source of these abuses. Yet, the brunt of the change in regulations would directly affect these investors.

A better remedy lies in allowing recordkeepers the opportunity to demonstrate that rigorous processes are in place to prevent illegal after-hours trading. This can be accomplished through a cooperative effort between recordkeepers, brokers, mutual funds, and the government in establishing a standard for a secure processing system, and a rigorous enforcement procedure. In this way, after hours trading abuses could be curbed within the 401(k) industry, without adversely affecting the average 401(k) participant.

We ask that any remedy to curb illegal after-hours trading activity be weighed carefully given the large number of individual investors who are likely to be affected, and the fact that any solution is likely to require time -- and potentially material cost -- to implement.

Excessive Trading

Hewitt appreciates and shares the concerns regarding excessive trading within investment funds (particularly international funds). We have worked with fund managers and 401(k) plan sponsors to find appropriate ways to curb this activity when it occurs as we recognize the harm such activity can do to long-term shareholders. We are also committed to working with the appropriate industry groups and regulatory bodies to find common and effective solutions to address this issue, as we feel this is ultimately in the best interest of all 401(k) plan participants.

Background on Excessive Trading Strategy

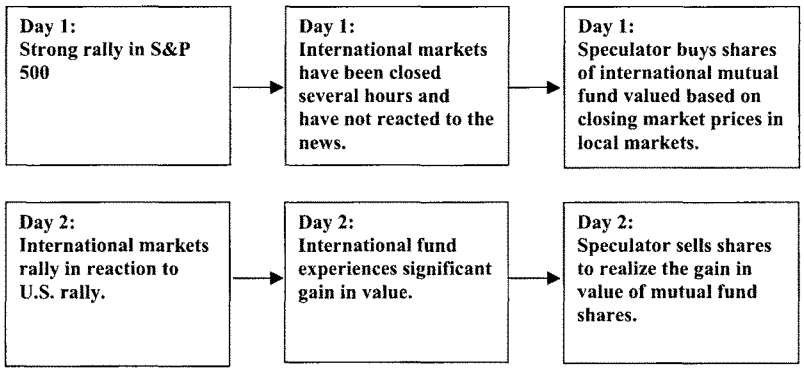
A small number of 401(k) plan participants have been able to take advantage of a trading strategy that has long been discussed in academic circles. This is the same strategy that has been reported as being employed by other investors, including some hedge funds.

Specifically, mutual funds are valued at the close of the market in the U.S. Investors who execute transactions in a mutual fund before 4 p.m. ET have their trades valued at that day's Net Asset Value (NAV). To set the fund's NAV, fund companies typically value the individual securities within their funds based on the closing price of those securities within their local markets. However, in the case of international securities held in the funds, those values may have been determined many hours prior and thus could be considered "stale." News that could affect the "fair value" of those securities could have been released after the close of the local markets but before mutual fund investors are required to place their trade orders in the U.S.

Often, this "news" is in the form of a large market rally or decline in the U.S. market. There is a significant correlation of large changes in the U.S. market with subsequent changes in foreign markets. While a rally in the U.S. market will often result in a rally in foreign markets, those markets have often been closed for several hours and thus their current day closing market prices do not reflect this news. However, when those markets open the next day, the securities traded in that market will be able to react.

Thus, a typical strategy of a market timer is to take advantage of this mispricing by buying into the international fund on the day of a U.S. market rally and then selling out of the international fund a

day or two after the purchase, at a higher value, often putting their money in to a more conservative option such as a money market or stable value fund. The following is an illustration.



Excessive Trading Within the 401(k) Marketplace

This trading strategy has found its way in to the 401(k) marketplace. Overall, the number of participants who engage in this activity is very small. Most participants do not trade actively in their 401(k) accounts. Hewitt research finds that only 5 percent of 401(k) participants made more than 10 trades in their account in 2002.

There are some unique features to the 401(k) marketplace that, if unchecked, can allow participants in a company-sponsored 401(k) plan to take advantage of this market-timing strategy. That being said, there are also proven remedies that can restrict a plan participant from engaging in this behavior. Hewitt is committed to implementing these strategies, in conjunction with plan sponsors and their fund managers. We also recognize the need within the recordkeeping industry for a standard approach to addressing this issue.

As the 401(k) industry has evolved, plan participants have benefited greatly from platforms that offer a broad choice of investment options from a variety of fund managers. Further, because of their tax-deferred status, participant transfers within 401(k) plans are not subject to the immediate tax

consequences of frequent trading. In addition, because of their institutional nature, 401(k) plans are designed to provide participants with a low-cost, daily trading environment, where fees such as "loads" can be waived. Such features have made 401(k) plans attractive investment vehicles for long-term retirement savings. However, some participants have taken advantage of this low cost trading platform by engaging in the market timing activities outlined above.

Remedies for the 401(k) Marketplace

We believe it is in the best interest of 401(k) plan participants for an industry-wide standard to be adopted. The cost to administer unique rules for each individual fund manager can become prohibitive. This is a cost that will ultimately be absorbed by the plan sponsor and their participants.

Due to the absence of an industry-wide standard to stop excessive trading, one alternative remedy Hewitt has developed is "Aging of Monies," whereby money that is transferred into a restricted fund cannot be transferred out for a set period of days. While the number of days is variable, our research suggests that a limitation of seven days is sufficient to curb the activity.

We developed this approach after conducting research of participant trading activity after various restrictions were put into place, and after consulting with plan sponsors and fund managers. We have found this approach to be extremely effective in curbing excessive trading, more than any of the other approaches that we have studied. In one plan that adopted this "Aging of Monies" approach, the average daily trading volume in that fund dropped by 98.7 percent in the 30-day period after the restriction was put in place. In addition, in the 30-day period prior to implementation, the largest daily trading activity equaled 62.2 percent of the total plan balances. In the 30-day period after the restriction, the largest single trading day equaled 0.5 percent of the total balances.

While we recognize that redemption fees have been suggested to stop the activity, Hewitt does have some reservations about this approach. The need to set accounting processes for those accounts and to administer the movement of those fees will raise additional costs to plan participants. Most importantly, our research has found that redemption fees that are too low (e.g., 1 percent) are effective in slowing down this excessive trading activity, but are often not very effective in stopping it. On days of wide swings in the market, the threat of a redemption fee may not be enough to remove the potential upside of a market timing strategy.

Conclusion on Excessive Trading

Hewitt is dedicated to finding a solution to stop the market-timing behavior that a few participants in 401(k) plans have followed. In the interest of the average 401(k) investors, we think it is critical to retain features such as daily valuation, investment choice, tax deferral, and low cost trading, in order to provide participants with an attractive vehicle in which to invest their retirement savings. At the same time, we strongly endorse the implementation of an industry-wide standard to address the market-timing behavior that many plan sponsors and their recordkeepers are working to stop.

Senator Daniel K. Akaka
Ranking Member
Subcommittee on Financial Management, the Budget and International Security
Senate Committee on Governmental Affairs

Mutual Funds: Trading Practices and Abuses that Harm Investors
November 3, 2003

Question for the Record

Paul F. Roye
Director, Division of Investment Management
U.S. Securities and Exchange Commission

Question:

What is your evaluation of the use of fair-value pricing and to what extent is this practice being used? Should more funds be using this technique to help discourage stale pricing and unfair trading practices?

Response:

The Investment Company Act of 1940 requires mutual funds and closed-end funds to calculate their NAVs by using the market quotations of their portfolio securities when those quotations for those securities are readily available. When market quotations for portfolio securities are not readily available, however, or when those quotations have become unreliable, the Investment Company Act requires a fund to calculate its NAV by using the fair value of those securities, as determined in good faith by the fund's board of directors.

Fair value pricing is critically important to ensure that fund transactions take place at prices that are fair for all shareholders. Fair value pricing provides a mechanism for funds to value their portfolio securities on a current basis when there are no readily available market quotations for those securities. Funds that calculate their NAVs by using fair value prices when there are no readily available market quotations for their portfolio securities are more likely to avoid diluting the interests of long-term shareholders. This protects the interests of all fund shareholders, regardless of whether they are short-term or long-term investors.

In 1984, the Commission issued a release that specifically addressed the inappropriate use of stale prices by funds investing in securities whose primary markets are overseas. The Commission stated that funds must fair value price their portfolio securities if a significant event occurs after the close of the market on which that security trades, but before the time as of which the fund calculates

its NAV, which would cause the market price to no longer be readily available.[1] In 2001, the staff reiterated the Commission's 1984 position in a public letter to the industry, and stated that funds should be vigilant in determining whether events occurring after the close of foreign markets should be factored into the fund's NAV calculation in order to prevent dilution of shareholder interests.[2]

In addition, in connection with rules considered at the Commission's open meeting held on December 3, 2003, the Commission will soon be issuing unambiguous statements reiterating that funds must fair value price their portfolio securities when market quotations for those securities are unavailable or become unreliable. Such statements should eliminate any doubt as to a fund's statutory obligation to fair value price portfolio securities under appropriate conditions.

It should be noted that on September 11, 2003, the Commission's Office of Compliance Inspections and Examinations sent letters to mutual fund complexes that have at least one fund that invested a majority of its assets in securities whose principal trading markets were outside the United States. The letters requested the complexes to respond to a variety of questions designed to elicit information about how funds price portfolio securities that trade in non-U.S. markets, and the extent of the oversight of such activities by funds' boards of directors. Based on its preliminary review, the staff believes that most funds have procedures that require that portfolio securities be fair value priced under certain conditions. The staff is currently examining how comprehensive those fair valuation procedures are, and the extent to which the funds follow their procedures when pricing their securities.

---

1 Investment Company Act Release No. 14244, at n. 7 (Nov. 21, 1984) (proposing amendments to Rule 22c-1) ("[i]f an event does occur which will affect the value of portfolio securities after the market has closed, the fund must, to the best of its ability, determine the fair value of the securities, as of the time pricing is done under Rule 22c-1, by using appropriate indicia of value which, in certain cases, may include the opening price at which trading in the securities next begins").

2 Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management (Apr. 30, 2001).

Senator Daniel K. Akaka
Ranking Member
Subcommittee on Financial Management, the Budget and International Security
Senate Committee on Governmental Affairs

Mutual Funds: Trading Practices and Abuses that Harm Investors
November 3, 2003

Question for the Record

Paul F. Roye
Director, Division of Investment Management
U.S. Securities and Exchange Commission

Question:

Mr. Roye, in your testimony to the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, you indicated that the portfolio turnover ratio is a relatively good proxy for transaction costs. Which is the more accurate indicator of transaction costs: portfolio turnover or brokerage commissions and why?

Response:

Currently, all mutual funds (except money market funds) provide investors with information about two items that are related to transaction costs – portfolio turnover rate and dollar amount of brokerage commissions.[1] Funds disclose in their prospectuses the annual rate of portfolio turnover that they have incurred during the last five fiscal years.[2] Portfolio turnover rate measures the average length of time that a security remains in a fund's portfolio.[3] The requirement to disclose portfolio turnover rate is premised on the observation that a fund's transaction costs tend to be highly correlated with its turnover

---

1 Money market funds purchase and sell securities on a principal basis. Transaction costs for these securities are embedded in the purchase price or sale proceeds and are not separately stated.

2 *See* Item 9 of Form N-1A, the form on which a mutual fund registers the offering of its shares under the Securities Act of 1933. Form N-1A includes a description of the information that a fund must provide in its prospectus and statement of additional information.

3 For example, a fund that has a portfolio turnover rate of 100% holds its securities for one year, on average. A fund with a portfolio turnover rate of 200% holds its securities for six months on average.

rate, other factors held equal.[4] Thus, by comparing turnover rates, investors can obtain an indication of how transaction costs are likely to vary among different funds.

Funds (with the exception of money market funds) also must disclose in their statements of additional information (SAIs) the dollar amount of brokerage commissions that they have paid during their three most recent fiscal years.[5] Brokerage commission amounts, although they must be interpreted carefully, can nevertheless provide useful information to fund investors. This disclosure informs investors of the magnitude of the fund's overall assets that are expended on commissions.

The advantage that turnover rate (an indirect indicator of fund transaction costs) has over the dollar amount of brokerage costs (a more direct measure) is that turnover rate is less affected by the asset size of a fund. For example, a fund with assets of $1 billion is likely to pay many more dollars of brokerage commissions than a fund with assets of $100 million, even if their turnover rates are identical.

Unfortunately, disclosure of a fund's portfolio turnover does not directly reveal a fund's actual transaction costs or elicit specific information about these costs. A mutual fund's transaction costs include commissions, spreads, market impact costs and opportunity costs. Commissions are charges that a broker collects as agent for executing and clearing a trade. Spreads, the variance between bid and asked prices, are the profits a dealer, acting as principal, makes on the trade and include both an imputed commission on the trade and any market impact cost associated with the trade. Market impact costs are incurred when the price of a security changes as a result of the effort to purchase or sell the security. Opportunity cost is the indirect cost of intended trades that are not executed.

Commissions are explicit costs – readily identifiable and quantifiable. Spread, market impact, and opportunity costs are implicit costs that are difficult to identify and quantify, and can greatly exceed explicit costs. A transaction cost number that fails to capture the true cost of executing portfolio transactions could mislead investors. Transactions that achieve a low commission at the expense of unnecessarily high purchase prices or low sales prices may be no bargain for fund shareholders. Thus to provide the most meaningful disclosure, the total transaction cost needs to be quantified.

---

4 *See, e.g.*, Miles Livingston and Edward O'Neal, "Mutual Fund Brokerage Commissions," JOURNAL OF FINANCIAL RESEARCH, Vol. XIX, No. 2 (Summer 1996) at 283 and Rich Fortin and Stuart Michelson, "Mutual Fund Trading Costs," JOURNAL OF INVESTING, Vol. 7, No. 1, Spring 1998, at 67. *But see* John M.R. Chalmers, Roger M. Edelen, Gregory B. Kadlec, "Fund Returns and Trading Expenses: Evidence on the Value of Active Fund Management," Aug. 30, 2001, at 2 (available at http://finance.wharton.upenn.edu/~cdelen/PDFs/MF_tradexpenses.pdf). ("Turnover is likely to be an unreliable proxy for funds trading expenses because it does not account for heterogeneity in the per-unit costs of trading an asset. For example, an uninformed manager that frequently trades assets with a low cost-per-trade may incur lower trading expenses than an uninformed manager who infrequently trades assets with high cost-per-trade.")

5 See Item 16(a) of Form N-1A.

The lack of a generally agreed-upon method to calculate these implicit costs complicates the calculation of securities transaction costs in their totality. For this reason, the Commission staff is recommending that the Commission issue a concept release that would ask for comments on how mutual fund transaction cost disclosure requirements should be revised to provide more meaningful information to investors. This matter will be considered at on open meeting on December 17, 2003.

Existing portfolio turnover and brokerage commission disclosures while useful have their limits. We believe that shareholders need to better understand a fund's trading costs in order to evaluate the costs of operating a fund. As outlined above, the Commission intends to examine what steps can be taken to improve the disclosure of transaction costs in order to make the information more useful and understandable to the average investor.

○