S. Hrg. 108–461

OVERSIGHT HEARING ON MUTUAL FUNDS: HIDDEN FEES, MISGOVERNANCE AND OTHER PRACTICES 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

SECOND SESSION

JANUARY 27, 2004

Printed for the use of the Committee on Governmental Affairs

U.S. GOVERNMENT PRINTING OFFICE

92–686 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

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TUESDAY, JANUARY 27, 2004

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OVERSIGHT HEARING ON MUTUAL FUNDS: HIDDEN FEES, MISGOVERNANCE AND OTHER PRACTICES THAT HARM INVESTORS

TUESDAY, JANUARY 27, 2004

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 10:07 a.m., in room SD–342, Dirksen Senate Office Building, Hon. Peter G. Fitzgerald, Chairman of the Subcommittee, presiding.

Present: Senators Fitzgerald, Akaka, Collins, Levin, Lautenberg, and Sununu.

OPENING STATEMENT OF SENATOR FITZGERALD

Senator FITZGERALD. This meeting will come to order. Today we are conducting our second oversight hearing on the mutual fund industry. At our first hearing in November we examined the breadth and the depth of the illicit trading practices that have come to light in the past year. We also examined mutual fund management and governance and sought to identify statutory and/or regulatory reforms that should be enacted to better protect mutual fund shareholders.

I would like to begin by welcoming all of our witnesses who are present today, and to thank each of them for taking time out of their schedules to share their insights with us. I see that some of them flew in last night, which turned out to be a good move given the weather conditions in Washington today.

I also want to acknowledge the dedication and hard work of my colleagues with us today, Governmental Affairs Committee Chairman Susan Collins, whose experience as Maine's Commissioner of Professional and Financial Regulation has contributed an invaluable perspective to our reform dialogue; and the Subcommittee's Ranking Member, Senator Akaka, whose bill, S. 1822, introduced the U.S. Senate to serious legislative treatment of these issues. Also with us is Senator Levin from Michigan, whom I know to having a keen interest in the welfare of America's mutual fund investors.

The general consensus of the panelists at the November hearing was that illegal late trading and illicit market timing were indeed very serious threats to investors, but that excessive fees and inadequate disclosure of those fees were an even more serious threat to American investors. We heard extensive testimony from industry experts who forcefully noted that small differences in mutual fund fees can add up to enormous differences in investment returns over time, but that poor disclosure of those fees, and in fact no disclosure of transaction cost, makes it very difficult for investors to compare funds.

In general the experts agreed that regulators could readily stop illegal or illicit practices such as market timing and late trading, but that it would be far more difficult and complex to address the problem of excessive fees and the inadequate disclosure, in part because most mutual funds are organized in a manner that makes the interest of fund managers largely adverse to the interest of fund shareholders.

The purpose of this hearing is to take the bull by the horns and to pick up where the last hearing left off. We will examine mutual fund fees, the whole menu, the whole panoply of mutual fund fees, their propriety and the adequacy of their disclosure under the current regime. We will attempt to lift the veil off hidden fees such as revenue sharing, directed brokerage and soft money arrangements. We will also attempt to unmask and deconstruct hidden loads such as 12b–1 fees. We will discuss how statutory or regulatory changes might improve disclosure and allow for more informed comparisons between funds.

This Subcommittee has specific jurisdiction over Federal retirement benefits. Later this year we will hold a hearing on the unique mutual fund system that is available only to employees of the Federal Government. It is called the Thrift Savings Plan, or the TSP for short. I have a brochure right here from the Federal Thrift Savings Plan. The TSP is essentially a public sector version of the private sector 401(k) plan. All Members of Congress, all of us up here, the Administration and their agency staffs, can invest their retirement savings in any or all of five TSP funds, each of which is either an equity or a debt security index fund.

While I may be jumping ahead somewhat to a future hearing, it is worth mentioning here that the expense ratio of the average government TSP fund last year was only 11 basis points, or 11 cents per $100 invested, and that in previous years it has been as low as 7 or 8 basis points. In fact, one of the funds, the Government G Fund, in 1999 and 2000, had a net expense ratio of only 5 basis points.

In contrast, according to the most recent data available from the Lipper Services, the average expense ratio for private sector S&P 500 Index Funds is 63 basis points. That is 63 cents per $100 invested. Many private sector S&P Index Funds have total expense ratios substantially lower than that, maybe as low as 17 or 18 basis points, but none even comes close to the Government Thrift Savings Plan. The difference between expenses of 11 cents per $100 invested and 63 cents per $100 invested may not sound like much, but keep in mind what all the experts emphasize, that small differences in fees add up to large differences in returns as the principal invested is compounded over long periods such as 10, 20 or 30 years.

I point these facts out now because I think it ironic that Members of the House and Senate have managed to protect themselves from the sort of abusive practices and excessive fees which eat away at the savings of many Americans. If you are lucky enough to be a Senator or a Member of Congress, you simply do not have to worry about excessive fees, directed brokerage, revenue-sharing arrangements or soft dollar payments eating away and siphoning away your retirement savings like most Americans do. Nor do you have to worry about an incestuous board of directors that is beset with conflicts of interest because board members are completely independent and required by law to act solely in the interests of plan participants and beneficiaries. The TSP competitively bids out the management contract for the TSP Fund, and not surprisingly, the management fee charged to TSP shareholders is only a negligible percentage of the overall TSP expense ratio. I said that the expense ratio averaged 11 basis points last year for TSP participants. A large portion of that was for a computer system that they had to charge off. They entered a contract to change their computers. Chairman Collins is investigating that. In previous years the expense ratios for the TSP Fund have been much lower than that, and it is projected that next year it will go back down into the single digits, 7 or 8 basis points.

The mutual fund industry is indeed 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. Is it not special that Members of Congress and Senators have set up a special separate mutual fund deal for themselves in which no skimming is allowed? Sad to say, retirement investing appears to be yet another instance in which Federal employees get a great deal, but everyone else gets the shaft. A Senator or a Congressman or a member of the SEC staff, for that matter, who participates in the Thrift Savings Plan will have more money at retirement than a member of the general public who invests the same amount for the same number of years in a comparable private sector index fund. That is not right. In fact, it is outrageous.

This Committee and this Senate should not rest until Congress has given every American the same retirement savings opportunity that it has given itself.

As we commence this oversight hearing, I would like to note that the Senate Committee on Banking, Housing and Urban Affairs, the authorizing committee which will ultimately decide questions of mutual fund industry reform, has scheduled a series of legislative hearings to examine the mutual fund scandal and the merits of various proposals. I commend the leadership of Chairman Shelby and Ranking Member Senator Sarbanes, and look forward to continuing to work with them on this issue in the coming months.

Today we will hear a broad spectrum of informed opinion on the problems confronting the mutual fund industry. We will hear the State and Federal Government perspective in our first panel, the illuminating, in-the-trenches whistle-blower perspective in our second panel, and a truly diverse and academic perspective in our third panel.

At this point I would like to also acknowledge Senator Lautenberg from New Jersey, who has joined us. Senator, we thank you for your participation. The Senator had a distinguished business career before coming into the Senate, and before retiring and then coming back into the Senate. Welcome back. It is good that you are here for this issue.

Senator LAUTENBERG. Pleased to be here.

Senator LEVIN. Mr. Chairman, if you could just yield on that. There was another event in Senator Lautenberg's life on Sunday which we all ought to take note off, which I just found out about. His beloved Bonnie is now his wife.

Senator FITZGERALD. Congratulations. You did not go on a honeymoon.

Senator LAUTENBERG. Thank you for the mention, everybody. It is about time.

Senator FITZGERALD. There we go. No honeymoon? Maybe later.

Senator LEVIN. That is a sore point already probably. [Laughter.]

Senator LAUTENBERG. In a safe, secure relationship, it is all right to take the precise week that you want for your honeymoon.

Senator FITZGERALD. Maybe wait until congressional recess to do that.

Senator LAUTENBERG. Thank you very much.

Senator FITZGERALD. At this time, before I introduce our witnesses, I would like to recognize our Ranking Member, Senator Akaka, who may have an opening statement, and then I will proceed to the Chairman of the full Committee, Senator Collins, and then to Senator Levin and Senator Lautenberg.

Senator Akaka, thank you.

OPENING STATEMENT OF SENATOR AKAKA

Senator AKAKA. Thank you very much, Mr. Chairman. I really appreciate your conducting this hearing today, and thank you for your leadership on the issue of mutual fund reform. I look forward to continuing to work with you, Mr. Chairman, along with our colleagues on the Senate Banking Committee in enacting meaningful legislation intended to protect investors.

Mr. Chairman, I have found the betrayal of trust of mutual fund investors by fund companies and brokers appalling, because mutual funds are investment vehicles that the average investor relies on for retirement, savings for children's college education, or other financial goals and dreams. In one example directly related to worker retirees in the State of Hawaii, Putnam Investments had been responsible for managing $440 million for the State of Hawaii's Employees Retirement System, which administers retirement and survivor benefits for over 96,000 State and county employees in Hawaii before the company was fired due to the late trading abuses that one of our witnesses, Mr. Scannell, helped to bring to the attention of regulators.

Today's hearing will provide an opportunity to closely examine the hidden financial relationships between mutual fund companies and brokers. For example, shelf-space payment and revenue-sharing agreements between mutual fund companies and brokers present conflicts of interest that must be addressed. Brokers also compile preferred lists which highlight certain funds which typically generate more investment than those left off the list. It is not clear to investors that the mutual fund company also may pay a percentage of sales and/or an annual fee on the fund assets held by the broker to obtain a place on the preferred list or to have their shares sold by the broker. Brokers have conflicts of interest, some of which are unavoidable, but these need to be disclosed to investors. Without such disclosure investors cannot make informed financial decisions. Investors may believe that brokers are recommending funds based on the expectation of solid returns or low volatility, but the broker's recommendation may be influenced by hidden payments. Mutual fund investors need to know the amount of compensation the broker will receive due to the transaction instead of simply providing a prospectus. The bottom line is that the prospectus fails to include that detailed relevant information that investors need to make informed decisions. Mutual fund investors deserve to know how their broker is being paid.

I am also concerned that although consumers often compare the expense ratios of funds when making investment decisions, they are not getting a realistic view of the true expenses of mutual funds. The expense ratios fail to take into account the costs of commissions in the purchase and sale of securities. Brokerage commissions are only disclosed to the investors upon request in the Statement of Additional Information. Brokerage commissions must be disclosed in a document and in a format that investors actually have access to and utilize.

Mr. Chairman, I want to take a moment to commend the Securities and Exchange Commission for its proposals intended to improve the corporate governance of mutual funds and to increase the transparency of mutual fund fees that investors pay. The SEC has recently proposed rules to require an independent chairman for mutual fund boards, an increased percentage of independent directors to 75 percent, and a confirmation notice so that investors will be able to know how their broker gets paid in mutual fund transactions. These provisions mirror those in the Mutual Fund Transparency Act of 2003, which I introduced along with Senator Fitzgerald and Senator Lieberman in November in order to restore public trust in the mutual fund industry.

I am pleased that the Commission has taken these and other actions to protect the 95 million American investors who have invested a significant portion of their financial security in mutual funds. I am encouraged by the steps taken by the SEC and I look forward to the implementation of many of the proposed reforms. However, legislation is still needed to codify several of these proposals and to bring about additional changes so that comprehensive reform of the mutual fund industry is achieved. For working Americans, mutual funds are an important investment vehicle that offers diversification and professional money management.

We must restore the trust of investors in mutual funds, and I look forward to today's discussion and what needs to be done to accomplish that essential goal.

Thank you very much, Mr. Chairman.

Senator FITZGERALD. Senator Akaka, Thank you very much. Chairman Collins.

OPENING STATEMENT OF CHAIRMAN COLLINS

Chairman COLLINS. Thank you very much, Mr. Chairman. I want to thank you for holding a second hearing to examine the mutual fund industry, and particularly to recognize your leadership in focusing on a very important topic this morning, the fees paid and expenses borne by mutual fund shareholders.

For many investors, as the Chairman has pointed out, high fees and excessive expenses are even more of a problem than market timing, late trading and other abuses previously examined by this Subcommittee. Mutual funds have long been promoted as a haven for the small investor who may not have the time nor the expertise to pick stocks. Many investors like to leave the difficult and worrisome decisions regarding which companies to buy and sell to a mutual funds professional manager. To achieve their saving goals, whether it's for a new home, a college education, or a secure retirement, many American families put their hard-earned savings into mutual funds. Savings for the future often mean sacrifices for the present. A secure retirement may mean a shorter vacation. A college education for children can equate to buying a used car rather than a new one. Saving for a first home means fewer dinners out and foregoing other luxuries.

These sacrifices, Mr. Chairman, are why I am so concerned that we maximize investors' mutual fund returns, and even more important, that investors understand precisely the fees and the expenses they are charged. Maximum returns for investors cannot occur if fees are excessive or opaque, or if any other questionable practices that reduce investment returns are permitted.

By now we are all too familiar with the allegations regarding late trading, market timing, and other practices. What they revealed is that far too often there are two sets of rules, one for favored insiders and another set for the average investor. Perhaps most disturbing, however, was that these practices were carried out not by shady dealers in boiler rooms, but rather by senior executives at some of the most respected names in the mutual fund industry. In the most egregious cases these practices were not only tolerated by senior management but actually exploited by them as well. These executives seem to have forgotten the fundamental principle of money management, that the money given to them to invest is not their money but rather the shareholders' money. That is why Federal law imposes upon investment advisers who run mutual funds a fiduciary duty to the fund and its shareholders. At the very least this should mean, as one former regulator put it, that mutual fund executives are not spending their days trying to invent new ways to skim their shareholders' assets.

Although mutual funds have been around for some 80 years, they have only become popular investment choices in the past 25 years. The American public's investment in mutual funds has exploded during that time. In 1980, total assets amounted to about $135 billion, and only 10 percent of Americans owned mutual funds. Today approximately 50 percent of Americans own a mutual fund, and total assets are at least $6.4 trillion. It can be very difficult for consumers to choose among the 8,200 mutual funds. Consumers often focus primarily on the historic rate of return, rather than on fees and expenses. Yet according to the former chief economist of the Securities and Exchange Commission, small differences in investor costs can make a huge difference in the ultimate return over the long run.

For example, assume a worker chooses a mutual fund at the beginning of her working career. Should she choose one with high returns in recent years and expenses of 1.5 percent, or should she choose another with steadier, less spectacular recent returns, but only a 0.5 percent expense ratio? Sadly, there is a very good chance that most average investors will choose the former, but choosing the latter would, by the end of this woman's career, probably have returned 35 to 40 percent more money. That is the difference that the amount of fees and expenses charged can make.

The government does not place limits on how much mutual funds can charge, nor should it, in my opinion. We know that U.S. mutual funds generally have lower costs than those in many other countries. But research by the General Accounting Office and the SEC suggest that we can do much better in lowering mutual fund investors' costs.

It is my hope that today's hearing will shed more light on why the mutual fund market is simply not more cost competitive. It may be that consumers simply do not understand, or have not been given enough information to understand the impact of fees. But one problem clearly is that it is often very difficult for the average investor to discern the level of fees. We do not have a simple system such as we do with our checking accounts, where every month we can clearly see what fees were assessed. I think we need to look at the disclosure of fees and the location of that disclosure to bring increased transparency and disclosure to the process.

Again, Mr. Chairman, I want to thank you very much for your leadership, and I look forward to hearing the testimony today.

Senator FITZGERALD. Thank you very much, Chairman Collins. That is an incredible statistic, 8,200 mutual funds in the country. I believe there are only about 6,000 publicly traded corporations, so that statistic would seem to suggest it is a very good business to own or run a mutual fund.

Senator Levin.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Thank you, Mr. Chairman. With 95 million Americans invested in mutual funds, hoping and planning to use their investment dollars for college expenses, mortgages, retirement, and to help their kids, the recently-exposed mutual fund scandals have brought home the need to look at potential reforms to stop late trading and market timing abuses, as previously examined by this Subcommittee. We are going to examine this morning to prevent hidden fees and to end ongoing conflicts of interests and other harmful practices that hurt mutual fund investors.

Investors pay $75 billion each year in fees that support the mutual fund industry. The immense size of this dollar amount reflects the importance of the subjects of this hearing: Clear fee disclosure and the elimination of conflicts of interest. Investors deserve complete and accurate information about mutual fund costs so that they can make informed investment decisions and comparison shop to find well-run, low-cost mutual fund products. They also need to have confidence that the fees that they incur are legitimate. They deserve to know that the persons in charge of their investments are exercising independent and careful judgments on their behalf and that their investment advisers are providing them with objective investment advice.

As we consider appropriate mutual fund reforms, it is critical to recognize and address conflicts of interests and lax oversight practices. We can start at the top. Like a typical corporation, every mutual fund is governed by a board of directors that has a duty to act in the best interest of the funds' shareholders, but as we can see from recent scandals many of these boards, as currently constituted, have failed to provide needed oversight of their funds.

One way to address director conflict of interest concerns is to make sure that the requirement for so-called independent directors is met with directors who are truly independent of the funds they oversee. For instance, right now a current officer or director of a service provider to a fund can be counted as an "independent director." We must change that.

Other troubling conflicts of interest arise when mutual funds make undisclosed arrangements with brokerage houses which now sell about half of all mutual fund shares. For instance, recent press reports indicate that some brokers receive undisclosed incentives from mutual funds, without telling their customers about the compensation they get to push that fund's products. These types of secret commissions and arrangements mean that investors are not getting objective investment advice.

We need to throw a spotlight on hidden, difficult-to-understand arrangements between mutual funds and brokerage houses involving so-called directed brokerage, revenue sharing and soft dollars arrangements. Directed brokerage occurs when a mutual fund buys stock from a brokerage firm for its holdings if that brokerage firm promotes the mutual fund's shares to their other customers. In so-called revenue sharing, the mutual fund gives the brokerage firm a share of its revenues if the brokers sell the mutual fund shares to their customers. With soft-dollar arrangements, a mutual fund pays a brokerage firm for research and other services, in the expectation that the brokers will promote the mutual fund's products. These hidden practices raise troubling conflicts of interest that need to be ended. As SEC Chairman Donaldson has said, "Investors have the right to know everything that is inducing a broker to recommend a particular fund."

Another key reform would be to standardize the method for calculating and disclosing mutual funds' "expense ratios" and ensure that they include all material costs. That ratio is designed to show the total annual operating expenses of a fund is a percentage of its total assets. The figure is already compiled by every fund and theoretically should be one of the most helpful numbers to investors comparing fees. If designed well, it should function in a way similar to the per-unit price listed on a grocery shelf price tag, giving a "price per ounce" so that comparison shoppers can assess the price savings between different brands and sizes. But right now, many funds leave out key expenses when calculating that ratio. For example, while the ratio now includes the management fee charged by the fund management, distribution fees and other administrative expenses, it excludes what can be one of the fund's largest expenses, portfolio transaction costs such as broker commissions.

According to consumer groups, these portfolio transaction costs sometimes exceed all the costs combined that are currently included in the expense ratio. These transaction costs ought to be disclosed in a standard and easily-understood format.

Other fee reforms are also needed. Many investors find the various fee options for mutual funds bewildering and rely on their broker's advice about which to choose. However, a broker's interest is often at odds with the investor's. The fee option with the greatest payoff for the broker may result in the highest charge to the investor. That conflict of interest could be addressed by requiring a clear fee disclosure prior to the purchase that presents a clear comparison of the dollar costs of investing in each class of shares over a certain period of time.

Mutual funds are the investment of choice for a large percentage of Americans. It is their money that provides much of the fuel for economic growth. All of us have a duty to protect the average investor and in turn the American economy. It is sad but true that the mutual fund industry has shown that it cannot be relied upon to protect its customers. Strong reforms must be put in place in law and in regulation.

I salute our Chairman, Senator Fitzgerald, Senator Akaka, Senator Collins, all of those who are involved in the leadership of advocating needed reforms for the mutual fund industry on behalf of the average investor.

Thank you, Mr. Chairman.

Senator FITZGERALD. Thank you, Senator. We have been joined by Senator Sununu from New Hampshire, and if I go in the order that Senators arrived, I would go first to Senator Lautenberg and then we will come back to Senator Sununu.

Senator Lautenberg.

OPENING STATEMENT OF SENATOR LAUTENBERG

Senator LAUTENBERG. Thanks, Mr. Chairman. Senator Sununu has got all kinds of excitement going on in his State, so he has to get back to the TV screen and we will permit him to do so very shortly.

Mr. Chairman and Chairman Collins, we thank you both for having this hearing at this opportune moment. We have been looking at hidden fees and misgovernance and self-dealing and other practices that have harmed investors in the mutual fund industry, and it seems that there is no end to corporate scandals shaking Wall Street and Main Street.

I am a former chief executive and a founder of a company called ADP, Automatic Data Processing, and I always felt that my responsibility to the investor was a paramount part of my obligation, that if I could face them regularly, and even if we had an occasional dip in earnings because of the general economy, there was very good acceptance of our stock, and the PE, which I assume most people here are familiar with, was always at a very high level, and that is because they had faith and it is because that was the only way we knew how to run a company.

Now what we see is instead of working to enhance shareholder value, it seems that many directors and fund investment advisers have used their trusted positions to line their own pockets and the pockets of their industry cronies. I am on the board of the Columbia University Business School—it is my alma mater—and recently established a chair in corporate governance. And having served on the public corporation for 25 years, I learned a lot from my trusted directors, including Alan Greenspan, who came to the Fed directly from the ADP Board, and recently departed Larry Tisch, who we all knew and who was a terrific example of credibility and care about how you treat public funds.

So to see that the mutual fund principles have been so lax that their mission appears to be not to serve the shareholders, not the 95 million Americans who invest in mutual funds because they believe that the funds are diversified, well-regulated and managed by honest professionals, but it turns out that some investment fund managers are more concerned about creating arrangements that are profitable for them, leaving the leftovers for the investors, many of whom are counting on the safety and growth of what might be their only reserve.

Today's witnesses—and I am pleased to see the list of witnesses, Mr. Chairman, are credible people, and we are pleased to have them. I am particularly familiar with Attorney General Spitzer's record and zeal in rooting out corruption wherever it can be found, and I salute that effort and urge you to continue it.

Today's witnesses will testify—and this may be slightly repetitive but I think worth mentioning—that while the total assets of all mutual funds increased from $56 billion in 1978 to $6.4 trillion in 2002, the expense ratio of the average mutual fund, which actually represents less than one half of all the costs incurred by fund investors, increased from 0.91 percent in 1978 to 1.36 percent during the same period. It sounds like good business to me. That is an increase of 49 percent in the expense ratio. Mutual fund investors have not realized any of the benefits of the economies of scale, and to make matters worse, industry experts have concluded that the return earned by the average mutual fund in the past 20 years, from 1982 to 2002, has lagged behind the return of the S&P 500 by more than 3 percent. That is more than double the lag from the previous 20 years of 1950 to 1970. In other words, mutual funds have gotten more expensive, thus, their performance has realistically gone down.

I am searching for a good reason why this has happened. It is hard to think of one. We do know that there has been a rash of corporate malfeasance that has extended into the mutual fund industry. It is clear that the fund managers and investment advisers seem to have become less interested in how their funds perform to the benefit of all shareholders, and more interested in creating schemes that line their own pockets regardless of performance. *The New York Times* reported last week that corporate executives at the World Economic Forum in Davos, Switzerland complained that the Sarbanes-Oxley Bill passed in the wake of the accounting scandals at Enron, WorldCom, Tyco, is hampering their ability to do business. They brought it on themselves. I think the simplest axiom for Sarbanes-Oxley is "tell the truth" and then you do not have to worry about those kinds of imposing laws. They brought it on themselves. Someone has to look out for shareholder interests for the public interest, and there is too much at stake.

Just think, this comes at a time when it is suggested that some part of Social Security ought to be permitted to be invested in the public marketplace. Well, I think that if that does happen, it is going to have serious scrutiny in the Senate and House, and we are going to make sure—if I can do anything about it; my colleagues here I think would agree—that we highlight the performance of the funds including the expenses both hidden and real and make them part of the reporting system. It comes up frequently and regularly.

That is where this timing, Mr. Chairman, is so important. I congratulate you. I look forward to hearing the testimony of our distinguished witnesses. I think that we have heard much about Attorney General Eliot Spitzer, almost all of it very positive and very exciting. I urge him to continue. It is a difficult and painful review, but it is essential that we get the markets functioning properly again and restore the American people's faith in the fundamental way that this country conducts its business affairs, and I thank you.

Senator FITZGERALD. Senator Lautenberg, thank you very much for that excellent opening statement.

Senator Sununu, last but not least.

OPENING STATEMENT OF SENATOR SUNUNU

Senator SUNUNU. Thank you, Mr. Chairman, and thank you for putting together this hearing. I am also a member of the Banking Committee and I look forward to the series of hearings that Chairman Shelby will also be holding on these issues.

Let me begin picking up on a point that Senator Lautenberg made, and that is the importance of the board structures and the responsibility of the board structures. It is easy to be a little bit disdainful of wealthy board members that might be meeting overseas for a big economic forum and that they are lamenting some of the regulatory complexities of Sarbanes-Oxley. But at the same time these are board members that are supposed to be representing shareholders' interests and if we pass regulations, whether it is Sarbanes-Oxley or any other piece of regulation, one that limits their ability or creates disincentives for them to make creative decisions and good investment decisions on behalf of shareholders, or two, if we pass legislation against Sarbanes-Oxley or any regulations having to do with the mutual fund industry that makes it difficult to encourage good people, independent minds, creative individuals to sit on boards, we will have done a disservice to shareholders. So while it is important that we have regulations in place that set a clear path, set clear standards for behavior, a bright-line for legal and illegal behavior, conflicts of interest and disclosure, we do not want to create an environment, whether they are volunteer or compensated, where good, qualified people no longer want to participate in the process or serve the interests of shareholders on boards because our financial systems and our markets will have been hurt significantly by it.

We all have concerns about some of the issues that have been uncovered and revealed in part by the work of Eliot Spitzer and others. Late trading, market timing, these are practices in some cases that were discouraged if not outright illegal, that need to be clarified and dealt with either by the SEC or by legislation passed by Congress. Investors need to be protected by the impact of any illegal or inappropriate trading schemes. They can place undue burdens on the funds themselves, and they can also undermine the confidence that investors have in our financial system, and that is what we saw with some of the concerns that were addressed by Sarbanes-Oxley.

First and foremost we are concerned about confidence in the marketplace because without confidence we cannot have efficient trading and investing activities. Disclosure is also extremely important and highlighted here in a number of cases. We want to have consistent standards for the fees reported by these mutual funds or any other investment vehicle. What are the costs, what are the fees as a percentage?

But at the same time, the absolute level of the fee is not the most critical piece of information that consumers can have, and if we suggest otherwise as policy-makers or witnesses or anyone else, then we are doing the public a disservice. The most important number is the returns of the fund net of all the fees. That is how you compare one fund to another, and if I say this fund has expenses of 20 basis points and this one has expenses of 50 basis points, but one has a return that outstrips another, then we are not going to be giving the consumers all the information that they have, so it is important that we are able to discern that different funds are going to have different risk profiles, or different returns. We want to look at those returns net of all the fees.

Given good information, I think consumers will make good decisions, and I think it is a mistake to suggest that the entire mutual fund industry is a giant skimming operation. There are some bad funds out there, of course, 8,000 funds, Senator Collins pointed out. There are funds that have individuals, managers, brokers that might have broken the law and they should pay. They should certainly be prosecuted under current or future securities laws. There are funds that have done a very poor job in delivering returns to their investors, and they should certainly pay in the court of public opinion that we call the marketplace. Eight thousand mutual funds suggest to me at least an extremely competitive marketplace that is good for investors, that is good for the country.

By doing a good job here with our oversight to deal with disclosure issues, we can make that marketplace even stronger and healthier, but the oversight needs to be geared toward not just good disclosure but fairness in disclosure. Some of the proposals that I have seen seem to be weighted against independent research firms. The very firms that as a result of the settlement by the Attorney General of New York and the SEC has been encouraged and I think strengthened. Independent research is a good thing. We should not do anything now in our oversight or new regulations that put independent researchers at a disadvantage. I do not believe that we should undertake regulations that try to micro manage the selection of boards on behalf of shareholders. If anything, we should be looking at ways to give the shareholders themselves, whether it is a mutual fund or a public company, the power that they need to exercise a choice in selection over board members and even hold board members accountable, and it is not the topic for this hearing, but questions of proxy and how shares are voted and the disclosure of those votes are all very important, I think, to giving power to shareholders and the decisions that they make.

I appreciate the opportunity to make an opening statement and appreciate the work of the Chairman that he has done on this issue. Thank you, Mr. Chairman.

Senator FITZGERALD. Senator Sununu, thank you very much. We are glad to have you here.

I would like to now introduce our first panel of witnesses. Our first witness is Richard J. Hillman, who is the Director of Financial Markets and Community Investment at the General Accounting Office (GAO). Mr. Hillman has served at the GAO for the past 27 years and has worked on a series of reports regarding the mutual fund industry including an assessment of the industry's transparency, the quality of listing standards within securities exchanges and other corporate governance and oversight matters. The GAO conducted a review of the mutual fund industry and published an extensive report in June 2003 stating the need for greater transparency. Of course, that was before the market timing and late trading scandals broke, and now that report is getting needed attention, as are many other reports you wrote in previous years, going at least as far back as 2000 that I have seen.

Our second witness is the Hon. Eliot L. Spitzer, Attorney General for the State of New York. Attorney General 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.

I would like to thank both of you for appearing before us. In the interest of time your full statements will be included in the record, so we would ask that you limit your summary statement to 5 minutes. Thank you very much.

Mr. Hillman, you may proceed.

TESTIMONY OF RICHARD J. HILLMAN,[1] DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, GENERAL ACCOUNTING OFFICE

Mr. HILLMAN. Thank you, Mr. Chairman. Thank you, Chairman Collins and Members of the Subcommittee.

I am pleased to be here today to discuss GAO's work on the disclosure of mutual fund fees and the need for other disclosures of mutual fund practices. Concerns have been raised over whether the disclosures of mutual fund fees and other fund practices are sufficiently fair and transparent to investors.

Our June 2003 report, entitled "Greater Transparency Needed in Disclosures to Investors" reviewed (1) how mutual funds disclose their fees and related trading costs and options for improving disclosure of those costs; (2) changes in how mutual funds pay for the sale of fund shares and how the changes in those practices are affecting investors; and (3) the benefits of and the concerns over mu-

[1] The prepared statement of Mr. Hillman appears in the Appendix on page 81.

tual funds' use of soft dollars. This testimony summarizes the results of our report and discusses certain events that have occurred since the report was issued.

In summary, we recommend that SEC consider the benefits of requiring additional disclosure relating to mutual fund fees and evaluate ways to provide more information that directors and investors could use to evaluate the conflicts of interest arising from payments funds make to broker-dealers and fund advisers' use of soft dollars.

Specifically regarding mutual fund disclosures, we learned that although mutual funds disclosed considerable information about their cost to investors, the amount of fees and expenses that each investor specifically pays on their mutual fund shares are currently disclosed as a percentage of fund assets, whereas most other financial services disclose the actual cost to the purchaser in dollar terms. The SEC has proposed that the mutual funds make additional disclosures to investors that would provide more information that investors could use to compare fees across funds. However, SEC is not proposing that the funds disclose the specific dollars amount of fees paid by each investor, nor is it proposing to require that any fee disclosure be made in the account statements that inform investors of the number and value of mutual fund shares they own. Our reports recommend that SEC consider requiring mutual funds to make additional disclosures to investors including considering requiring funds to specifically disclose fees in dollars to each investor in quarterly account statements. Our report also discusses less costly alternatives that could also prove beneficial to investors and spur increased competition amongst mutual funds on the basis of fees.

The work that we conducted for our report also found that 12b–1 fees, which allow fund companies to deduct certain distribution expenses such as sales commissions from fund assets can raise cost to investors, but also provide additional ways for investors to pay for investment advice. Our work also found that mutual fund advisers have been increasingly engaging in a practice known as revenue sharing under which they make additional payments to the broker-dealers that sell their fund shares. Although we found that the impact of these payments on the expenses of the fund investors was uncertain, these payments can create conflicts between the interests of broker-dealers and their customers that could limit the choices of funds that these broker-dealers offer investors. However, under current disclosure requirements, investors may not always be explicitly informed that their broker-dealer, who is obligated to recommend only suitable investments based upon the investor's financial conditions, is also receiving payments to sell particular funds. Our report recommends that more disclosure be made to investors about any revenue-sharing payments that their broker-dealers are receiving, and on January 14, SEC proposed new rules in this area.

We are also reviewing a practice known as soft dollars in which a mutual fund adviser uses fund assets to pay commissions to broker-dealers for executing trades and securities for the mutual fund portfolio, but at the same time also receives research or other brokerage services as part of that transaction. These soft-dollar arrangements can result in mutual fund advisers obtaining research or other services, including research from third-party independent research firms that can benefit the investors in their funds. However, these arrangements also create a conflict of interest that could result in increased expenses to fund shareholders if a fund adviser trades excessively to obtain additional soft-dollar research or chooses broker-dealers more on their ability to provide soft-dollar offerings, rather than their ability to execute trades efficiently.

SEC has addressed soft-dollar practices in the past, and recommended a number of actions, but has yet to act upon them. Our report recommends that more disclosure be made to the mutual fund directors and investors to allow them to better evaluate the benefits and the potential disadvantages of the fund adviser's use of soft dollars.

In conclusion, GAO believes that various changes to the current disclosure and other practices would benefit fund directors and investors. Additional disclosures and mutual fund fees could help increase the awareness of investors of the fees they pay and encourage greater competition amongst funds on the basis of those fees. Likewise, better disclosure of the costs funds incur to distribute their shares and the costs and benefits of funds' use of soft-dollar research activities could provide investors with more complete information to consider when making their investment decision.

Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to questions at the appropriate time.

Senator FITZGERALD. Thank you, Mr. Hillman. Mr. Spitzer.

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

Mr. SPITZER. Thank you, Mr. Chairman, Madam Chairman, Members of the Subcommittee.

This Subcommittee's hearing last November played an important role in focusing attention on the conflicts inherent in an industry where directors were beholden to management. That hearing also started the process of crafting solutions to protect the $7 trillion Americans have invested in mutual funds. Several of the proposals that seemed radical when we discussed them in November have already become conventional wisdom. Requiring mutual funds to have truly independent directors and an independent board chairman are now the centerpiece of every reform proposal. There is now also widespread recognition that mutual fund directors must be given the staff and resources needed to allow them to effectively oversee the management companies that run the funds' day-to-day operations. Many reformers also recognize that mutual fund compliance officers should report to the funds' independent directors and not to the managers, whose activities are being monitored and reviewed. Perhaps most significantly, there is universal agreement that the disclosures provided to mutual fund customers are inadequate, and several competing proposals address this problem.

I continue to believe that the proper approach would be to provide each investor with an itemized statement of the actual costs charged to his or her account. This would provide mutual fund cus-

[1] The prepared statement of Mr. Spitzer appears in the Appendix on page 102.

tomers with the information necessary to engage in true comparison shopping. That is the good news. The bad news is that the industry and many of its apologists are still opposing true reform in the area that most directly impacts investors, advisory fees.

As I indicated when I was here last November, in 2002 mutual fund investors paid advisory fees of more than $50 billion and other management fees of nearly $20 billion. That is in addition to the tens of billions of dollars in marketing fees and trading costs imposed by the fund industry. The advisory fees that mutual funds charge their shareholders greatly exceed those charged to institutional customers. If mutual fund customers were charged the lower rate for advisory fees paid by institutional investors they would save more than $10 billion every year.

The industry has asked whether there is a link between the advisory fees charged to investors and the late trading and market timing practices that were the initial focus of investigation. The answer is yes. Improper trading and exorbitant advisory fees are both a consequence of a desire by managers to enrich themselves at the expense of investors and an inability or unwillingness on the part of directors to protect investors. This can be demonstrated by the fact that the managers who permitted late trading and market timing in many instances did so in return for increased investments in other funds that they managed. As one mutual fund manager frankly admitted in an E-mail uncovered during the investigation, "I have no interest in building a business around market timers, but at the same time I do not want to turn away 10 to 20 million dollars."

Mutual fund directors and managers breached their duties to investors in many ways, and we must pursue every manifestation of that breach. This includes breaches of duty that allowed managers to overcharge investors.

When I was last before this Subcommittee I spoke in generalized terms about the advisory fee overcharges imposed on investors. Now that our investigation has progressed, I'd like to talk more specifically about the advisory fees charged by two fund complexes, Putnam and Alliance.

In 2002 Putnam managed approximately $279 billion from mutual fund and institutional investors. Our investigation revealed that Putnam charged mutual fund investors significantly higher advisory fees than those charged to institutional investors. Here are the numbers. Putnam's mutual fund investors were charged 40 percent more for advisory services than Putnam's institutional investors. In dollar terms what this fee disparity means is that in 2002 Putnam mutual fund investors paid $290 million more in advisory fees than they would have paid had they been charged the rate given to Putnam's institutional clients, and these are for identical services.

There was a similar disparity in the advisory fees charged by Alliance. Once again mutual fund investors were charged significantly higher advisory fees than institutional investors. Specifically, Alliance's mutual fund investors paid advisory fees that were twice those paid by institutional investors. In dollars terms this means that Alliance investors paid more than $200 million in advisory fees than they would have paid had they been charged the rate given to Alliance's institutional clients.

Because of these findings I refused to join in a settlement with Putnam that did not provide investors with some form of compensation for the advisory fee overcharges they incurred. Similarly, my office's settlement with Alliance requires them to return $350 million to investors by way of a 5-year 20 percent reduction in their advisory fees. These actions have led some to accuse me of engaging in rate setting. That is simply wrong. Requiring mutual funds to return to investors money that should never have been taken from them is not rate setting. It is what regulators across the country do every day when they uncover evidence that consumers have been ripped off, and it is what I will continue to do as I uncover more evidence that mutual fund investors have been overcharged.

When the charge of rate setting fell flat, the industry turned to a more audacious argument in defense of their advisory fees. Earlier this month the Investment Company Institute issued a report that attempted to rebut the evidence showing that mutual fund investors pay more than institutional investors for advisory services. The ICI report tries to rebut the important conclusions of an academic article published in the *Journal of Corporation Law* by Professors Freeman and Brown. Professor Freeman is testifying in a later panel and does not need my assistance to articulate the foundation of his analysis, but he is due our thanks for shedding light on an abusive practice that takes billions of dollars each year from the pockets of average family savings of families who are saving for a new home of their children's education.

The ICI's conclusion that mutual fund investors do not pay more than institutional investors for advisory fees was unfortunately misleading and wrong. It was not based on data showing what mutual funds charge for advisory services. Instead, the ICI relied exclusively on data concerning the fees that sub-advisors, the outside advisors occasionally hired by mutual fund managers to give investment advice, charge management companies. There are three reasons it is inappropriate to rely on data concerning sub-advisors. First, fewer than 20 percent of all mutual funds employ sub-advisors. Indeed, after the ICI released its report, *Business Week* noted that as few as 7 percent of mutual funds employ sub-advisors. Second, unlike most mutual fund fees where directors rubber stamp their affiliated management companies request, the fees charged by sub-advisors are the product of an arm's length negotiation between disinterested parties. Third, even the small percentage of mutual funds that employ sub-advisors often impose their own costs on top of those of the sub-advisor. For example, if the sub-advisor charges the fund 30 basis points, the fund will tack on its own premium of 20 or 30 basis points and charge investors the combined amount. The ICI report used the amount charged by the sub-advisors without accounting for the premiums tacked on by the mutual funds and passed on to shareholders. The result is that even in mutual funds that are sub-advised, shareholders pay more for advisory services than the actual cost for that service incurred by the management company. Thus, the ICI report takes a number that reflects a narrow slice of the industry and is the only part of the industry where fees are a product of arm's length negotiation, ignores the markup imposed by mutual fund and then attempts to pass that number off as representative of the entire industry. The real data that reflected the overcharge throughout the overwhelming majority of the industry are those such as what I gave you from Putnam and Alliance, data, by the way, that the companies themselves provided to us.

I know that the ICI has a representative testifying in a later panel. I hope the Subcommittee will explore the issue of sub-advised fees, especially the premiums that the funds impose on top of sub-advisory fees. My sense is that these premiums are often as much or more than the fees charged by the sub-advisor itself. This raises the question of what service is being provided to justify these premiums. In the coming weeks my office will take a closer look at that question.

When discussing advisory fees the challenge is not in determining the scope of the problem but in crafting an appropriate solution. I would like to ask this Subcommittee to consider a proposal endorsed a few weeks ago by the treasurers of California and North Carolina and by the New York State Controller. This proposal would require all mutual fund fee contracts to control break points providing economies of scale savings to shareholders, and would require mutual fund boards to justify fees in an analysis published in the fund's annual report. The analysis must include a comparison of the fees charged to institutional investors, a review of the management company's pretax profit and a detailed itemization of the costs of the various services including investment advice, marketing and advertising, operations and administration. I believe that this proposal, if enacted, would lead to savings of billions of dollars or more every year. I hope the Subcommittee will give it serious consideration.

Thank you very much.

Senator FITZGERALD. Thank you, Attorney General Spitzer. I wondered if you had any kind of response to Senator Sununu's opening statement where he argued that the investment returns of the funds are equally if not more important than the fees charged by the funds. I know that last time he was here, John Bogle, who will be on our final panel today, noted that 88 percent of mutual funds underperformed the market, and that while some funds do outperform the market sometimes for a number of years, ultimately they all tend to revert to the mean, and they are at or a little bit less than the market return. So that in Mr. Bogle's view the fees are indeed very important over time, and I think that was reflected in Chairman Collins' opening statement. Do you have a response to Senator Sununu's argument?

Mr. SPITZER. Yes, sir, I do. I think that certainly I am not going to dispute that the net return is a critical number that one should look at, but I think that as you just pointed out, Senator Collins and Senator Lautenberg and my great friend John Bogle, have pointed out that the fee component of the overall return is so critically important that the failure to explain adequately what fees are being built into that overall return really is what has been leading to substantial misinformation out in the marketplace. If we do not understand what fees are, why they keep increasing over time and how the compound impact of that fee will affect overall return, then investors are making a decision that is not based upon a full litany of the facts they should have.

Clearly, return is a critical determinant to where we invest. Clearly as well, the fee structure, which is a constant number, is important, and I think it was Senator Collins who so well articulated if you have a momentary above-market return but high fees, that above-market return may be volatile and it may be that 2 years from now that return has returned back to the market mean, in which case the high fees that you are paying for will overwhelm that 1 year of high returns. And consequently, all these numbers are critical, must be disclosed, and the sort of disclosures that I laid out for you, that so many others have laid out for you I think is the way we should go.

Senator FITZGERALD. The ICI and its allies, and even some perhaps at the SEC, seem to have been critical of you for negotiating settlements with mutual fund companies where you have required them to reduce their fees. What is your justification for bringing fees into the mix in your settlements? Is it your thought that telling them to end market timing and late trading and pay some kind of a fine really is just a slap on the wrist, that where they are getting rich really quickly is with these exorbitant fees. In my judgment we do not have a total free market here because disclosures are inadequate. Some funds are captive; they are in accounts that are tax sheltered that cannot just be moved into any other funds. To some extent these mutual funds have a lot of money, lazy money that cannot be moved. They have a guaranteed clientele.

What is your public policy justification for tying fees in to your settlements?

Mr. SPITZER. Let me articulate it this way, Senator. I agree with everything you just said with respect to the market reason that fees are as high as they are. The assets in the mutual fund industry are sticky, by which we mean they do not move as rapidly as they should if investors were making a market determination every day or every quarter based upon returns and costs, and consequently there is a complacency in the board room. There is an improper relationship between boards and management companies. There has been inadequate disclosure.

Having said all that, none of that would give me an appropriate rationale for seeking a fee reduction in a settlement absent a belief on my part, a provable belief on my part that the boards had breached their fiduciary obligation in a way that led directly to the increased fees. I believe that we need disclosure. I have laid out in my testimony—and others who have studied this much longer and in greater depth than I will speak more wisely than I to the types of disclosures that will lead to better market behavior. But I do believe that where a regulator finds a board that has permitted behavior to continue, behavior that is a breach of its fiduciary obligation, then you seek a remedy that addresses that breach. In this case the breach was permitting and acquiescing, and indeed sometimes soliciting overcharges that injured those to whom they owed a fiduciary duty, the investor.

Senator FITZGERALD. In saying they breached a fiduciary duty are you describing that fiduciary duty in the traditional sense of corporate law, that the directors owe a fiduciary duty to their shareholders?

My legal staff tells me they have canvassed all the reported cases out there and have never found an instance in which a mutual fund board was held to violate or breach a fiduciary duty, and my staff tells me that is because the fiduciary duty in the Federal laws, in the Investment Company Act, is a weaker fiduciary duty than the one we are accustomed to in State corporate laws, and the State courts have found a weaker fiduciary duty apply in State laws. Most mutual funds are organized either as a Delaware trust, I believe, or a lot of them are organized under the laws of the State of Massachusetts.

Have you had an opportunity to examine the nature of the fiduciary duty that is imposed by law on mutual fund directors?

Mr. SPITZER. We have looked at it and I would say this, that it is an area where these unique facts have really not been presented to the courts, and it is my belief that if we were ever to be forced to litigate a case where we could show that a board had knowledge and was aware that there were two different fee structures that had been imposed, one that permitted institutional investors to be getting a fee structure that was significantly lower than that was being charged to the other mutual fund investors, we would be able to demonstrate that was a breach of the duty and we would succeed in that litigation.

Senator FITZGERALD. One final question before I turn it over to my colleagues. It has come to my attention that some of the funds charge fees to their mutual fund shareholders in order to remit their dues to the ICI which has been fighting you so aggressively. I find it kind of incredible that fund boards debit everybody's account to get dues to pay for the ICI to go lobby in Washington against the interests of the shareholders that are paying for their lobbying. Do you have any thoughts on that issue, and what do we do about that, because does not the ICI really represent the insiders? They encourage the perception that they represent mutual fund shareholders, ma's and pa's here in Washington, but is it not really the case that they represent the insiders?

Mr. SPITZER. I agree with your conclusion because I agree with your premise which is that the ICI does, in fact—and with all deference to my friends who are here from the ICI—the ICI has not been a voice for reform or protection of the shareholder, but really has been a voice for the status quo and a voice for the very internecine set of relationships that have led to the enormous breaches of fiduciary duty——

Senator FITZGERALD. Do you think they have acted in the interest of mutual fund shareholders?

Mr. SPITZER. No, I do not, and needless to say, I have disagreed, as my testimony makes clear, fundamentally with not only the conclusions but the very way that the ICI has addressed this issue. I will say that the way that the ICI addressed and thought about the issue of timing and other clear problems that existed, structural problems that existed within the industry has been deeply disconcerting to me because I think it was a voice for the status quo, a voice in opposition to meaningful and reasoned reform.

Senator FITZGERALD. Thank you very much, Mr. Spitzer. It is wonderful testimony and we appreciate you coming to Washington in this adverse weather.

Senator Akaka.

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

Mr. Spitzer, I would like to ask you two things. First, a study conducted by John Freeman and Stewart Brown showed that the average actively managed mutual fund company investing in large cap stock paid 0.52 percent of fund assets for investment advice, as opposed to the 0.21 percent paid by pension funds for large cap portfolio management. My request is that you please explain to the Subcommittee why this difference exists, and would like the benefit of your experience and your insights. What should be done so that mutual fund companies act more like pension funds and reduce their expenses?

Mr. SPITZER. Those numbers are perhaps the most important numbers that we should focus on because it is that net, that enormous margin between the 52 basis points and the 21 basis points that compounds every year to those enormous return differentials that investors are suffering from as a result of the disparity between what institutional investors pay and mutual funds by and large pay. What should be done falls into several categories, but first disclosure, and disclosure we all believe transparency. Disclosure ultimately will leave the marketplace and investors to make the appropriate determinations. But we also, given how broken the fund board structure is right now, we need to go beyond that to actually mandate—and this is what I wove into the final passages of my testimony—we need to mandate a particular methodology by which mutual fund boards would then begin to undertake this analysis. They can reach whatever conclusions they want of course. They are the board. But they must consider the factors that are enumerated, which are what fees are being paid by institutional investors, what are the margins that are being derived by those who are rendering this advice, what are the costs that are being incurred. Given the failure of the boards to properly weigh these factors—and we know that that is the case because of the 52 versus 21 basis point differential we just highlighted—we I think can fairly say to them: Do this analysis, reveal your conclusion. You are free to reach any decision you wish, but you must go through this analysis and give us the tools to evaluate the wisdom of your conclusion by giving us the data that you relied upon.

Senator AKAKA. Mr. Hillman, I am concerned that it is not clear to investors that the mutual fund company also may pay a percentage of sales or an annual fee on the fund assets held by the broker or both to obtain a place on the preferred list, or to have their shares sold by the broker. Investors may think that their broker is recommending funds based on the expectation of solid returns, low volatility or the needs of the investor, but the broker's recommendation may be influenced by hidden payments. Mr. Hillman, please describe for the Subcommittee what you have learned about the typical revenue-sharing arrangements found at the large fund supermarkets, and also what the typical investor knows about these financial relationships.

Mr. HILLMAN. Thank you very much. What you are referring to, revenue sharing, is payment that is made by the fund's investment advisor from its own resources to finance the distribution of fund shares. SEC, in 1977, through Rule 10b–10 of the Securities and Exchange Act, required that the nature of revenue-sharing arrangements be described in general terms which they are in mutual funds prospectus. However, a fairly simple statement amounting to the acknowledgement that payments are made to broker-dealers has historically met SEC's requirements. Therefore, no publicly available information that would allow one to quantify the nature or extent of revenue sharing at the fund or industry level exists. There is simply no transparency of these expenses. It is also a legal issue.

As to whether payments are an indirect use of fund assets to finance the distribution, you would think therefore that they ought to be included within a 12b–1 plan that funds' boards of directors are supposed to be evaluating. Because, though they are taking out of the investment advisor's profits, there is limited disclosure to the board of directors of these payments, and therefore limited information being provided to them for their review.

SEC has recently, January 14, proposed new rules to enhance the information that broker-dealers provide to customers at both the point of sale, which is critically important, as you mentioned in your opening statement, and during the confirmation process once a trade is executed, and we applaud the SEC for their initiative in this area.

Senator AKAKA. Thank you, Mr. Chairman.

Senator FITZGERALD. Thank you, Senator Akaka. Chairman Collins.

Chairman COLLINS. Thank you, Mr. Chairman.

Mr. Hillman, I want to explore with you the issue that the Attorney General brought up in his statement about the huge disparity in the fees charged institutional investors versus the every-day retain investor, at least in the two cases that he cited. For example, in the Putnam case I believe the Attorney General said there was a 40-percent difference, which is certainly substantial. In addition, one of our witnesses who will appear later this morning has also looked very closely at this issue and authored an article in the *Journal on Corporate Law* that also concluded that institutional investors were charged considerably less than the small investor.

The mutual fund industry, as the Attorney General cited, has done a study that says that such differences can be accounted for by a different level of service or more work being done to serve institutional investors. I also wonder if perhaps the industry looks at the institutional investor as deserving of volume discount, if you will.

What are your views on this issue? Is there a justification for having a very different fee structure, a much more favorable fee structure for institutional investors than for the average American who is investing in a mutual fund?

Mr. HILLMAN. That is a very good question, something that we have not looked at as part of our study in June 2003, but let me offer these viewpoints. It is clear that institutional investors bring to the table greater assets, and therefore a reduced fee will allow mutual fund companies to retain large amounts of funds from those individual institutional investors that is drastically different from what might be coming available from an individual investor who may have a smaller portfolio, a smaller amount invested. Additional costs on the part of that fund to maintain information could cause for a difference to be there between institutional cost expenses and those of individuals. But the numbers that the Attorney General surfaced are quite astounding. The difference between those fees are enormous over the long term, and something that is deserving of additional attention.

Chairman COLLINS. Mr. Spitzer.

Mr. SPITZER. Senator Collins, could I just add one thought to that? Obviously, it is not only framed properly, but really cuts to the core of the issue. I would point out that the differentials we talked about are for essentially equivalent pools of capital even though the individual institutional investor may be larger, obviously, than the individual mutual fund investor. We are aggregating those pools and we are saying: What did you charge to provide advisory services for equivalent pools of capital? $100 million, $200 million; not $100 million to the $10,000 mutual fund investor. The incremental costs that clearly are borne, in terms of redemption fees, in terms of communication, in terms of statement issuance that attached to the small investor are not part of the advisory fee costs. Those are shown elsewhere. Those are other fees. This is an apples to apples comparison.

When we generated these numbers, we went to Putnam and we said: Give us your best apples to apples comparison for identical services. The numbers were from them for that identical set of services.

Chairman COLLINS. That is a very important clarification, and I appreciate you adding that to your testimony.

I want to explore with both of you the best way that we can ensure that consumers have the information they need on the fees that they are paying. As, Mr. Hillman, you pointed out the amount of fees and expenses that each investor specifically pays now are currently disclosed only as a percentage of the fund's assets. Most other financial services disclose the actual cost to the purchaser in dollar terms, and again I go back to my checking account analogy, where you can see very clearly what fees you are being assessed every month. It is my understanding that the SEC has proposed additional disclosures, but still is not proposing that funds disclose the specific dollar amount of fees paid by each investor, nor is the SEC requiring that the fee disclosures be listed on the account statements. And yet the account statement is what most of us rely on. We do not go back and read the prospectus to determine our investment expenses are. So really that means we are not getting any timely, regular disclosure at all of the fees if you are the average investor.

Starting with you, Mr. Attorney General, and I see my time is up, could you tell me if you think the SEC's proposal is adequate or whether you would like to see on the quarterly account statement a clear disclosure in dollar terms as well as percentages of the fees?

And then, Mr. Hillman, I would like you to answer the same question.

Mr. SPITZER. Thank you for that question, Senator. I vowed I was going to come to Washington and leave without being critical of the SEC, and so I am going to answer your question a little differently. Rather than saying whether the SEC is good or bad, I would merely say that I think the format of disclosure that you described would be enormously helpful for investors and perhaps would be the most important way for them to understand what fees they have actually been charged. I think that there is certainly a desire—there should be a desire to give each consumer an actual dollar cost that he or she is paying. There also should be a desire to provide an easy comparative basis, which means a per-unit comparison akin to what we all see at the supermarket, where as either Senator Levin or Senator Lautenberg referred to it, as either a per ounce, what am I paying per ounce? So there should be both a per dollar disclosure and what your portfolio is being charged per quarter.

Chairman COLLINS. Thank you. Mr. Hillman.

Mr. HILLMAN. This is an area that we have done considerable work on, and the concern here really is over investor awareness of fees. Despite existing disclosures and educational efforts, the degree to which investors understand mutual fund fees and expenses remains a significant source of concern.

There were studies conducted by the SEC and the OCC back in 1996 which found that one in five fund investors could not give an estimate of the expenses for their largest mutual funds, and fewer than one in six understand that higher expenses lead to lower returns. A Vanguard money investor literacy test back in September 2002 found that 75 percent of respondents could not accurately define a fund expense ratio, and 64 percent did not understand the impact of expenses on funds' returns. Clearly, more needs to be done to make sure investors are aware of the impact of fees on the returns for their mutual fund investors. Special dollar disclosure could be the incentive that some investors need to take action to compare their fund's expenses to those of other funds and to make more informed investment decisions.

Chairman COLLINS. Thank you, Mr. Chairman.

Senator FITZGERALD. Thank you. Senator Levin.

Senator LEVIN. Thank you, Mr. Chairman.

I would like to get into the area of revenue sharing and directed brokerage. This is a way that the mutual funds get money to brokers for selling their shares. I want to ask you just a very simple question about a public company that wants to have a broker sell its shares on the stock exchange and pays the broker a hidden fee of a dollar for every share of stock that it sells to that broker's customers. Is that legal?

Mr. SPITZER. I think not.

Mr. HILLMAN. It is not. Not a practice you would want to do, no.

Senator LEVIN. How is it any different when a mutual fund pays a broker a hidden fee, and one of the two ways that are involved in either revenue sharing or directed brokerage, to sell its shares to the broker's customers; how is that any different from a publicly traded company saying: For every share you will sell of my company on the stock exchange, I am going to pay you a buck?

Mr. SPITZER. I do not believe it is different. I think it is a hidden subversive interest that without full and complete disclosure runs contrary to the fiduciary duty that is owed to that customer to whom you are marketing the product.

Senator LEVIN. You would agree with that, Mr. Hillman?

Mr. HILLMAN. Yes. Hidden cost.

Senator LEVIN. The fiduciary duty that we are talking about here actually, I believe, or from what I know is the broker's fiduciary duty.

Mr. SPITZER. That is correct.

Senator LEVIN. It seems to me that is what we have to really clarify. We have to focus on what conflicts of interest we are talking about here. With directed brokerage what we are talking about is that a mutual fund is going to agree that it will buy stock from a broker if that broker sells that mutual fund's shares. So it will give business in effect to that broker if that broker sells its shares. It is a hidden deal.

Mr. SPITZER. For the mutual fund it is a disclosure violation, that it is not disclosed that it is providing this incentive to the broker, and that is a material fact that obviously should be disclosed in their hidden fee issues. For the broker, who has not disclosed to his or her client that there is a hidden benefit that he or she derives from that sale, it is a breach of the fiduciary duty.

Senator LEVIN. Is it an illegal act for a broker to receive that hidden fee from somebody to sell a share to that broker's customer?

Mr. SPITZER. Let me state it this way because I do not want to suggest that necessarily it would be a criminal act. We would have to look at all sorts of surrounding factors, but it is something that we would consider to be a violation of the Martin Act.

Senator LEVIN. Of the what?

Mr. SPITZER. Of the Martin Act, the New York State securities law.

Senator LEVIN. If it is a violation of law for a broker to sell me a share of stock when unbeknownst to me he was paid by that company to sell me that share of stock, it seems to me that is obviously, it is more than a conflict of interest. It seems to me it is a violation of law. If it is not, it should be.

Mr. SPITZER. It is.

Senator LEVIN. Now looking at the mutual fund that is paying the broker to do that, are they not aiding and abetting an illegal act?

Mr. SPITZER. You could certainly try to bring them in as aiders and abettors, absolutely.

Senator LEVIN. Should we try to bring them in as aiders and abettors either by regulation or by law? Are they not contributing to an illegal act by making a payment to somebody to sell me something that is not known to me? Is there not an inherent conflict there which either is or should be illegal on the part of the broker and should it not be illegal to do that because you are aiding and abetting that just the way—if I give you a bribe and you accept the bribe, you have violated the law by accepting a bribe. But have I not violated the law by offering the bribe? How is this different except that it is in a market setting?

Mr. SPITZER. It is not different. I would come at it from a slightly different perspective. I would reach the same conclusion, but I think it is the behavior that we want to eliminate, and whether we eliminate the behavior by saying the mutual fund is aiding and abetting or whether we simply ban the behavior without full and fair disclosure to all participants and make everybody equally culpable, I suppose I could say I am indifferent to how you address it. The behavior we wish to eliminate is the hidden fee shifting.

Senator LEVIN. I agree with that, but when we come to eliminating behavior we do it in two ways. One is disclosure, but the other one is a prohibition with a fine at least, an administrative fine and maybe sometimes a criminal fine, but nonetheless there are a number of ways to address the conduct. I agree with you, we want to stop the conduct, but disclosure is one way. It may or may not succeed by the way, just like these fee disclosure may or may not succeed depending on how complicated they are. You get a fee disclosure on your telephone bill, most people do not have the vaguest idea, looking at a complicated telephone bill, what the heck is in that bill. That is disclosure, but it does not do the job.

I guess this is my final question because my time is up. It seems to me that is a critical question which we face. We have got to act against the conduct. It is clearly a violation of a fiduciary duty on the part of a broker, it seems to me, to be selling something to me without disclosing to me that he is getting paid by the guy whose share he is selling to me or whose stock he is selling to me, to sell it to me. If that is not a violation of law, it surely ought to be. But, what we need to do is decide do we want to get at the conduct from the mutual fund side by either forcing disclosure, but if it is improper, it should not just be disclosed. We do not just want to disclose impropriety. We want to stop impropriety it seems to me. And if it is a conflict or aiding and abetting in a conflict, why should we not just ban that action rather than simply say disclosure is good enough? That is my final question. It sounded like a speech but it is really a question. [Laughter.]

Mr. SPITZER. With all due respect, if I were in the courtroom I might have objected to the question as being compound, but that is all right.

Senator LEVIN. I think it was a leading question.

Mr. SPITZER. I am going to hedge right now on whether there should be a ban because I can imagine situations where smaller mutual fund companies would want to announce to the world: We have many representatives out there, who when they sell your products, we give them some degree of compensation. There are salesmen who have relationships with us and many other mutual funds as well. As long as the investor is fully aware—and I do not mean the sorts of disclosures that are on the third page of an 18-page contract. I mean they are really being informed why the salesman, the broker as it were, has an interest in pushing particular funds over others. Then I can imagine that that is a conflict.

Senator LEVIN. A financial interest?

Mr. SPITZER. Correct.

Senator LEVIN. Has a financial interest.

Mr. SPITZER. That is correct, because that is a way to disseminate and market the product.

Senator LEVIN. I would end with a request then, that you would give us advice for the record on that issue because I think that is one of the really fundamental questions we face as to whether disclosure is going to be adequate or whether there ought to be some kind of a prohibition that we ought to urge on the regulators.

Thank you, Mr. Chairman.

Senator FITZGERALD. Senator Levin, those were excellent questions, and I hope to have the opportunity to share with you a bill I am working on, because I tend to agree with you that a lot of these practices, these shadowy practices which people are only vaguely aware of, should simply be banned as opposed to disclosed in a better fashion. I think your analogy with what if a publicly traded corporation, not a mutual fund, went to brokerage houses and said: We will give you a dollar for every share of our stock that you sell. That would be an outrageous fraud on the public. Right now you have brokerage firms steering their clients into certain mutual funds, not because it is necessarily in the best interest of their client, but because they are going to get revenue sharing or some other fee from the mutual fund. In Chicago they call that a kickback, as I said at the last hearing. I do not think it is right.

Senator Sununu.

Senator SUNUNU. Thank you, Mr. Chairman.

I did not understand all of the details of the previous question, but I assume in the public equities market to a certain extent, provided it is disclosed the right way and you comply with the laws, it is also called a commission. The brokers make commission all the time for selling stocks. You want it to be disclosed, and depending on who else they are doing business with there could be some conflicts of interest, and that is obviously what the line of questioning gets to, but simply being a broker is making money by selling mutual funds or stocks does not necessarily mean they are doing anything wrong.

I want to pick up on a point that you made, Mr. Spitzer, and I think it is a very important one, which is in this discussion about the financial arrangement, you emphasize that there could be a situation where a small mutual fund in particular, your example, was disadvantaged. In other words, you focused on the disclosure but you could imagine, I think you said, a situation where a small mutual fund was trying to get out information about the new fund. Without getting into the particulars of the example, I think that is an important point because there are other areas of regulation here where we might see practices we would enjoy better disclosure of. We want to make sure we are not disadvantaging new mutual funds, smaller funds, at the expense of the larger funds or to the benefit of the larger funds. I was not very clear there, but we want to make sure we have a level playing field, which gets to my first question.

Would you be concerned about regulations that treat independent research in a discriminatory manner with respect to the large full service brokerage houses?

Mr. SPITZER. Let me restate your question. I have seen the articles that I gather you have seen as well that suggest that if there were a straight ban on soft money as a means of compensating certain entities, that could have a disparate impact and a very negative impact on some of these smaller independent research boutiques that are there.

Senator SUNUNU. That qualify either a straight ban or a discriminatory reporting report, that one set of fees has to be reported in a particular way, and another set of fees for the full service does not have to be reported.

Mr. SPITZER. The answer to your question is yes, I am worried that we not act in a way—and as you pointed out in your opening statement, one of the efforts 2 years ago now really was to resuscitate the role of independent research and to make sure that there was somehow a business model that would work. I think we need to think carefully as we address the issue of soft money and the issues relating to these regulatory schemes, what collateral impact there may be in the context of research.

Now, I do not say any of that to justify what I think is at best a very murky area, which is the enormous sum of money that flows through these soft dollar commissions which is untracked and hard to understand, and I think is an area that significantly cries out for some very careful thought.

Senator SUNUNU. Are you for banning all soft dollar transactions, or are you for uniform disclosure of those transactions?

Mr. SPITZER. I have said in prior testimony, and my position has not changed since then, I simply have not looked at the issue to have an informed judgment on the matter. I have seen obviously enough to know that there is, as I said, significant area for inquiry, but there are also significant subtleties in how we deal with it.

Senator SUNUNU. A hypothetical. Two funds, they are mid-cap funds. They are the size——

Mr. SPITZER. Mid-cap, I am sorry, you said?

Senator SUNUNU. Mid-cap funds. They advertise themselves in the same way, have generally the same requirements for investment, about the same size in total assets. One has a 5-year return of 11 percent and an expense ratio of 40 basis points.

Mr. SPITZER. Five years, 11 percent, OK. I want to make sure I get my numbers. I do not have an HP 12.

Senator SUNUNU. One has a 5-year annualized return of 8 percent and expenses of 20 basis points. Which one was the better investment?

Mr. SPITZER. I will have to ask Mr. Bogle. He is the master of these numbers.

Senator SUNUNU. I think both the esteemed Mr. Bogle and you could come to the same conclusion. The 11 percent with the 20 more basis points in the expense is going to be the better return over the 5 years. I mean 300 basis points and at least the gross returns really does make a difference in the long run. A simple example, I know, but it just comes back to this point that we want to make sure we are emphasizing the important statistics for investors, and I will consistently come back to the issue of returns net of all expenses I think is the best barometer because it takes into consideration different levels of investment, different levels of assets. I could have expenses of $387 for my mutual fund investment, but it obviously makes a difference whether my total assets are $350 million invested in that or $1,000 in the expense ratio.

So the dollar value could be important. I could imagine circumstances where I would want to be able to compare that, but I think the return net of all expenses is the one that consumers will use most often to compare mutual fund performance across their own portfolio or to other funds that are out there.

With regard to the board structure, you support the idea of an independent board chair, correct?

Mr. SPITZER. That is correct.

Senator SUNUNU. Did any of the firms against whom you brought charges have independent board chairs?

Mr. SPITZER. Yes. In fact, let me just clarify. I support the notion of an independent chair and the 75 percent threshold, but have always made it clear these are not panaceas. To go back to a slightly different context, if you were to look at the Enron board and look at the constituency of that board on paper you would say: What a spectacular board. So clearly when you define board membership, and we try to promote good board behavior by defining constituency, that does not guarantee any result. It is sort of like a prospectus. But it perhaps permits us to be in a situation where we can raise expectations and get divergent views.

Senator SUNUNU. Unless there is an academic study out there that I am unaware of, and I would be very interested in seeing it, why support a "reform" if there is no empirical evidence that it has ever resulted in better behavior or better results for shareholders or investors?

Mr. SPITZER. I think you are drawing the wrong logical conclusion. To say that it does not inevitably guarantee an appropriate result does not mean that it is not logically superior as a matter of principle to have an independent board chair who would then be in a position to negotiate at arm's length with a management company to which he or she does not owe a parallel duty.

Senator SUNUNU. Do the independent board members not participate in those negotiations with fund managers now?

Mr. SPITZER. They might participate but I think the record suggests that the participation has not been adequately vigorous, and that is why as a theoretical matter, what we are trying to do—as I think we all, even you, I dare say, would agree with the notion that we want to resuscitate the vigor with which the mutual fund board enters these negotiations. As a matter of principle it seems quite clear that having a board which does not have a significant overlap with the management company is more likely to give you an arm's length negotiation.

Senator SUNUNU. But I come back to my belief, which could be wrong, that there is no empirical evidence that shows that those boards led by independent chairmen have had their boards engage in these negotiations "more vigorously" than boards that do not have independent chairmen. You can feel free to respond, but I think it would be wrong to suggest that we know there would be a better result if there were an independent chairman, even though we cannot show that in all the cases where there were independent chairmen there was a better result. That seems to me to be a non sequitur.

Mr. SPITZER. I am happy——

Senator SUNUNU. No, you do not have to respond.

Mr. SPITZER. I think we have stated our positions with some clarify, but I think the premise of independence is one that most people feel would move us in the right direction.

Senator SUNUNU. Do you support—one final question, it is a yes or no; can I just ask one more? I am sorry.

Senator LAUTENBERG. Time is flying, and we are trying to parcel it out.

Senator SUNUNU. Do you support the same proposal for every public in America, that they have to have an independent disinterested chairman?

Mr. SPITZER. I do not, but I will tell you some of the most staid and conservative corporate lawyers in America have come to that conclusion. I would point to Ira Millstein at Weil Gotshal, who has for years been calling for independent chairs as one of the critical ways to resuscitate board behavior.

Senator SUNUNU. Thank you.

Thank you, Senator Lautenberg. I apologize for running over.

Senator LAUTENBERG. That is all right.

Senator FITZGERALD. Senator Lautenberg.

Senator LAUTENBERG. Thank you, Mr. Chairman.

I want to say to Senator Sununu I think that he is on a good track, and the hearing thus far has been excellent, and I thank both of the witnesses here for their testimony.

I look at this a little bit differently. First of all, I think that in the case of an underwriting, which I think was Senator Levin's kind of focus, compare it to the difference between—may I call it—wholesale and retail, because everyone knows that if you want to buy a car, Mr. Levin's example perhaps ought to be—that what you pay does not give you all of the details about what the dealer you bought it from paid. You make your decisions based on a net, but it is a lot easier to compare Chevrolet to Ford, etc., than it is for the arcane business of details about mutual fund purchases, etc. For most of the public it is foggy. For most of the people in our business it is foggy because it is very complicated, hard to understand.

One of the things I think we might have to do is—I think Senator Sununu was on the right track with one exception, and that is that simply measuring the net performance of a mutual fund to its shareholders is not quite sufficient because you do not know what these hidden costs are, and maybe the shareholder ought to get more. Just because they got 11 percent compared to an 8 percent, maybe they should have gotten 15 percent, and had they been aware of where it was going, that they would have required that. Someplace along the way we have to make this knowledge comprehensible about what people ought to look for. I do not know whether it is an index, a mutual fund index that says here are the costs, here is the net result, the difference between the two is thus, and give people an easy way of forming opinions about whether or not they go ahead and purchase these shares.

The thing that is scandalous is the amount of—some call it baksheesh; it is a common term in the Middle East, and we paid plenty for that in Iraq—but it is distributed around. I think that if they are giving away your money, even if you got a pretty good return for it, that is not appropriate.

Mr. Spitzer, I would like to know if anything has happened since you broke the mutual fund scandal in September? Have you seen anything that says: Uh-huh, they are making changes that would correct some of the conditions that brought on these problems?

Mr. SPITZER. Yes, sir. I think the answer is that it is—I do not know if it was Justice Holmes, I may be wrong—light is the best disinfectant, which is not only the premise to disclosure but the enormous spotlight that has been beamed and been focused upon the industry over the last number of months that has revealed not only the warts and improprieties but also those who are good, has led every board to reconsider and rethink its behavior, and therefore we are seeing embers, that hopefully will burst into flames, of changed behavior. So, yes, there is change that results from first the sheer embarrassment of having the names of companies in the headlines, the fact that people have been taken away in handcuffs and sentenced to jail, and so, yes, there are changes.

Senator LAUTENBERG. There are still people being taken away in handcuffs.

Mr. SPITZER. And there will be more.

Senator LAUTENBERG. This is kind of a pet subject of mine, and that is directorships and how they function, and I think one day that in America we will see a class of executive called director. I know this, that when I was running ADP and we started with nothing, we had nothing to invest except our hard work, and the company that we started many years ago, today has over 40,000 employees and had the longest growth record of any company in America, over 10 percent gain each and every year for 41 years straight in a row. It was a good investment. I should not have sold my stock. [Laughter.]

But I do believe that to obtain the interest of a director away from a company, I never took another company's board seat. I did for a while and decided that was not for me. If I was going to run my company, I wanted to focus exclusively on my company. If I wanted to do something that was a not-for-profit or something like that, I enjoyed it, but I did not believe that I had the right to take time away from my company, no matter how comfortable they offered to get me there or whether it was an overnight conference in Las Vegas, that that was enough to divert me from my appointed rounds, as I say. I think we are going to see a class some day of directors exclusively, people who will have attained a degree of experience and reputation and so forth that can qualify as directors, and they will sit on several boards. This is where I think we are going, and I think it is essential. Otherwise, it is too tough. People become friends. There are relationships, serious relationships that develop.

But to respond to Senator Sununu's question about have you see any different result as a consequence of an independent board, I think it is fair to say that what you have seen is just the reverse of that, which is a corollary, and it says, hey, when you look at Enron and you look at the people and you look at some of the people who were directors, they closed their eyes. They did not have the time, they did not have the interest.

You made a very important statement, directors should be furnished with a staff person, resources, and information expanded that the public can understand. No matter what happens, I do not think the CEO of a company—this is a personal thing—ought to be able to walk away with the profits of the store unless he owns the store. I think that he has a job like everybody else, and when a chief executive walks away from a job that paid millions and millions and millions of dollars, and then there is still a reach out, there are grasps out there to see that the favorite wines or the favorite airplanes or the favorite massages are still included. I think it is a travesty.

One thing we have to make sure of is that we have people taking their assignments seriously. Maybe they begin to understand that when they too are punished for either lack of interest of lack of action on their part when they see these abuses.

I commend you, Mr. Chairman, for holding this hearing. We are going to go much further before these subjects are fully aired.

Senator FITZGERALD. Thank you.

As I wrap up, I just would like to make my own comments on Senator Sununu's suggestion. I think, again bringing up the analogy of the Government Thrift Savings Plan that we are all members of, our directors have to be independent by law, and they competitively bid out the management contract. The management contract was won on a competitive bidding basis by Barclays Global Investors in London. They charge an exceedingly low fee to manage the TSP fund for Federal employees. I wonder how we would feel if all of a sudden we changed the law and the directors of our TSP board did not have to be independent and they could instead be insiders at the outside manager. What if the chairman of the TSP board were an officer of Barclays Global Investors and owed a fiduciary duty to shareholders of Barclays? We might not sleep as well at night knowing that.

Yes, there are independent directors who do not have conflict who are not very bright or are not very diligent or do not work very hard or whatever. So having an independent director is no guarantee that you are going to have a good director, but certainly it helps to eliminate conflicts that could otherwise arise. We do not have to worry about that for our retirement funds because Congress has created a separate investing regime for Members of Congress. We get one special deal, and the whole rest of the world is stuck in this rotten world where conflicts are all over the place, where fees are exorbitant, where there is revenue sharing, directed brokerage. We do not have to worry about that, but my goal is that hopefully we can give the rest of America as good a mutual fund deal as Congress has given itself.

With that, I want to thank these two witnesses. They have been excellent. We have gone on for 2 hours. You have been very patient. We are going to give you leave to go back to New York or go back to your offices. Thank you very much for being here.

Mr. SPITZER. Thank you, sir.

Mr. HILLMAN. Thank you.

Senator FITZGERALD. Our next panel is the whistleblower panel, and before I introduce them I am going to take a 2-minute break so that we can all stretch. We have been here for 2 hours. So why don't we take a 2-minute break and then we will return.

[Recess.]

Senator FITZGERALD. During the break there was a request made to take one of our panelists out of order because he has a plane to catch, and we are happy to honor his request.

John Bogle probably needs no introduction. In the mutual fund world I think he is probably the best known investor in the country. He is the founder of Vanguard. It is something he had wanted to do since he was in college and wrote his thesis at Princeton I believe on the Massachusetts Investment Fund at the time. He had this dream of creating a truly mutual mutual fund, and he had the opportunity to fulfill that dream in founding Vanguard and watching it grow in a short period of time to be one of the two largest mutual funds in America. He is the author of several books on mutual funds. He is an industry expert without equal, as far as I am aware, and we are honored and delighted to have him back for the second time before this panel.

So without further ado, Mr. Bogle, thank you very much for being here.

TESTIMONY OF JOHN C. BOGLE,[1] FOUNDER AND FORMER CHIEF EXECUTIVE OFFICER, THE VANGUARD GROUP, AND PRESIDENT, BOGLE FINANCIAL MARKETS RESEARCH CENTER

Mr. BOGLE. Thank you, Chairman Fitzgerald, and thank you particularly for the courtesy in accommodating my schedule. Sometimes we get a little bit over scheduled and that is the position in which I find myself today.

I am very happy to be here because when you think about it, if you do for a moment, out of all the persons you have heard from, I am the only one who has actually been in the mutual fund business. I have been the Chairman of the Investment Company Institute back in 1970–71, I think, and I have actually been in this business for more than half a century. So I hope the perspective that I can bring to you is helpful. My entire career has been in this business, and I have observed in that period that this industry has changed greatly in that half century and it has not changed for the better. It has been a business that originally focused on prudent stewardship. It focused on long-term investing. It focused on putting the shareholder first. It had very low costs and attracted people who were attracted to the wisdom of long-term investing.

Since then the industry has changed in almost every measurable way. Portfolio turnover is higher. Costs have doubled for equity funds. Funds hold their shares for a much shorter period of time, meaning we are selling the public speculative funds that basically are capitalizing on the folly of speculation rather than the wisdom of long-term investing. Instead of running this industry in the interest of fund shareholders, we are running this industry, I am sorry to say, to too great an extent in the interest of fund managers. We have become too much of a business and not enough of

[1] The prepared statement of Mr. Bogle appears in the Appendix on page 106.

a profession. So this industry has to rethink, has to stand back and look at itself.

I think the steps that are necessary to bring this change around—I will not deal with the technical steps too much—requires us to figure out how to give the mutual fund investors the fair shake they deserve. Part of that is to give the weight of the mutual fund structure more heft, if you will, on the mutual fund shareholder side and less left on the mutual fund manager side. To that end I believe deeply that we need a more independent board, a completely independent board chairman, and I believe we badly need an express Federal standard of fiduciary duty which requires directors to act with loyalty and care in the best interest of fund shareholders.

I think we need to help fund investors better understand their costs, and what would do that is the full disclosure of the total costs you bear as a shareholder in your fund, including transaction costs and others, the actual dollar cost each investor pays. I think it would be unarguably a great advantage for investors.

We also need something that has not been brought up today. We need mutual funds to report not just their per share results, which are the time-weighted, returns you read in the paper—we got a return of, say, 11 percent per share—but the returns their shareholders actually earn, what are called dollar-weighted returns. So many mutual fund purchases are done at the wrong prices at the wrong time and the wrong funds that those dollar-weighted returns are often as many as 6 or 7 percentage points behind the returns that the funds actually report. That should be reported. It is a known number. It should be reported in fund reports. I think those will help.

I also think that we should direct the Securities and Exchange Commission to undertake a comprehensive economic study of the mutual fund industry. With $7 trillion in assets, in mutual funds, the national public interest and the interest of investors would be well served by shining the simple spotlight of disclosure on the revenues and expenditures of mutual funds and their managers, taking into account the fees, the sales charges, the transaction cost, where they are spent, where they come from, where are they spent, and how much is left for manager profits. Mutual fund investors incur not only the $70 billion of costs that were referred to earlier. That $70 billion is the direct cost that the mutual funds pay, but they pay another $40 or $50 billion in transaction costs, sales charges and other expenses like that. We need to follow that money because those costs of $120 billion are the amount by which mutual fund returns are apt to fall short of the financed markets' returns year after year.

I also think, strongly agreeing with Attorney General Spitzer, that we need a requirement for fund advisors to provide, and fund directors to consider, the amount and structure of fees paid by institutional clients. One brief example to show how shocking this disparity can be. One advisor charged its mutual fund 97 basis points on a $4.5 billion fund, $41 million. But it charged a fee of 98 basis points, less than one-tenth as much, for a $900 million fund for California retirement system, or one-sixtieth as many dollars, just $700,000. California also pays investment incentive fees for investment success, but such fees, so-called performance fees, are conspicuous by their absence in the mutual fund industry.

Finally, as I say in my formal statement, there are two firms in this business—actually three now that you mention the Federal Thrift Savings Plan—that have in fact been truly mutual in their struture. One is Massachusetts Investors Trust, which started the first mutual fund 80 years ago, had an excellent record, was the largest fund in this industry for 45 years with the lowest cost. It abandoned that structure in 1969. Five years later Vanguard adopted a similar mutual structure, albeit very different in concept and development. And we are unique in many other ways.

So over 75 of this industry's 80-year history, we can observe how mutuality worked. Our costs are the lowest in the industry, 100 basis points below the industry norm. We operate at a quarter of 1 percent compared to 1.4 percent for the industry. Our market share has gone up 20 years in a row from 1 percent of assets to 9 percent of industry assets. So mutually has been a successful business strategy. It has provided above-peer returns to our shareholders and the lowest cost in the industry. I think we have to have some language in the new legislation that requires mutual funds to consider, once they reach a certain size, the option of mutualization. It works for investors.

Directors also need an independent staff, I believe, when they get to a certain size or when directors oversee a certain number of funds, a staff that will be independent of the manager, giving them the objective information they need.

Who would pay for that? Let me tell you how we did that at the inception of Vanguard. We said to the manager, "We are going to have our own independent staff to evaluate you, and we will not only reduce your fees by the cost of that staff, we will reduce them by a 50 percent fee markup because that is the profit you are making in those services." I think it would be a wonderful example for other firms to follow.

Thank you, and sorry to be a couple of minutes long, Mr. Chairman.

Senator FITZGERALD. Mr. Bogle, we are so honored to have you here. I appreciate your coming down a second time, and as always, your comments were directly on point. You and I talked the last time you were here about the fact that Vanguard was the only private sector mutual fund. We have now identified the Government Thrift Savings Plan as being in essence a truly mutual mutual fund in that it is not directed by somebody else who is profiting off it.

I was troubled by the fact that mutual funds in America are allowed to call themselves mutual funds because that implies they are mutuals, like Mutual of Omaha, or a mutually-owned insurance company like State Farm in my State, in which the owners are actually the policy holders. We have a system in this country for chartering mutual savings banks. There are lots of mutual savings banks in which there are no stockholders. The depositors in the banks are the actual owners of the savings bank.

Do you think it is appropriate that we allow mutual funds, when they are in fact not mutual and they are not owned by their fund shareholders? They are in effect used by an outside private company that is stock held to make money. I mean, do you think it is appropriate that mutual funds be allowed to call themselves mutual funds, or does the name "mutual" not mean much to younger people today so it is no longer a misleading term? Do you have any thoughts on that?

Mr. BOGLE. We have somehow tried to get around that by calling ourselves mutual mutual funds, which is a little bit repetitious but gets the point across. I think we would have a hard time changing the name that everybody has come to give this industry, and of course, I would be enough of a rebel to say that maybe what we ought to do is do the opposite, require mutual funds to be mutual, and I think we can do that without going to a full mutualization, by the way, simply by giving that board the heft, the weight that I talked about in my testimony.

Senator FITZGERALD. I know you want to comment on Senator Sununu's suggestion in his opening remarks that one of the most important things for investors to focus on is investment returns, and that if investment returns in a given fund are very high, then a higher fee will not really matter over time. What is your response to that? That line of reasoning suggests that the Senate, this panel, should not be so concerned about mutual fund fees. What do you think about that?

Mr. BOGLE. With all due respect to Senator Sununu, I hope he does not invest the way that little syllogism of his would suggest. That would be very unwise indeed. Because what we have here is a—of course, he is mathematically correct. If a fund earns twice as much as another, let us say 20 percent compared to 10, and they charge you 9 percentage points a year, you would have been better off in that 20 percent minus 9, rather than the 10 percent fund minus 1. I mean that is just mathematics.

However, the reality of the matter is that we know that over time the lowest cost funds win. A simple statistic, and that is if you take the lowest-cost quartile of funds—and this is not in any selected 10-year period; this is every 10-year period we have looked at—the lowest-cost quartile of funds outperforms the highest-cost quartile of funds by 2½ to 3 percent per year in all of the Morningstar boxes. So you know from looking back, cost matters. It has been said that the mutual fund industry is the only industry in the world where you get what you do not pay for. Think about that. You get what you do not pay for, and that is a truism.

What happens in our business, however, is the broker or the salesman that wants to sell a high-cost fund, he picks a high-cost fund because there are plenty of them, and he picks one with a high return in the past, and he makes the exact argument that Senator Sununu was putting forth. But the reality is that the past has nothing to do with the future. We did a study about a year ago, and we looked at the 10 highest-performing—I am sorry—the 20 highest-performing mutual funds of the 3 year period, 1997, 1998 and 1999, and compared those returns of those funds with the 3-year period 2000, 2001, and 2002. It was literally biblically true that the first shall be last. The first mutual fund, number 1, in the first performance derby was last in return, 841st, I think the number was, among those groups of funds that had been in business all that time over a certain minimum size level, 841st. And the other 20 funds—I believe this was the number—there was one that was not ranked below 700 out of those 800 funds. So much for past performance. It tells you nothing except probably the manager is speculating, exactly the opposite of what that Federal Thrift manager is doing.

Senator FITZGERALD. Senator Collins.

Chairman COLLINS. Thank you, Mr. Chairman.

Mr. Bogle, thank you so much for testifying before us today. I am a great admirer of yours and I think we have a lot to learn from your experience, because as you pointed out, you have actually done this for much of your life.

One of the challenges that we face is making sure as we attempt to bring about reforms that we do so in a way that does not cause unintended problems down the road, and therefore it is difficult to decide what should be legislative, what should be left up to SEC, and what should we look to the industry to do for itself to self reform.

My inclination is to believe that we need a combination of all three. We are dealing with a law that I think in the mutual fund area has not been significantly revised in approximately 65 years. I suspect that it does need to be brought up to date. But can you give us any guidance of the areas that you think should be codified versus the reforms that you think the SEC ought to pursue via regulation, versus the areas that we should just stay out of and expect industry to pursue?

Mr. BOGLE. Yes, thank you. I would say on the regulatory side things like a redemption fee on short-term transactions, things like disclosure about soft-dollar brokerage, things like perhaps banning the shelf space sort of payments that are made that are such a cost for investors and so misshape the distribution process. Those kind of things I believe should be left to the regulators. I believe that the Congress, speaking for the people of the United States, should do its best to have a governance structure that improves on the governance structure that was given to us in the 1940 Act. That Act, as you know, says that mutual funds must be organized, operated and managed in the interest of shareholders, rather then the interest of investment advisers, and that is clearly not what is happening. That is why I feel we need to chairman of the board to be independent. That is why I feel we need a heavy majority—indeed, sometimes I wonder why any management representative should be on the board—and that is why we deeply need this Federal standard of fiduciary duty for fund directors. These are things that will require legislation.

As to the industry, I do not know how many of you have had a chance to read my paper on the development of mutualization that was my formal statement before the Committee, but it talks about how mutualization work, how it came, the struggle it was to get it done. An SEC report that was delivered in 1966 called Public Policy Implications of Investment Company Growth, that suggested many of the problems that we came to face later on. In that report, the SEC recommended very good solutions, but they were never implemented in law because the lobbying power of the Investment Company Institute was just too great. They wanted a requirement that the fees be reasonable. Well, nobody in the industry wanted that. So we got to where we are today I think through that route.

But at the end of my formal testimony is a very important point, and that is you can legislate a structure, let us say more power for the board of directors of the funds or the requirement that a mutual structure be made available or be considered at certain levels at fund size, but a structure will only take you so far.

I also mentioned next you have to have the right strategy in that structure. The Federal Thrift Savings Plan has that structure, and they have followed with the right strategy. The structure gives the power to get cost out of the equation and give the participants, Federal Government employees, basically the total return the stock market delivers, a magnificent return over the long run.

But the third thing you need—and this is the hardest part, we can't legislate it—is the spirit. How do you get that spirit into the mutual fund industry once you have the structure and once you have the strategy? I think we have to rely on the individual investor, the man on the street, and I have talked to thousands and thousands of mutual fund shareholders individually, and I do not know how many hundreds of thousands in groups, and the people that come out to the meetings or the people that I meet with sense that spirit. How do you get it out to the public? That has a lot to do with the kind of cost disclosure. Investers will learn. They will learn in the long run, but they will be hurt as they. I would like to make the experience of mutual fund investors a very positive one for them, but it takes all of those fronts, as you say, Chairman Collins.

Chairman COLLINS. Thank you. My second question that I want to ask you has to do with soft dollars. We have heard comments about that today. I think of soft dollars in terms of campaign finance reform, but here we are learning of another kind of soft dollars, but one that once again creates possible conflicts of interest. Is the answer a ban on soft dollars?

Mr. BOGLE. I think ultimately the answer is yes, there should be a ban on soft dollars, and it seems to me it comes down to a very simple principle, and that is, it is amazing how cheap everything you buy is if you buy it with other people's money, and that is true of distribution services and it is true of research, which of course as we all know, has as soon as it is out in the public eye, a value of zero. Because everybody has it, it cannot be capitalized on any longer. It would be very disruptive to the brokerage system and the market system, but I think that should be the direction.

In the meanwhile, I am somewhat concerned about banning soft dollars for the smaller research firms when the large firms, the big brokerage firms, will just collect more and more hard dollars in the guise of payments for research. As enlightened as that solution may appear at first glance, it is not the right solution. So I think we need a more global solution for soft dollars than that.

Chairman COLLINS. Thank you.

Senator FITZGERALD. I have a follow-up on that. Soft dollars are expenses that, if a mutual fund paid for its research, would show up in its expense ratio. So what they do is in order to get research or other services, such as when some mutual funds want to get a new set of computers, they cut a deal with the brokerage firm. The brokerage firm will buy them new computers for their office. One mutual fund had a brokerage firm buy new carpeting for their office, and the way the brokerage firm was able to do that is the mutual fund permitted the brokerage firm to charge an excessive brokerage commission, which was passed along to their mutual fund shareholders.

There seems to be an impulse on the part of mutual funds to convert operating costs into brokerage expenses or transaction costs because then they do not show up in the expense ratio. Am I not right about that? And that is a problem with our disclosure law, we do not require transaction costs to be disclosed so mutual funds keep trying to convert their ordinary overhead, like buying computers and carpeting, into a transaction cost which does not have to be disclosed.

Mr. BOGLE. You are quite right, Chairman Fitzgerald and I have even heard an anecdotal story that goes beyond the computers for these traders who are working so hard. This may be apocryphal, but I was told with a straight face that the person offering the soft dollars said: Well, these traders are working so hard we not only get them good computer systems, but we ought to get them golf club memberships so they can relax on the weekend. Both arguments are equally valid. Once you start going down that long trail, you are going to be wasting the shareholders' money.

But the reality is that it is in the manager's economic interest. And one thing we should always be confronted with is that these directors who are directors of both the manager and the mutual fund, have a fiduciary duty to the manager's shareholders as well, and that is something that we cannot get away from. They have two sets of loyalties and are trying to be, as the biblical quote says, "men who can serve two masters." I do not think it can be done. When they are buying research with soft dollars they ae maximizing the profitability of the manager. If they took that, say, $25 million of soft dollars and expensed it through the manager's books, the manager would earn $25 million of lower profits. So of course they want to get their own expenses as low as they can.

So it is a very tough system to beat, but it is going on, and that is certainly where very strong action, both disclosure and I think ultimately regulatory will have to be required.

Senator FITZGERALD. Senator Lautenberg.

Senator LAUTENBERG. Thanks very much, Mr. Chairman.

It is interesting to see how you can play it straight and make so much money, Mr. Bogle. It can be done in this great country of ours. Obey the rules and do it the way you should do it.

These situations, a lot of these funds are regarded as if they are a gold mine, and if you mine it hurriedly, you know that you have yours all taken care of before it goes to the marketplace, and frankly, I think that the problem is an informational problem. How do we get a message to the mutual fund investor that makes them clear, informs of the risk, informs them of the cost, other than perhaps hiring Howard Dean to go out and put out the message. [Laughter.]

The fact of the matter is, that does not get him elected President, but it does show that your message can be delivered.

How do we tell the public that they are getting gypped in part, that this idea of, well, simply say 11 versus 8 or what-have-you, but as I said earlier, that 11 maybe ought to be 20. I ask you this with a degree of innocence because I am not as familiar with the mutual fund industry as you might be. I know that you do a pretty good job. Is yours the lowest cost?

Mr. BOGLE. By far. Our second lowest-cost competitor, lowest cost next to us, has costs that are approximately 200 percent higher than ours. We run for about 26 basis points, and the second lowest cost is up there around 75 basis points.

Senator LAUTENBERG. You have managed to grow with that modest cost, have you not?

Mr. BOGLE. Our market share has grown from 1 percent of industry assets to 9 percent, and has not declined in any one of the last 20 years.

Senator LAUTENBERG. How much is invested now, and are you—how much are the funds that you are managing these days?

Mr. BOGLE. We started in 1974 with one billion dollars under management. We used to celebrate each billion additional, and our most recent number was $700 billion, so we gave up the one billion celebrations quite a while ago.

Senator LAUTENBERG. That is a nice celebration to give up, on to the larger increments. Is there a way, when we see a prospectus or proxy or a mutual fund that parallels that for industry generally——

Mr. BOGLE. Mutual fund prospectuses are singularly unhelpful. There are pages after pages of type. There is no highlighting of things like costs, or even for that matter returns or returns compared to the market, or the total dollar amount of costs. I think we need a uniform disclosure document in which certain things are highlighted in large type, the dollar amount of the fee, the fund's record compared to the stock market over long periods of time, the impact of cost on returns, things of that nature, in a very simplified way, and then throw in the rest of the prospectus afterward.

Senator LAUTENBERG. Does a typical mutual fund annual statement include salaries or profits made by the senior executive team?

Mr. BOGLE. No, sir, it does not, and it does not because we have never been able to pierce the corporate veil. The mutual fund itself reveals its directors' compensation, but all we know about the manager's compensation is the total fee paid. I believe we absolutely need disclosure of the officers and the management company's salaries, disclosure of portfolio manager's salaries, disclosure of the transactions and ownership they have in the funds, none of which is out there now, and disclose of each individual's share of the profits the management company has earned. I would also add that we need disclosure of how the manager spends that money—and that is why I want this economic study of the industry done. If the manager is getting paid $100 million, is it spending $10 million on investment management and $50 million on marketing, and has a profit of $40 million or whatever the case may be? We have been unable to get to that because the management company is a separate and often privately-held company.

I should add to that there is another extremely unhealthy trend that has taken place in the years over the last half century, and that is, 36 of the largest 50 mutual fund management companies are subsidiaries of giant financial conglomerates. Believe me, sir, you know enough about corporate America to know that those conglomerates are in this business to earn a return on their capital, not a return on the capital of the mutual fund investors. When those two conflicting goals butt up against each other, as we have now seen in some of these scandals, it is the return on capital to the manager that has taken precedence. While I do not think we can ban that conglomerate ownership, we ought to think long and hard about whether the American public is served by conglomerating this once professional business.

Senator LAUTENBERG. Is there any kind of an index out there that identifies the efficiency of the operation of a fund and shares its cost basis in a way that the public can understand it, or would it be a good idea? I think in terms of indices because we used to, at ADP, we delivered the Alan Greenspan econometric space. They sold it, but we would deliver it through our network. It seems to me that there is a heck of a value out there if we can put this information in a simple enough form that it tells the investor, hey, these people have this kind of a cost ratio, they have that kind of a result, and really understand what it is. There is a comfort derived from thinking that you are going into a mutual fund that everybody—you said it, Mr. Chairman—is like an insurance company, that here we are all in this together so everybody is going to take care of everybody and we need not worry about it. Meanwhile, we have seen some of the most outrageous scandals that have come across the financial marketplace in this hidden array of things that are there.

Mr. BOGLE. The array of costs and revenues and ways money gets spent, and profitability of managers, is so vast that I have to confess to you that I am not sure, other than dealing with the most basic information I think would be understandable and palatable to the public. When you get to the real information to see how this industry works, I think it is more complex than that, and therefore, I think what we need very urgently is to have a staff responsible to the board of directors that can provide that information to directors on an independent basis. The present consultants to boards are always paid by the mutual fund managers, so they shape that information—for example, they often leave Vanguard out of the comparisons I am told—but I think it is up to the fund directors to be responsible in this industry, where unlike corporate America there are no large owners; in corporate America, we have 100 large financial institutions that own 50 percent of all stock, and if they just asked for information, they would receive it. There is no such dominant body in the fund industry, so I think we need the fund directors to assume their responsibility.

I agree with you, by the way, on the potential emergence of a kind what we will call a director class. I think it is an excellent idea, because the responsibility in this business largely owned by small investors is to have a board that puts those small investors first. The board will be able to digest any information that we can think of, particularly if it is provided by independent sources.

Senator LAUTENBERG. Just this closing question. Is there a point in time when size becomes a determinant as to whether or not another fund under the same management company must be created so that there is not such a mass in one place, it can destroy a company's value if there is a decision to sell?

Mr. BOGLE. Yes. You bring up a very good point, Senator Lautenberg. In this business, when you are in the business of asset gathering and fee maximizing, which is what a management company does—you can argue it is fine, for that is their business—you tend to let funds grow to awesome size. One of the funds in the industry grew actually to $100 billion. They had a 1 percent management fee. They were paid $1 billion for investment management. And of course, by the time they were that large, they turned into an index fund. They did not want to be an index fund, but they had no other choice. They could not buy small-cap stocks or mid-cap stocks in any appreciable way. So you can observe them now kind of going along the index route, which is fine for me—I mean I love it—except at a cost that means they are destined to fall short of the index return. So, yes, we let funds get to too large a size, and no, we do not cut funds off at a reasonable level, and it is very difficult to replace one large fund with another fund doing the same thing. In other words, they say, we are going to close Fund A and start Fund B. But if you use the same advisor, clearly the problems do not go away, unless, as we did at Vanguard in the case of Windsor Fund and Windsor II, you use a totally different advisor. So it is another area that I believe the SEC should be looking at very carefully. I do not think that is a legislative issue on fund size because I do not think any of us can articulate it very well.

But, yes, there is a size beyond which you cannot differentiate yourself because the cost of portfolio transactions simply overpowers your ability to move the money.

Senator LAUTENBERG. I appreciate your candor. Thank you very much.

Mr. BOGLE. Thank you, sir.

Senator LAUTENBERG. Thanks, Mr. Chairman.

Senator FITZGERALD. Thank you, Senator.

Mr. Bogle, we want to thank you once again for making the journey down to Washington in the inclement weather, and as promised, we will have you out of here in time to make your plane. But thank you very much for coming here. We really appreciate it.

Mr. BOGLE. Thank you all for your courtesy. It has been a privilege to be here.

Senator FITZGERALD. Thank you. Now I would like to go to the whistleblower panel.

Mr. BOGLE. I am not one. [Laughter.]

Senator FITZGERALD. You are not one of the whistleblowers. Well, I guess you are, yes.

I would like to ask Peter Scannell and James Nesfield to please come up to the witness table. Thank you very much for being with us today, and we appreciate your patience waiting through the first panel and giving a special dispensation to John Bogle so we could accommodate his schedule.

Mr. Scannell began working for Putnam Investments in March 2000. As a preferred services specialist in Putnam's call center, Mr. Scannell noticed a pattern of high-volume trades by a group of investors. In March 2003—that is nearly a year ago—Mr. Scannell disclosed this repeated trading to the Boston office of the Securities and Exchange Commission, then subsequently presented his information to the Massachusetts Securities Division within the Office of the Secretary of State. Shortly thereafter, William Galvin, the Massachusetts Secretary of State, issued subpoenas seeking further information that later led to disclosures about Putnam's mutual funds.

Our second witness on this panel is James Nesfield, a former contractor with Canary Capital Partners. Mr. Nesfield cooperated with authorities in their investigation of market trading abuses. When Mr. Nesfield was hired by Canary as a consultant, he was asked to help find companies willing to allow Canary to actively trade their funds and find points of access to enter orders for market timing purposes. Mr. Nesfield has extensive knowledge of trade processing systems on Wall Street that enabled him to communicate directly with many mutual funds.

I would like to note for the record at this time that Peter J. Kugi[1] of Grafton, Wisconsin, has submitted a statement for the record. Mr. Kugi was recently profiled in *Newsweek Magazine* as an aggrieved investor who saw the savings he invested in mutual funds for his son's college education dwindle by more than half. Mr. Kugi considers himself to be an above-average investor. As reflected in his statement, however, even he found that he could not understand the fee structure of the mutual fund in which he invested, leading him to believe that the vast majority of average investors are likely to share his frustration.

Thank you both for appearing today. Mr. Scannell, you may proceed. As with the earlier witnesses, we will ask you to submit your written statement for the record. It will become part of the permanent record of this hearing, and if you are able, we would appreciate it if you could summarize your testimony in 5 minutes. Thank you.

Mr. Scannell.

TESTIMONY OF PETER T. SCANNELL,[2] WEYMOUTH LANDING, MASSACHUSETTS

Mr. SCANNELL. Thank you, Mr. Chairman, Subcommittee Members and Senators. I have submitted my written testimony. It is fairly lengthy, so I will do an overview. Again, I would like to thank you for this extraordinary opportunity to come forward before you to share my experiences and profound concerns.

If I was told a year ago that I would be present at a Senate Subcommittee hearing addressing the very issues I was trying to expose, I would not have believed it possible. Every step of this fight was met with obstacles designed to keep someone like myself, without a corporate title, from being heard.

I became aware of the market timing abuses taking place at Putnam Investments in April 2000, and tried to expose those abuses to the Boston office of the Securities and Exchange Commission in March 2003.

[1] The prepared statement of Mr. Kugi appears in the Appendix on page 276.
[2] The prepared statement of Mr. Scannell appears in the Appendix on page 131.

I was working at the fifth largest mutual fund company in the world, and although most prospectuses state that market timing is either prohibited or discouraged, known to be a detriment to the unwitting long-term investor, it was my experience it was occurring daily. My fear was that market timing abuse and exploitation of the mutual funds were not only an accepted practice at Putnam, but that my understanding of the darker side of human nature and the research I had done told me it may be an accepted practice for those with influence and money throughout the mutual fund industry. For years no news was good news for both the mutual fund industry and the regulators who had oversight responsibilities.

A tangled web has been woven, and from my perspective in the mutual fund scandal, it is an imperative that we fully understand the scope and the depth of those abuses. of fiduciary malfeasance and the lack of proactive regulating. These abuses should have been brought to light years ago.

Senators, the important part of my testimony is not about my family and I, but it is more importantly about what happened to me on this road not traveled by others. Every step in this fight has been met with an imposing force. That is, until I met with Massachusetts Deputy Secretary of State Matthew Nestor. Mr. Nestor immediately understood the magnitude of what I was presenting to him, and also understood the immensity of the burden that I carried. I put my welfare and the welfare of my family aside because of the importance of bringing to light this behavior.

I must emphasize that there were thousands of decent, honest, hard-working Putnam employees who live in the area I call my home, and most if not all, had no knowledge of the abuses I speak of, yet their lives could be greatly impacted as well. In my neighborhood there is outrage. We have read that the American public does not seem to have great concern because of the inflows of monies to the funds. The American family, who is being responsible for their future retirement needs and their children's higher education have no other choice. For them, mutual funds are the only game in town, and they realize that however lopsided that game may be, they have to participate. They know it is time in the market, not timing the market that will help them reach their goals. Families are working two jobs, taking care of their children, and deeply concerned for the world they live in. They have no time and energy left to protest in the streets over the mutual fund scandal.

Senators, let me commend you for your deep concern and understanding of the issues that face the American worker, who is the taxpayer and who ultimately is the long-term investor. Every single day they are getting nickeled and dimed to death, and through no fault of their own they are being scammed on such a daily basis their heads are spinning. Here we are, the very lifeblood of our economy, and to think that there are some of the many who manage the mutual fund industry think the contributions entrusted to them are theirs to divvy up amongst themselves is outrageous. The longer it takes mutual fund companies that are under scrutiny to address their past, the longer it is going to take them to move ahead, if they can move ahead at all. For a CEO to leave Putnam Investments in such a horrendous state, risking the livelihoods of all the innocent rank and file has to be a crime.

Individuals in these corporations need to be held accountable. Consequences need to be imposed and licenses need to be yanked. If you do not care about your neighbor, you need to get out of the mutual fund business. And for those who do not think market timing is not a real problem, I believe we should think again. After I read Stanford University Professor Eric Zitzewitz' study on market timing, I was not surprised. I was validated. But there was one question that was not addressed that I thought was critically important, so I gave Eric a call and asked him quite simply, "Did market timing in the last 5 years contribute to the historic volatility we have experienced affecting all markets?" His answer was, "Sure it did, but it would be unquantifiable."

So that means we permitted a select group, not just market timers but those who allow market timing, to affect our markets in a way we will never fully understand, and that is a very troubling thought.

Mutual fund trading abuses and hidden fees can be curtailed with the appropriate regulation, but there is one form of uncovering abuse that has yet to be suggested. As the Federal Government has in place a very effective Whistleblower Statute for the monies we entrust the government to spend, so too should there be a replicated statute for the securities industry.

The Sarbanes-Oxley Act of 2002 will not inspire those who may want to come forward but are not willing to risk their careers and maybe more. Every regulator that I have spoken to has said: Peter, it is going to take an insider like you to make a difference. It is the proverbial needle in a haystack, and with the technologies available today, as well as future technologies, which will magnify thousands of times, we can make the difference. Maybe the next person to step up to the plate may have even more to offer than a former waiter from Boston's North End,

Senator, as I have read to you and submitted my previous testimony, I have been dismissed by a CPA, a CEO and the SEC, and all of them more than likely regret it. I was bashed in the head for the American investor.

It is our once in an investor's lifetime opportunity now to level the playing field. I remember Matt Nestor saying that he worked on the side of the angels, and to do effectively you must think like the devil. Let us not close the back door to have offenders slip in the side window. There will always be those who will try to take what is not rightfully theirs.

I would like to thank you once again for allowing me to present these issues for your consideration, and it is truly a privilege and an honor for me to do so.

Senator FITZGERALD. Thank you for being here, Mr. Scannell. Mr. Nesfield.

TESTIMONY OF JAMES NESFIELD,[1] NESFIELD CAPITAL

Mr. NESFIELD. My name is James Nesfield. I have worked in the securities industry at various levels since 1978. In 1999, I was approached by Hartz Trading, later to be named Canary Capital, to find brokerage firms, trust companies and mutual fund managers

[1] The prepared statement of Mr. Nesfield and Mr. Grigg appears in the Appendix on page 150.

that would be willing to accept large orders at frequencies generally not available to the average shareholder. This activity is known as market timing. A critical feature is permission by funds managers or a way to hide the volume of frequency of the transactions from the fund managers, thereby avoiding being blocked.

In 5 minutes of testimony I will not be able to relay the intricacies and techniques developed by timers, mutual fund managers, administrators, and other agencies to thwart detection. It has taken hours and days of multiple communications to convey my knowledge to the AG's Office. My job was to find those that would bend the rules for Canary because they were richer and could provide a quid pro quo of investing in other funds or private equities or separate accounts operated by the fund managers.

I found these people simply by reading the news, public directories and searching for their E-mails. Most people within the fund industry hated timers, as that was the official doctrine. I found as I got closer to the upper levels of management, the morality was gray and easily shaded by immediate need or greed. The same is true of brokerage firms and trust companies. It is the golden rule that he who has the gold rules, and if you want a friend get a dog.

No support staff member sets out to originally break a law or help the boss break a law. There is a slow process of inclusion, indoctrination, that pulls the helpers into the complex web. It was that naive perspective that would convince me that the founders and former managers of Hartz Mountain Pet Food were pursuing legitimate investments. Lawyers had vetted them with opinions on the strategy, and it was shocking to learn these pillars of society were violating laws.

Because I worked from my home in North Carolina I learned from the newspapers that Mr. Stern, the Chief Executive at Canary Capital, had computers in his office connecting directly to the mutual funds, and he was purloining portfolio inside information from them and making investments with every edge imaginable. While it was a secret shared by many mutual funds that the Sterns were late timing and receiving portfolio inside information, the pawns were not enlightened. Each knew their part. None could fathom the entire picture. Although any one could see if they examined the NSCC FundServ system, that late trading was possible and easily transacted.

I was never once at a meeting with Mr. Stern or a mutual fund manager or had any other significant business contact through Mr. Stern. I was never given information about the trades except after they were complete and mismarked in execution to hide the true time of execution so that no one would know. A good conspiracy rotates on its ability to keep the critical elements apart. Canary Capital kept staff separated from both trading parties and from senior management. Even Noreen Harrington, who is another mutual fund whistleblower, only reported suspicions by overhearing some mutual fund lingo on the trading form. I filled in technical detail and produced the errant confirms, but the AG still had to find the extent of the trading through subpoena.

Even today it is unclear if the $40 million penalty was commensurate with the profits on and offshore.

I may not have originally understood all the parts of Hartz Mountain's operations, as we had come to know them, because I was not the accountant or the trader with direct responsibility for transactions. But once I understood the severity of these allegations without legal representation, as I still am here today, I came forward to inform completely. I like to think that if I knew earlier, I would have come forward voluntarily. Indeed, in December 2002, I filed a form CA–1, a Form 1 with the SEC outlining potential industry abuses, a way to stop them through automation.

The lesson here is that if there is a legislative solution, it is that mutual funds needs to be regulated on par with broker-dealers as they occupy a strange place of issues, investment advisor, and in many cases points of distribution. A coordinated regulatory regime and checks and balances must be established for mutual funds that can be verified in a robust manner. The lack of expenditures by mutual funds for compliance and critical self assessment warrants concern and suggests an almost intentional neglect of public trust.

I also hope that the Securities and Exchange Commission will review its duty to the public in the strictest terms as well. If legislation is passed in this Congress, the SEC should take care to consider the best interest of the investor first and foremost in implementing any legislation.

Too many times I have seen legislative mandates watered down by interpretations of agencies implementing them. The mutual fund industry should have a higher level of disclosure and inspection since the shareholders are not protected by the Security Investor Protection Act. Mutual funds are exempted.

Thank you.

Senator FITZGERALD. Mr. Nesfield, you have come forward and given your story to the New York Attorney General's Office, as I understand it. You cooperated with Attorney General Spitzer's office, and ultimately your cooperation, as well as that of a couple of others led to the charges that were announced in early September of this past year against Canary and others.

Did the Attorney General grant you immunity?

Mr. NESFIELD. No.

Senator FITZGERALD. Apparently because of your cooperation, they have not pursued any criminal charges against you for your participation?

Mr. NESFIELD. No, there has been none.

Senator FITZGERALD. What were you doing before 1999? You were a consultant of some sort?

Mr. NESFIELD. Before I went to work for Canary I worked at SIPC liquidation in Longview, Texas.

Senator FITZGERALD. What did they do?

Mr. NESFIELD. SIPC is the Security Investors Protection Corp. A brokerage firm had gone under, and I was working for the trustee.

Senator FITZGERALD. OK. You were hired as a consultant by the trustee?

Mr. NESFIELD. Yes.

Senator FITZGERALD. When you were hired by Canary, were you hired as an outside contractor or as an employee?

Mr. NESFIELD. Outside contractor.

Senator FITZGERALD. Outside contractor. Who at Canary hired you?

Mr. NESFIELD. I was contacted by Andrew Goodwin.

Senator FITZGERALD. Andrew Goodwin.

Mr. NESFIELD. Yes.

Senator FITZGERALD. What is his position or was his position?

Mr. NESFIELD. He was one of the traders there.

Senator FITZGERALD. He was one of the traders.

Mr. NESFIELD. Yes.

Senator FITZGERALD. What did he say to you? Did he call you up on the phone? How did he find your name?

Mr. NESFIELD. He basically saw my resume on the Web and it lists a number of skill sets I have in regards to some of the technical aspects of the business.

Senator FITZGERALD. He called you up. What did he say?

Mr. NESFIELD. "I would like to meet with you. I will pay you," basically, if you want to——

Senator FITZGERALD. Did he tell you what he was interested in over the phone?

Mr. NESFIELD. No.

Senator FITZGERALD. So he met with you in his office at Canary?

Mr. NESFIELD. I went up to Secaucus, New Jersey and met with him, Eddie Stern and Noah Lerner.

Senator FITZGERALD. And Mr. Stern——

Mr. NESFIELD. Yes.

Senator FITZGERALD [continuing]. Was in the room. And Mr. Stern and Mr. Goodwin?

Mr. NESFIELD. Yes.

Senator FITZGERALD. And a lawyer?

Mr. NESFIELD. No. Noah Lerner. He is another gentleman that worked with Mr. Stern.

Senator FITZGERALD. Noel Lerner?

Mr. NESFIELD. Noah, as in the boat.

Senator FITZGERALD. Noah, OK. Noah Lerner, Mr. Stern and Mr. Goodwin, they met with you?

Mr. NESFIELD. Yes.

Senator FITZGERALD. What did they say to you in that meeting?

Mr. NESFIELD. They basically said, "We do market timing." I knew what it was. I had talked to somebody else. This might have been 5 years before that I knew about market timing. And somebody had approached me to—mutual fund companies had started implementing automated means of detecting market timing activity so they would be able to block those orders or stop timers. If you look at the design of the system that is used to put orders in for mutual funds, there is a way to subvert that, and essentially that is what they hired me to do.

Senator FITZGERALD. Did you advertise your ability to help them engage in market timing?

Mr. NESFIELD. No.

Senator FITZGERALD. They called you in. You did not know exactly what they wanted to hire you for, and then they explained to you, "We do market timing. Can you help us?"

Mr. NESFIELD. You have to understand market timing is not illegal, correct?

Senator FITZGERALD. Maybe illicit. Could be illegal in certain circumstances.

Mr. NESFIELD. It is what you call gray, is that correct?

Senator FITZGERALD. Well, it could be illegal in certain circumstances. If Mr. Stern, as you said in your opening remarks, was receiving insider portfolio information——

Mr. NESFIELD. I did not know that directly. I learned that in the paper.

Senator FITZGERALD. You did not know that by working there?

Mr. NESFIELD. No. I never put an order in for Mr. Stern. I was never—as I said, I never had direct knowledge.

Senator FITZGERALD. OK.

Mr. NESFIELD. I knew all the technical aspects of it, but that is why Mr. Spitzer's office had to go and get Mr. Goodwin because Mr. Goodwin had the direct knowledge.

Senator FITZGERALD. So when they were hiring you, you did not view this as them asking you to help them with any illegal activity?

Mr. NESFIELD. Basically, just find people, find the people that had access to this.

Senator FITZGERALD. What did you tell them? Did you tell them you thought you could help them with that?

Mr. NESFIELD. I knew I could.

Senator FITZGERALD. You knew you could.

Mr. NESFIELD. Yes.

Senator FITZGERALD. That you knew the processes at mutual funds and you would be able to sift out the ones that would——

Mr. NESFIELD. Well, it is not just mutual funds, OK?

Senator FITZGERALD. OK.

Mr. NESFIELD. Anybody that is an NSCC FundServ participant——

Senator FITZGERALD. NSCC?

Mr. NESFIELD. Right. National Security Clearing Corp.

Senator FITZGERALD. OK.

Mr. NESFIELD. Anybody that is an NSCC FundServ participant can time mutual funds with or without the permission.

Senator FITZGERALD. OK.

Mr. NESFIELD. So Mr. Bogle's fund was timed.

Senator FITZGERALD. Did they tell you at that meeting how much they would pay you? Did you settle on an arrangement?

Mr. NESFIELD. Yes. $50 an hour to start.

Senator FITZGERALD. So you were paid by the hour?

Mr. NESFIELD. Initially, yes.

Senator FITZGERALD. Initially.

Mr. NESFIELD. Yes.

Senator FITZGERALD. Did that fee later go up?

Mr. NESFIELD. About 2 weeks later.

Senator FITZGERALD. What did it go up to?

Mr. NESFIELD. It went on a percentage of assets they put into timing capacity channels I had found.

Senator FITZGERALD. What was that percentage?

Mr. NESFIELD. A tenth of 1 percent or 10 basis points.

Senator FITZGERALD. You got 10 basis points. That is the total expense ratio for the Government Thrift Savings Plan.

Mr. NESFIELD. Well, I worked harder. No.

Senator FITZGERALD. How much money did you make doing this?

Mr. NESFIELD. Over 4 years, maybe between $250,000 and $300,000.

Senator FITZGERALD. Over 4 years?

Mr. NESFIELD. Yes.

Senator FITZGERALD. How much in total assets did you find market timing capabilities for them?

Mr. NESFIELD. I do not know. A great deal. I was not paid on some of it.

Senator FITZGERALD. You were not?

Mr. NESFIELD. No.

Senator FITZGERALD. Did they owe you money at the end?

Mr. NESFIELD. Well, Mr. Stern has a funny way of accounting for things. He owes me money and he owes Mr. Goodwin money as well.

Senator FITZGERALD. How much money do you think you are owed?

Mr. NESFIELD. I do not know. I do not have full disclosure, but I mean if I take a guesstimate, not concerned about how it appears, he might owe me $3 million.

Senator FITZGERALD. Do you have other clients that you have helped market time?

Mr. NESFIELD. No. Mr. Stern nailed me to an exclusivity contract.

Senator FITZGERALD. Had you ever helped any other entities engage in market timing?

Mr. NESFIELD. Someone proposed the question to me years ago before Mr. Stern. I gave them my best answer and they would not take my advice.

Senator FITZGERALD. So you have not done this, provided this service to anyone else?

Mr. NESFIELD. No.

Senator FITZGERALD. Just for Canary Capital.

Mr. NESFIELD. Right.

Senator FITZGERALD. It is quite a story. It is really an interesting story. You said that you wondered whether the fine, the $40 million penalty that the Attorney General's Office assessed on Canary, you wondered whether that was enough. How much do you think they made?

Mr. NESFIELD. I think the Attorney General's Office probably—this is my assumption, but they probably did not go and turn over every rock inside the Stern organization. I mean they probably trusted what was given to them for——

Senator FITZGERALD. How big is the Stern Hedge Fund?

Mr. NESFIELD. It was $4 billion.

Senator FITZGERALD. It was $4 billion. How big was it when you started in 1999?

Mr. NESFIELD. It was $300 million.

Senator FITZGERALD. So it grew really fast?

Mr. NESFIELD. Yes, but it's not just——

Senator FITZGERALD. With this market timing it was having abnormally high returns?

Mr. NESFIELD. They made 110 percent the first year.

Senator FITZGERALD. One hundred seven percent?

Mr. NESFIELD. One hundred ten percent.

Senator FITZGERALD. One hundred ten percent?

Mr. NESFIELD. Yes.

Senator FITZGERALD. How about the second and third years?

Mr. NESFIELD. Diminished returns, 25 or 26 percent.

Senator FITZGERALD. Is that because the fund was getting bigger and bigger?

Mr. NESFIELD. Yes.

Senator FITZGERALD. Were they making most of their money from market timing or did they have some real good investments? And a lot of this—the market crashed in 2000, right?

Mr. NESFIELD. You have to understand, if you—the mutual funds need market timing. I mean nobody really understands. There is this organization called Reflow.com that has been funded by—what is his name—Getty, the oil guy, Gordon Getty? He started this investment advisory firm. What it does is it helps mutual funds deal with negative redemptions, and in some sense it was the prudent—I mean it sounds obtuse to say this at this point, but it was the prudent manager of the mutual fund who actually required cash, additional cash coming in from market timers to handle the impact of negative redemptions. So it is really a money management technique, even though when Stern does late timing, or anybody does late timing, it is illegal.

The fund manager, when—some fund managers like MFS ran a trading program or a timing program. When they were doing it, it was basically a means for them to borrow money short term in order to handle a falling market or negative redemptions. So while they might not ordinarily accept that, during a falling market, which we have experienced, which we are still in more or less, they are going to have to take some rather weird type of money management things. They have to get their money where they can get it.

The other thing that happened is since 1999 the investment advisory companies collateralized their fees. There is actually bonds that are issued on the fee income derived from mutual fund managers. One of the reasons they are so adverse to having the assets under management go down is because it will affect their debt service on those bonds that they have written. You know, you can put your finger in the water, but it is a pretty mixed pond. There are a lot of things going on there. That is why when I hear people talk about legislative solutions, it is not so clear cut. It is not as easy to perceive—I mean it is not as easy as everybody would like to make it. It is very complex and it has got to be done carefully.

Senator FITZGERALD. Let me ask you this. You started trying to search out mutual funds that would give market timing capacity to the Stern Hedge Fund.

Mr. NESFIELD. Right.

Senator FITZGERALD. How many mutual funds did you find over the course of your 4 years there?

Mr. NESFIELD. Hundreds.

Senator FITZGERALD. Hundreds?

Mr. NESFIELD. Yes.

Senator FITZGERALD. What were the five biggest funds?

Mr. NESFIELD. Janus.

Senator FITZGERALD. Janus.

Mr. NESFIELD. Invesco.

Senator FITZGERALD. Invesco.

Mr. NESFIELD. AIM, A–I–M. That's part of Invesco.

Senator FITZGERALD. A–I–M.

Mr. NESFIELD. Putnam.

Senator FITZGERALD. Putnam?

Mr. NESFIELD. Yes. And that's all I can recall off the top of my head.

Senator FITZGERALD. OK. But it was hundreds of them, so many that——

Mr. NESFIELD. Yes, everybody had a deal.

Senator FITZGERALD. OK. But typically——

Mr. NESFIELD. Kinetic is another one, yes.

Senator FITZGERALD. Who?

Mr. NESFIELD. Kinetic Funds. They're a small group of funds. Kinetic had one.

Senator FITZGERALD. Kinetic.

Mr. NESFIELD. Yes.

Senator FITZGERALD. So on your first go-round with these people, how would you—a lot of times you are turned down. Were there some that accepted you right away?

Mr. NESFIELD. Well, my motto—and it held true—is if you heard no, you didn't ask the right person, or you didn't ask at the right time.

Senator FITZGERALD. Were there any that turned you down?

Mr. NESFIELD. Yes.

Senator FITZGERALD. Who turned you down?

Mr. NESFIELD. Scudder. But I have recently found out in the newspaper that they had a timing program, so obviously it was the wrong time and the wrong person.

Senator FITZGERALD. Scudder turned you down. Who else turned you down?

Mr. NESFIELD. Well, I was turned down by most of them. It is just I had to reapproach it—see who do you ask.

Senator FITZGERALD. Who kept turning you down and never changed their mind?

Mr. NESFIELD. Nobody.

Senator FITZGERALD. Oh, once you told them that you are huge, you are big, you are a multi-billion-dollar——

Mr. NESFIELD. Kind of like the same pick-up lines you use at a bar, yes. I am kidding around; it is a joke. I'm sorry.

Senator FITZGERALD. So they all were agreeing ultimately. Were they putting any limits on you at Janus?

Mr. NESFIELD. They would have limits, but I didn't discuss them. They would—once the contact became like affirmed, if you will, then I turned it over to Mr. Stern, and he would negotiate with them.

Senator FITZGERALD. And then Stern would negotiate with them personally?

Mr. NESFIELD. Yes. I didn't have the latitude to actually negotiate the deal.

Senator FITZGERALD. Now, you probably made them, if they had 102-percent return the first year you came on board, you probably just made millions and millions of dollars for them, and all you got paid was $250,000 over 4 years.

Mr. NESFIELD. Just my luck, right?

Senator FITZGERALD. Just your luck.

Mr. NESFIELD. Yes.

Senator FITZGERALD. Mr. Scannell, turning to your experience with Putnam, you noticed large, repeated timing trades happening at Putnam, apparently in accounts of some union members?

Mr. SCANNELL. Yes. Those are the ones that would stand out, Senator, only because of——

Senator FITZGERALD. What union was it?

Mr. SCANNELL. The initial union was the Joint Industry Board of Electricians. This was a 27,000-member union. That was in 2000, and probably almost 3 weeks into my employment after training, again, for a complete career change, this was very unique. I believe one of the things that made it stand out to me is because I didn't have a background in the financial services industry. They were marketing timing two tech funds, and they were being hurt significantly. They were losing literally thousands and thousands of dollars in individual accounts. These gentlemen had two, three, four hundred thousand dollars in their accounts. I've given examples in my testimony to you. And they just went away in 2000, September 2000, a little later. The NASDAQ just wouldn't provide enough recovery for the systems or the techniques that they're using to market time.

It was my belief that it was almost like scuttlebutt or what have you. They'd call up—I mean, these are hardworking guys. They'd call up between three and four, Hey, people, what's the NASDAQ doing? And, put me in, put me out.

Senator FITZGERALD. They would call into your call center where you worked?

Mr. SCANNELL. Exactly.

Senator FITZGERALD. And initially you were probably helping some of them, not knowing what they were doing.

Mr. SCANNELL. I was executing transfers at the request of participants and/or members, of which they were. This was something that many representatives brought up to our supervisors, and this was a——

Senator FITZGERALD. Had you been trained to look out for this?

Mr. SCANNELL. Absolutely not. There was no training.

Senator FITZGERALD. You had no training.

Mr. SCANNELL. No. As a matter of fact, one of our concerns was, as the market was plunging in 2000, the mantra in the industry was diversity, suitability, really trying to get people to do it. And I'd address supervisors with that and would talk with preferred services specialists like myself who were becoming licensed and more educated in regards to the mutual fund industry and what detriment this was doing.

Senator FITZGERALD. So did you understand the detriment to the other funds?

Mr. SCANNELL. Absolutely. Before I even received my first license.

Senator FITZGERALD. At what point did you go—you went to supervisors at Putnam?

Mr. SCANNELL. Yes.

Senator FITZGERALD. Who was your supervisor?

Mr. SCANNELL. I had many supervisors.

Senator FITZGERALD. You had many supervisors.

Mr. SCANNELL. Yes. It's a very high-turnover call center, and what happened was we actually became very adept at what we were doing. Putnam increased our ability to form multi-task and do the——

Senator FITZGERALD. What did the supervisors tell you?

Mr. SCANNELL. Just discouraging the discussion. Yes, stating we cannot give advice. We were always constantly being—it was trying to be told to us that there was a bill before the legislature that would allow us to give advice over the phone. I mean, it was fairly——

Senator FITZGERALD. Just they would give you the roundabout.

Mr. SCANNELL. Exactly.

Senator FITZGERALD. Did you take it beyond your supervisors in the call center?

Mr. SCANNELL. Yes.

Senator FITZGERALD. Where did you go to?

Mr. SCANNELL. Well, later on, discussing, again, after I received my Series 63, and Series 7 license, we became this preferred services unit where we encountered a different market timing strategy, and that was an international fund market timing. Now, this was a fund that the—it happened to be just another union. We had a lot of market timers at Putnam Investments throughout the 2,000 plans. But, again, because they had a technique and as a group they had the fund within their plan, they had the ability to market time.

Senator FITZGERALD. And what union was this?

Mr. SCANNELL. This was the Boilermakers Local 5.

Senator FITZGERALD. In Boston?

Mr. SCANNELL. No, it was not in Boston. I believe it was New York or New Jersey.

Senator FITZGERALD. In New York or New Jersey?

Mr. SCANNELL. Yes.

Senator FITZGERALD. And you start getting boilermakers calling you.

Mr. SCANNELL. Right. And, unfortunately for myself, the connotation unions, market timing, and what it's conjuring isn't the case. I mean, they had a technique that we allowed them to do. It was the International Voyager Fund, and any fund family that has their participants or members, as we describe union members, had a particular group of funds that they could invest in.

Now, they had the ability to transfer those funds daily from an International Voyager Fund into a guaranteed investment contract fund. That was the technique. It was done 100 percent, as Mr. Nesfield was discussing. That was very common. The market going down was insignificant for transfers of Internal Voyager Fund and their ability to turn a profit.

Senator FITZGERALD. So you began to wonder why your firm permitted this because you knew it was harming the other fund shareholders.

Mr. SCANNELL. It was not only harming the other fund shareholders, but, again, I'm going back to the initial, Joint Industry Board for the Electrical Industry (JIB), that it was actually—we were allowing—I compared it to a pharmacist—and, again, not the boilermakers—refilling a prescription over and over again knowing that it's doing great harm to somebody.

Senator FITZGERALD. Was anybody else in your call center as concerned as you?

Mr. SCANNELL. Absolutely.

Senator FITZGERALD. And did anybody else do anything?

Mr. SCANNELL. Absolutely. We brought it up to the attention—of senior management. It was discussed in front of one senior manager that said it wasn't criminal in a preferred services specialist meeting where one of my peers brought it to their attention. We had a great buffer between senior management for obvious reasons.

Senator FITZGERALD. But you did get in to see the senior——

Mr. SCANNELL. Well, we were at a meeting, and it was brought up.

Senator FITZGERALD. With the senior manager there.

Mr. SCANNELL. Exactly, and his reply was it's not criminal.

Senator FITZGERALD. Who was that senior manager?

Mr. SCANNELL. His name was Robert Capone.

Senator FITZGERALD. Like Al Capone.

Mr. SCANNELL. Exactly.

Senator FITZGERALD. OK. And you brought it up to Mr. Capone, and what did Mr. Capone say?

Mr. SCANNELL. It was brought up to Mr. Capone by another representative in front of another senior vice president, and a human resources representative——

Senator FITZGERALD. Is Mr. Capone still there?

Mr. SCANNELL. I believe so.

Senator FITZGERALD. He is?

Mr. SCANNELL. I believe so. I'm not sure.

Senator FITZGERALD. OK. It was brought up at one of those meetings. You weren't the one who brought it up. Someone else brought it up.

Mr. SCANNELL. Yes.

Senator FITZGERALD. And his response was? Mr. Capone's——

Mr. SCANNELL. It's not criminal.

Senator FITZGERALD. It's not criminal so don't worry about it.

Mr. SCANNELL. It was very shocking to hear him say that.

Senator FITZGERALD. OK.

Mr. SCANNELL. But that he would say that in front of us—for myself, understand as well that——

Senator FITZGERALD. Was this after-hours trading or market timing?

Mr. SCANNELL. This is market timing.

Senator FITZGERALD. OK.

Mr. SCANNELL. And it could be just as successful as after-hours trading with an international fund. Again, it's well known now, we all seemingly have a good idea of market timing. It does not take a positive movement in the market. It just takes taking advantage. It's the arbitrage that's available.

Senator FITZGERALD. OK. So after it was brought up to Mr. Capone and he just said it's not illegal and dismissed it, then what? Did you or your——

Mr. SCANNELL. One of the representatives, again, who—and because he's still working there actively, I'd rather not mention his name. He confronted a supervisor with a spread sheet. I already had a spread sheet active in my—an Excel spread sheet. I was tracking them. I knew that they knew I was tracking them. Everything that I did was monitored, whether it was on my computer or on my phone—everything.

So I was putting myself in a position that, well that's——

Senator FITZGERALD. Did anybody tell you, warn you off, to quit pursuing this line?

Mr. SCANNELL. Well, what happened—no, they wouldn't. But, again, it wasn't applauded. And the efforts—one of the interesting things was that we were constantly told that there is not a system to do this. And that was for a number of years.

And back to your point about another supervisor, I put this spreadsheet together, and I actually gave them the account numbers of market timers, and nothing was ever done. That's when I decided that I need to take my time and make sure I provided all the documents I could not only to protect myself but to expose Putnam. And I found internal documents that suggested Putnam was aware of this in 2000.

Senator FITZGERALD. You then went to the SEC?

Mr. SCANNELL. Exactly.

Senator FITZGERALD. Was that the first place you went?

Mr. SCANNELL. Yes.

Senator FITZGERALD. OK. And when did you go to the SEC?

Mr. SCANNELL. I went to the SEC at the end of March. First I went to—I have a brother who is an attorney, and he said, "You need a securities attorney." And I was fortunate enough to find a firm in town, and she happened to be an employment specialist. It was through a family friend. So it was decided in March that I would go to the SEC and provide them the documents.

Senator FITZGERALD. Did the lawyer go with you?

Mr. SCANNELL. Well, there was some discussion first. Evidently this wasn't incredibly welcome news, and it was described what I did have, a very compelling and succinct anthology of what I believed was something disturbing at Putnam Investments.

It took a number of communications, as I provided in my testimony, before they would even meet with my attorney. I wanted to remain—my identity to remain confidential. Unfortunately——

Senator FITZGERALD. OK. So they didn't meet—you didn't go initially to the SEC?

Mr. SCANNELL. We had a number of communications through my attorney.

Senator FITZGERALD. Through your attorney.

Mr. SCANNELL. There was about seven.

Senator FITZGERALD. Seven, before they met with her?

Mr. SCANNELL. Before they met with her, three attorneys on 76 Tremont Street.

Senator FITZGERALD. And how long did that take?

Mr. SCANNELL. That was in April.

Senator FITZGERALD. So you started this process at the end of March, and by April——

Mr. SCANNELL. April 24, I believe it was.

Senator FITZGERALD. April 24, your attorney——

Mr. SCANNELL. I finally was able to meet with them. This was happening——

Senator FITZGERALD. Did they meet with your attorney first?

Mr. SCANNELL. They met with my attorney first. I believe it was on April 14.

Senator FITZGERALD. OK. And they were interested?

Mr. SCANNELL. Again, they came back to me—I mean, my attorney came back to me, and there was some more discussion. They did not agree to meet with me yet.

Once I met with them, I needed to provide them with the prospectuses of the funds that I was concerned about, and in doing so, obviously identify myself. There was a number of websites out there and there was a number of people at Putnam Investments that knew that it was me that was——

Senator FITZGERALD. Now, it wasn't necessarily illegal activity you were bringing to their attention, but perhaps activity that——

Mr. SCANNELL. It wasn't mine to judge that it was illegal. I was just seeing—I was seeing something that I didn't believe was in the best interest of initially the actual members doing it and losing hundreds of thousands of dollars.

Senator FITZGERALD. Did it contradict the promises in the prospectus?

Mr. SCANNELL. That was interesting. When I met with three attorneys from the SEC, they handed me back the prospectus that I gave them and asked me what my opinion was of it. I found that, as not an attorney, I read very clearly that it stated that short-term trading—this was not a vehicle for short-term trading. It would be prohibited. Putnam would do anything within its management ability to curtail or to stop or to refuse transactions, whether it was from one fund to another.

Senator FITZGERALD. So there is the violation, they advertise in their prospectus that they discourage this market timing, but then you see them allowing it every day.

Mr. SCANNELL. And there was also a disclaimer in it that said—there was a 1-percent redemption fee, which we now know that that would not stop market timing, a 1-percent redemption fee.

Senator FITZGERALD. Were they imposing that redemption fee or they were——

Mr. SCANNELL. That 1-percent redemption fee would not be imposed to anybody in a 401(k) Putnam-managed fund, omnibus plan, or variable annuity.

Senator FITZGERALD. OK.

Mr. SCANNELL. So that was kind of where it started to point me. Well, let's get into a Putnam plan, and if you don't have to worry about tax consequences, if you don't have to worry about redemption fees, you are all set.

Senator FITZGERALD. OK. So you meet April 24 with the SEC?

Mr. SCANNELL. Yes.

Senator FITZGERALD. You personally meet. Then what happens?

Mr. SCANNELL. With my attorney. We had a meeting for an hour and a half. They thanked me for my courage. And I went on my way.

Senator FITZGERALD. Did you hear from them again?

Mr. SCANNELL. My attorney contacted them in about 2 weeks. There was nothing to report. Then it went on for about 3 weeks, another 3 weeks. I asked her to contact them, and previously they asked me if I was going to be going anywhere else, to let them know first. And then for whatever reason, it was communicated through my attorney that they're not interested in updating me or keeping me abreast. All the while I knew that market timing was continuing at Putnam Investments.

Senator FITZGERALD. And at what point did you then go to somebody else, the Secretary of State's office?

Mr. SCANNELL. September 11, 2003. I met with Matt Nestor in the Federal Reserve Building where my attorney's offices are.

Senator FITZGERALD. And that was after the charges had been brought in New York against Canary, which Mr. Nesfield has worked for?

Mr. SCANNELL. Yes, right about that time.

Senator FITZGERALD. OK. And then you got the idea, you saw a State attorney general was pursing this in New York.

Mr. SCANNELL. Yes, and I had a lot of admiration for what Attorney General Spitzer was doing. At the same token, our Secretary of State William Galvin was investigating Prudential Securities before that for brokers—I believe it was trading after hours.

Senator FITZGERALD. OK.

Mr. SCANNELL. So obviously I went to my——

Senator FITZGERALD. And the Secretary of State, Mr. Galvin's office, got on it right away in September.

Mr. SCANNELL. Well, in about 4 hours after having met with Matthew Nestor, who I informed, that the SEC never got back to me and seemingly was not interested. From what I believed and from the market timing I knew was continuing, he assured me that William Galvin's office wouldn't behave like that, they would be acting on this. He was very impressed with the information.

Senator FITZGERALD. Are you still working at Putnam?

Mr. SCANNELL. No, I'm not. Excuse me. I am on disability from Putnam Investments. I was assaulted over what I believe this——

Senator FITZGERALD. When did you go on disability?

Mr. SCANNELL. February 2.

Senator FITZGERALD. OK. So you were bringing these concerns to the SEC after you had gone on disability?

Mr. SCANNELL. What happened to me right before February 2, I compiled my information and left, knowing—and telling a supervisor, an assistant vice president there, that I'd no longer be accepting transactions for known market timers. I was told to be careful and I had to do what I had to. It was the following Sunday at a meeting that I regularly attended that I was assaulted by somebody that I believed was trying to make me—the person who assaulted me looked like they were a Boilermaker Local 5 member.

Senator FITZGERALD. When were you assaulted?

Mr. SCANNELL. The following Sunday, February 2.

Senator FITZGERALD. On February 2.

Mr. SCANNELL. My disability is from my assault.

Senator FITZGERALD. Your disability is from your assault?

Mr. SCANNELL. Yes.

Senator FITZGERALD. And you had been raising concerns within Putnam?

Mr. SCANNELL. And downloaded documents and, again, that they're well aware that I did, once I left. People were aware that I was—I wasn't going to——

Senator FITZGERALD. Where did the assault occur?

Mr. SCANNELL. In Quincy, Massachusetts.

Senator FITZGERALD. OK, and you believe it related to your whistle-blowing activities within Putnam?

Mr. SCANNELL. Yes.

Senator FITZGERALD. Who do you think were——

Mr. SCANNELL. Actually, I feel kind of uncomfortable talking about this in detail, Senator. I've included that in my testimony to you very——

Senator FITZGERALD. OK.

Mr. SCANNELL. In descriptive form. It's another incredible coincidence, and that's something that a lot of people have wanted me to believe that all these coincidences are just that—coincidences. And I'm concerned that there's more to it than that.

Senator FITZGERALD. Did you tell the SEC when you met with them that you had been assaulted?

Mr. SCANNELL. Yes.

Senator FITZGERALD. And that you thought it related to your——

Mr. SCANNELL. Yes.

Senator FITZGERALD [continuing]. Complaints. OK. Well, I compliment you on your courage. I compliment both of you for coming forward. I think you have done a great public service by helping shed a spotlight on the experiences that you two had within the industry. A lot of this is difficult for people outside the mutual fund industry to understand technically how some of these activities, the market timing and late trading, actually occur. And both of you show a lot of courage by coming forward, testifying before Congress, and we certainly appreciate it.

Mr. Scannell, we do have your full statement for the record, and we can read the details there. And if you have more ideas, please feel free to be in touch with my office as all of this progresses.

Is there anything else either of you would like to add before we close up? Well, if not, we will allow you to get on your way, and thank you very much.

Mr. NESFIELD. Thank you, Senator.

Mr. SCANNELL. Thank you for the opportunity, Senator.

Senator FITZGERALD. OK. We are set to begin the third panel, and I want to begin by thanking all of you for your patience. You have probably been waiting here since the first panel, and I know it has been a long day. And I am sure many of you traveled a long way as well in the inclement weather, so we appreciate all that you have done to be here.

Our first witness on the third panel is Jeffrey C. Keil, who is vice president of Global Fiduciary Revier at Lipper, Incorporated, headquartered in Denver, Colorado. Mr. Keil has been analyzing the mutual fund industry for the past 12 years and has specialized in mutual fund fees and expenses as well as regulatory and disclosure issues.

Last week, Lipper released a study on the feasibility of eliminating the 12b–1 fees that mutual fund companies charge to cover costs such as marketing and advertising and reimbursements to brokers for distributing their funds. We look forward to hearing from Mr. Keil on Lipper's findings in their report.

Our second witness is Travis B. Plunkett, who is the legislative director at the Consumer Federation of America. The Consumer Federation of America is an association of 300 organizations that work to promote and protect the consumer interests by engaging in advocacy, education, and network building. Mr. Plunkett's focus at the CFA is on financial services, including credit reporting, credit counseling, and consumer privacy and insurance.

Our third witness is Paul S. Stevens, who is a partner at Dechert LLP, in the firm's financial services group. Mr. Stevens is with us today on behalf of the Investment Company Institute, known as ICI, where he served as senior vice president and general counsel from 1993 to 1997. While serving in this capacity, Mr. Stevens is credited for leading the ICI in its efforts to support passage of the National Securities Markets Improvement Act of 1996, as well as in the adoption of mutual fund disclosure reforms by the SEC and the formation of new industry standards on personal investing. In his position at Dechert, Mr. Stevens leads the firm's practice in the areas of mutual fund governance and bank/broker-dealer activities.

Our fourth witness on this panel is Marc E. Lackritz, who is the President of the Securities Industry Association. The Securities Industry Association represents the shared interests of over 600 securities firms, including mutual fund companies, investment banks, and broker-dealers. Mr. Lackritz has a great deal of experience in the securities industry, having served not only as SIA president since 1992, but also as executive vice president to the organization and as executive vice president at the Public Securities Association, which is now known as the Bond Market Association.

And, finally, with us today is Professor John Freeman of the University of South Carolina School of Law. Professor Freeman was referred to in remarks by Attorney General Spitzer. Professor Freeman holds the John Campbell Chair in Business and Professional Ethics and has taught courses in legal ethics and securities laws for the past 30 years. Professor Freeman has an extensive background analyzing mutual fund and other investment issues, and he recently co-authored an extensive study entitled "Mutual Fund Advisory Fees: The Cost of Conflicts of Interest." That was the report Attorney General Spitzer was referring to.

Again, I would like to thank each of the witnesses for being here, and in the interest of time, if you could all be kind enough to submit your written remarks for the record and we will include those remarks as part of the permanent record of this Subcommittee hearing, and if you could summarize those remarks in no more than a 5-minute opening statement, we would greatly appreciate it.

So, Mr. Keil, we will begin with you. Thank you for being here.

TESTIMONY OF JEFFREY C. KEIL,[1] VICE PRESIDENT, GLOBAL FIDUCIARY REVIEW, LIPPER, INC

Mr. KEIL. My pleasure. Thank you, Chairman Fitzgerald. Lipper appreciates the opportunity to be here and address the Subcommittee today.

I wish to address four issues vital to the business today in the next few minutes: Lipper's recent study on 12b–1 fees; generally on fees and expenses of mutual funds; costs opaque to investors; and fund governance. My aim is to clear up some misperceptions about these particular topics and outline some recommendations for reform.

First, with regard to 12b–1 fees, several misperceptions will require a bright light at this time. Rule 12b–1 fees frequently are referred to as an advertising and marketing fee borne by investors. Frankly, 95 percent of the fees pay for sales charges, investor service fees, and administration, while only 5 percent actually pay for advertising and promotion.

Second, given this particular reality, saying the 12b–1 sheets should create commensurate economies of scale through asset growth is effectively outdated since advertising and promotion is only 5 percent.

Finally, funds closed to new investors must continue to provide certain service to investors covered by the 12b–1 plan. Hence, some plans should be—are justified for closed funds.

Briefly, the highlights of our study on Rule 12b–1 recommendations update the factors that boards should consider when reviewing and continuing 12b–1 plans, issue more definitive guidelines as to acceptable 12b–1 expenditures, provide more investor transparency on the specific uses of 12b–1 fees, and commission a study that considers whether sales charges, meaning commissions to brokers actually under the rules, should be removed from underneath Rule 12b–1, and generally recraft Rule 12b–1 to account for today's market realities, as it is woefully outdated at this point. It hasn't been updated for about 23 years, if I'm correct. I believe I'm correct.

Copies of our 12b–1 study have been provided in its entirety to the Subcommittee for your review.

With regard to funds' management fees and expense ratios, based on Lipper expense data, most shareholders are not paying more in both management fees and total expenses than they were 10 years ago. Using funds' size-weighted ratios, fees for most investors have not risen. When simple average ratios are cited to the investing public and through the press, they are highly skewed by a larger proportion of very small funds not held by the vast majority of investors.

To the point about pension funds and mutual funds, we would maintain that funds do not necessarily pay substantially more in advisory fees than pension funds do. We have maintained that a more definitive study still needs to be authored that uncovers all reasonable benchmarks to the extent that the data actually is available, which is one of the limitations that the data are not

[1] The prepared statement of Mr. Keil appears in the Appendix on page 179.

available to a large extent; hence, the ICI study using sub-advisory comparisons.

A full 1.5-percent difference between the industry-wide median total expense ratio and a much lower ratio weighted for fund size indicates that size economies are being passed to investors. That obviously doesn't address the actual amount of the fee, but there are economies of scale that do exist in this business. I see it on a daily basis.

Finally, to extend the economies-of-scale argument to an entire fund business based on aggregate assets of the business is illogical. Scale is realized on the fund and the complex level only, not the entire business. This business has quite a few hundred variable very small fund complexes which have not reached any serious asset threshold, and there are very few economies to be had. Simple as that.

As far as Lipper's recommendations, we support initiatives to report hypothetical expense levels in dollars in shareholder reports. We suggest an aggressive investor education initiative on cost impacts on returns be launched. That comes from comments earlier. Last, we feel enhanced disclosure should be provided in the prospectus on expense benchmarks. This comes from earlier discussion as well so that investors know, in relation to some type of average or index, what are they paying.

With regard to costs opaque to investors, I would certainly echo the sentiment today that most of the lack of transparency centers around brokerage fees. There are very few misperceptions about brokerage fees because, frankly, there isn't a lot of disclosure about brokerage fees. We recommend transparency of all brokerage arrangements. That includes soft dollars, directed brokerage, etc.

Boards should review all brokerage arrangements and ensure shareholder interests are protected. Regulation considering requiring the quantification of brokerage costs based on consistent algorithms across all complexes. And to the benchmarking comment, require brokerage costs be reported as a ratio in the prospectus alongside the total expense ratio, again, for comparative purposes.

And, finally, with regard to fund governance, we recommend the following: We support the appointment of chief compliance officers reporting directly to independent trustees or directors. We also support calls for board administrative support and a 75-percent independent majority. We urge formal independent certification of board members' financial and fiduciary knowledge. Election of board chairpersons by independent board members would allow outside directors to determine whether they function more effectively with inside assistance or are hindered.

We feel, in line with several comments today, we think that the general level of fiduciary duty of boards needs to be elevated. We do not feel, however, that advisory contracts should be put out for bid. We feel market forces and investor demand should set prices.

We feel we can strengthen the current board structure through clear oversight guidelines. And probably the punch line, perhaps, of my oral testimony, we do not endorse or support punitive damages levied through indiscriminate advisory fee reductions unrelated to trading charges. Damages do not replace board activism. Rather, we feel if fees are reviewed by regulators as unreasonable, we feel a structured and equitable solution be designed to provide boards with a road map for ensuring reasonable costs are borne by investors and market forces are left to their own devices.

In closing, we wish to caution legislators and regulators to proceed with care. Quickly assembled reforms may have unintended consequences and costs unforeseen during this period of improprieties and investor outcry. We fully support reform of the mutual fund business to the extent it bolsters competition, protects investors, and strengthens the business long term.

Thank you.

Senator FITZGERALD. Mr. Plunkett.

TESTIMONY OF TRAVIS B. PLUNKETT,[1] LEGISLATIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

Mr. PLUNKETT. Good afternoon. I am Travis Plunkett, legislative director of the Consumer Federation of America. I want to congratulate you, Mr. Chairman, and Ranking Member Senator Akaka, for holding hearings on a mutual fund scandal that does far more harm to its victims than the recently revealed trading abuses, as shocking as those are. That is the scandal of how mutual funds are sold to unsuspecting investors and the high costs that result.

My concern today is primarily with the nearly 50 percent of mutual fund transactions that are conducted between broker-dealers and retail investors. What sets these transactions apart is the veneer of impartial advice that attaches to them. Despite their fancy titles and polished advertising campaigns, however, broker-dealers are not advisors. They are salespeople. And the overwhelming evidence now suggests that all too many brokers select mutual funds and other products they recommend not based on which offer the highest quality at the lowest price, but on which funds offer lucrative financial incentives to the brokerage firm and the individual sales representative. This is a phenomenon sometimes called "reverse competition."

This is allowed to occur because only a relative small portion of the mutual fund marketplace could be said to be truly cost competitive right now, and that is the 13 percent of mutual fund transactions that occur directly between the fund company and the retail investor outside of any employer-sponsored retirement plan.

In the growing number of fund transactions that occur through retirement plans, however, investors generally have very limited options and, therefore, cannot effectively make cost-conscious purchase decisions. And in the rest of the market, funds that rely on broker-dealers and other salespeople outside of company-sponsored retirement plans, as I mentioned, this portion of the market competes in ways that drive costs to investors up, not down, through a number of mechanisms we have heard about today: Sales loads, 12b–1 fees, payments for shelf space, and directed brokerage. This allows mediocre, high-cost funds to survive and even thrive that could not do so in a truly competitive market.

Another major factor undermining effective competition is the lack of good disclosure, either of mutual fund costs or of the conflicts of interest that can bias sales recommendations. For disclo-

[1] The prepared statement of Mr. Plunkett appears in the Appendix on page 205.

sures to be effective, they must provide the information investors need, in a form they can understand, at a time when it is useful to them in making their purchasing decisions. Mutual fund costs and conflict disclosures fail all three tests. In particular, they leave out key information, such as expense portfolio transaction costs.

Now, let's talk a little bit about the SEC's regulatory response. Initially, the SEC was slow to acknowledge the need for fundamental cost disclosure and governance reforms. Although the Commission now appears to be making important progress on these and other issues, there are still serious gaps in their regulatory agenda. For example, the SEC does not have the authority to strengthen the definition of independent director, as legislation introduced by Senator Akaka and Chairman Fitzgerald would.

Even if the Commission's promising disclosure proposals on broker conflicts of interest are offered—and we are waiting for the actual details there—they appear to have serious holes. We will not know for sure until the rule is proposed, but it does not appear that the Commission intends to include information about the non-distribution-related expenses of the fund, the annual expense ratio, in either the point-of-sale document or the confirmation statement. If the Commission is going to take the unprecedented step of requiring point-of-sale disclosure, it should do more to ensure that it covers all the information investors should have prior to sale, including information on investment risks, for example, and comparative information on fund costs, not just sales incentives. Congress should build on what the Commission has begun and ensure that all the key information investors need pre-sale is included in these reports.

Chairman Donaldson has indicated the agency will study use of soft dollars, but the SEC does not have the authority to repeal the safe harbor for this unacceptable conflict of interest. Congress should.

A major shortcoming of the SEC approach is that it relies exclusively on better disclosure of broker-dealer conflicts of interest rather than on bans of conflict-inducing practices. Such an approach ignores the fundamental reality of how investors relate to brokers and the degree to which they rely on them for advice. We doubt that even the best disclosures will be able to overcome multi-million-dollar advertising campaigns that encourage investors to view financial professionals as objective advisors. It is long past time to require brokers to either live up to the advisory image they project and accept the attendant responsibility to make recommendations that are in their client's best interest or to cease misrepresenting themselves to clients as advisors.

One timely idea is to get mutual funds out of the business of determining distribution prices entirely, not just by eliminating 12b–1 fees, directed brokerage, and payments for shelf space, but also by getting funds out of the position of determining commission levels altogether. If funds got out of the business of competing to be sold and brokers' compensation came directly from the investor and did not depend on which fund they sold, then brokers might begin to compete on the basis of the quality of their recommendations, and funds might have to compete accordingly by offering a quality product and good service at a reasonable price.

I want to thank the Subcommittee again for exploring these important issues, and we look forward to working with you as you move forward.

Senator FITZGERALD. Thank you, Mr. Plunkett. Mr. Stevens.

TESTIMONY OF PAUL SCHOTT STEVENS,[1] PARTNER, DECHERT LLP, ON BEHALF OF THE INVESTMENT COMPANY INSTITUTE

Mr. STEVENS. Chairman Fitzgerald and Ranking Member Senator Akaka, thank you very much.

I think it is appropriate to begin by underscoring on behalf of the Institute its strong support for the ongoing efforts of Federal and State Government authorities to root out abusive trading practices affecting mutual funds. The Institute is committed to taking whatever steps are necessary to prevent such abuses in the future and to fulfill the industry's fiduciary obligations to its tens of millions of fund shareholders. The SEC has moved swiftly across a broad front to bolster regulatory protections, and the Institute pledges its cooperation as Congress, the SEC, and other interested parties work to restore and maintain the confidence of fund investors.

I welcome the opportunity to present the Institute's views on mutual fund fees and expenses. My written testimony goes through a whole variety of issues. There are three in particular that I would like to emphasize here.

First, although you might not know it from this morning's discussion, we all should recognize that this is at least a glass that is half-full. Indeed, fully informing investors about mutual fund fees and expenses has been a long-time objective of SEC regulations. Current regulations, including the very prominent standardized fee table that appears in every mutual fund prospectus, assure a high degree of transparency about the costs of mutual fund investing. Is there more that might be done? This is the question that, Mr. Chairman, your hearing poses. Yes. And the SEC is developing a variety of new additional disclosure requirements. Maybe there are things that the SEC has not yet considered or proposed that should be added to that. Fair enough. But building on existing regulations, these and other reforms, it seems to me, will provide a level of information to fund investors that is unrivaled by any other financial product. I am more than prepared to discuss the details, but I want you to know that the Institute strongly supports precisely that objective.

Second, with respect to recent research on trends in mutual fund costs, I believe the consensus of all serious recent research is that the costs of mutual fund investing have trended downward significantly over the past 20 years. The Institute's own extensive published research supports this view. So, too, does the independent analysis that has been conducted by the SEC and the GAO. And it is fair for us to ask, why is that? Well, I believe there are a variety of market forces at work in producing this result, including, among others, the healthy level of competition that exists among fund providers, and the very widespread availability to investors of information about mutual fund costs, performance, and services.

[1] The prepared statement of Mr. Stevens appears in the Appendix on page 224.

In fact, if you look at trends over that 20-year period, the fact that mutual fund shareholders are now heavily invested in the lowest-cost funds suggests that they and their financial advisors understand and recognize the importance of fund fees.

Finally, Mr. Chairman, in light of the interest in this topic that has emerged during this hearing, I want to address how mutual fund fees compare with those of pension managers, other institutional investment managers, as well as—and this is a subject to which you have returned a couple of times—those that are associated with the Federal Thrift Savings Plan.

My colleague, Professor Freeman, on this panel and others have contended that differences between the "investment advisory fees" paid by a pension plan and the "management fees" paid by a mutual fund indicate that mutual funds are overpriced. The analysis is provocative. It is one that Attorney General Spitzer has cited numerous times. But, unfortunately, the analysis is seriously flawed.

The two types of fees that Professor Freeman and his colleagues compare are fundamentally different. A pension plan's "advisory fee" primarily covers portfolio management services. I have been a mutual fund lawyer for 25 years, and I know that, by contrast, a mutual fund's "management fee"—that is, the number that is reported in a fee table, the number available through Morningstar—covers a host of additional costs that are spelled out in the fund's contract with its manager. These can include a whole variety of things: Pricing the fund, providing it office space and equipment, providing a clerical staff and bookkeeping support, defraying the salaries of fund officers and directors, and paying for legal and regulatory compliance, which in the case of a fund is no small undertaking. And these are to name just a few.

The comparison drawn in Professor Freeman's study is for this reason incorrect and misleading. The ICI study that Attorney General Spitzer referred to earlier—and invited you, Mr. Chairman, to ask me about—is a study that makes precisely the point I just made: That this is an apples-to-oranges comparison, and the data is not normalized, if you will, in order to draw any inferences.

Now, the ICI study also suggests that if you compare the pure investment advisory fees of a pension plan with some equivalent in the mutual fund arena, the two would appear to pay comparable amounts for similar portfolio management services. Attorney General Spitzer and, I suspect, probably Professor Freeman, don't accept that comparison, but even if they don't, it doesn't make the comparison drawn in Professor Freeman's article accurate. The fact of the matter is the comparison he was drawing is just simply misleading.

Now, what about institutional versus retail money management? This is important and it is a subject that Attorney General Spitzer addressed this morning.

Institutional investment managers and retail investment managers occupy a very different space, and I think it is a truism in the business that it is much more difficult and expensive to deal at a retail than it is an institutional level. And if you think about it for a moment, it is intuitively obvious why that is the case.

First of all, retail assets are much harder to attract. They are out there in a much more disparate universe, belonging to households and individuals. Institutional assets come from institutions, of which there are fewer, and they are more readily identifiable and approachable.

Retail assets are also harder to manage. In a mutual fund form, for example, a high percentage of the assets has to be maintained in a liquid form. That is under SEC rules. But it is also to provide the daily transaction capabilities and redemption capabilities that a mutual fund promises to its investors, which institutional managers don't have to deal with.

They are also more difficult to administer, again, because of legal and regulatory issues, and they are harder to retain. Individual mutual fund investors make decisions every day about redeeming, exchanging from one fund to another, or moving to another manager, and the open-end form of their funds assures them the ability to do that. Institutional money, however sticky it may seem retail mutual fund money is, is far stickier.

Now, if it were, in fact, the case that institutional money managers' fee schedules are so much more reasonable by comparison to retail managers, you would think institutional money managers would be making a lot—retail money managers, rather, would be making a lot more money. That is simply not the case. We can provide for the Subcommittee's consideration after these hearings information concerning this point. Capital Resource Advisors conducts an annual survey called "Competitive Challenges," where it addresses these issues, among others.

In 2001, on average, as a percentage, retail investment managers' total operating profit margin was 22.3 percent. Institutional managers' profit margin you would think would be less if their fees were so much more reasonable. Well, it was not. It is 29.5 percent. In 2002, the comparison was 16.5 to 28.5. The truism is, I think, demonstrated in the profitability of the businesses. The retail part of investment management is simply a much more expensive and difficult exercise.

And then, finally, Mr. Chairman, I know my time is up, but let me say just a few things about the Federal Thrift Savings Plan.

When I was at the Reagan White House for 3 years, I participated in the Federal Thrift Savings Plan, so I know it from the point of view of an investor as well.

Senator FITZGERALD. Do you still have it, or did you get rid of it?

Mr. STEVENS. Well, as you know, President Reagan has been out of office a long time, and since I hadn't been back in Federal Government any longer, I did cash out my interest in the plan.

Senator FITZGERALD. OK.

Mr. STEVENS. Maybe that was a mistake, but it is a decision I made.

Senator FITZGERALD. It almost assuredly was a mistake.

Mr. STEVENS. Well, perhaps.

But I think one of the things that it reinforces to me, at least, my familiarity with both the Thrift Savings Plan and the retail mutual fund business, is that they are very different animals. For example, all of the Thrift Savings Plan's portfolios are indexed, and all of them are very large. That is not true with retail mutual funds.

Many of the costs that we think of in a mutual fund arena as administrative and distribution costs are actually subsidized by the Federal Government. They are borne by the agencies whose employees participate in the Thrift Savings Plan and are never taxed back to the expense ratios of the portfolios themselves. So there is a governmental subsidy. I am not saying it is inappropriate. It just does not appear in the performance figures.

And then, finally—and this is significant as well—there are no regulatory or related costs in running the Thrift Savings Plan. And I want to tell you, 25 years of being a mutual fund lawyer underscore to me those costs are not insignificant.

So at least some observations, Mr. Chairman, that may be of use. Thank you.

Senator FITZGERALD. I will hold my rebuttal until all the witnesses have finished, but thank you very much for that very good presentation.

Mr. Lackritz, thank you very much for being here.

TESTIMONY OF MARC E. LACKRITZ,[1] PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. LACKRITZ. Thank you, Mr. Chairman and Ranking Member Senator Akaka. Thank you very much for the opportunity to testify today on behalf of the Securities Industry Association.

First of all, let me begin by commending you and your Subcommittee for your long tradition of protecting the public, and I would add we look forward to working with you and your colleagues and the other committees in the Senate and the Commission to restore the public's trust and confidence in the Nation's securities markets and in mutual funds.

Our members, Mr. Chairman, underwrite securities—stocks and bonds—to raise funds—capital—for private companies and public bodies. These entities use the funds we raise to expand and grow—hiring new workers, investing in new equipment, and building public works. Our industry has raised more than $21 trillion over the last 10 years to finance innovation and growth in the form of new enterprises, new processes, new products, and new bridges, roads, hospitals, and schools.

We also help individual investors achieve their financial goals, such as planning for a child's education or for a comfortable retirement. Thus, as intermediaries between those who have capital on the one hand and those who need it on the other, we serve the very essential function of channeling capital to its most productive uses.

The securities industry is based on two bedrock principles: Disclosure and competition. The format of securities regulation was articulated by Justice Louis Brandeis back in the early part of the 20th Century, and the architecture of the securities laws reflect, that you need both full disclosure and vigorous competition. Justice Brandeis was also credited with the notion that sunshine is the best disinfectant, electric light is the best revealer. I think in this discussion that we are having about what to do in this area, Justice Brandeis' teachings are actually very relevant here, that, in fact, what we need is more transparency and what we need is bet-

[1] The prepared statement of Mr. Lackritz appears in the Appendix on page 250.

ter disclosure, because public trust and confidence are really the bedrock principles on which our market participants succeed, and as long as the same rules are vigorously and fairly applied.

Mutual funds are the vehicle by which an overwhelming majority of investors participate in our markets. Nine out of ten investors have at least some money in stock mutual funds, and just over half invest exclusively in funds. As a result, the health of our securities markets depends to a great extent on the public's continued robust participation in mutual funds. Yet, as we know from these hearings and other disclosures, not all is well with mutual funds. Revelations of wrongdoing, including late trading and market timing, contrary to fund prospectuses, as well as other practices, have shaken investors' confidence in many fund organizations and in the intermediaries distributing the funds.

To restore public trust and confidence in funds and their distributors, the interest of investors must come first. Investors must be assured, Mr. Chairman, that fraud, self-dealing, and dishonesty will not be tolerated and will be vigorously enforced and punished. Investors should be treated fairly and should be given complete, clear, and useful information about the funds that they buy. All aspects of the mutual fund business, including fund fee structures, financial incentives offered to intermediaries, fund investment and redemption policies, and fund governance must be as transparent as possible. And all investors should be assured of prompt execution in fair pricing of their fund transactions.

We think a two-pronged approach is necessary to restore the public's trust in mutual funds. First, swift, sure, and tough enforcement actions are the proper remedy to address clear violations of the law. I might add that, in addition to tough enforcement and swift enforcement, the time has come to implement some necessary reforms as well.

We support efforts to improve disclosure and sales and trading practices to ensure that investors' interests come first. Specifically, investors should have clear, direct, timely information in a useful format that allows them to comparison shop and that promotes consumer choice and competition. Disclosure must be easily accessible and investor friendly rather than a "Where's Waldo?" search through fragments of disclosures and long prospectuses and long legalese for relevant information.

In that vein, we strongly support efforts to enhance the transparency of revenue sharing agreements, including the nature of services received and differential compensation arrangements. Such disclosures should be uniform across regulatory agencies and should focus on arrangements that are likely to influence recommendations made to investors. Disclosures should provide investors with material information that they need. Finally, investors should have full, clear, and useful information on mutual fund fees, since they will have a significant effect on the investor's return.

With respect to both soft dollars and directed brokerage, the key investor protection here is to maintain best execution for the customers. We believe that soft dollars are both pro-investor and procompetitive, particularly for third-party research, as we heard earlier. But advisors, fund trustees, and broker-dealers must always put investors first. Thus, we support improved disclosure of soft-dollar arrangements to both investors and to fund trustees.

We have been appalled by reports of late trading of mutual fund shares. As Attorney General Spitzer noted earlier, such activity is the equivalent of betting on a horse race after it is over. Reforms should make late trading virtually impossible to achieve. At the same time, we believe strongly that any reforms here should not penalize innocent investors, particularly those in 401(k) plans or 529 plans or those who buy their mutual funds from broker-dealers rather than directly from funds.

We look forward to working with the SEC and your Committee to eliminate late trading in a way that protects all investors and does not create competitive disadvantages for some. Late trading has had a terribly corrosive effect on investor confidence, and we must find and implement an effective remedy now.

Mr. Chairman, we are very proud of the capital our industry has raised, the jobs we have helped create, the innovation and growth we have helped foster, the new products and services we have made available, and the dreams we have helped our consumers achieve. Yet, we abhor the abusive activities involving mutual funds that you have shone a spotlight on. We urge the SEC, the NASD, and State authorities to continue to bring wrongdoers to justice swiftly and surely. And we are eager to do our part to improve mutual funds so that they can continue to be an effective investment vehicle for all Americans.

Thank you very much.

Senator FITZGERALD. Thank you, Mr. Lackritz. Professor Freeman, thank you for being here.

TESTIMONY OF JOHN P. FREEMAN,[1] PROFESSOR OF LAW, UNIVERSITY OF SOUTH CAROLINA LAW SCHOOL

Mr. FREEMAN. Thank you for inviting me, Mr. Chairman and Ranking Member Senator Akaka. I am delighted to be here with you.

The issue isn't whether or not we should thoroughly regulate mutual funds. As my formal statement points out, there isn't an issuer of securities in the United States that is subject to more detailed regulation than mutual funds. They are the most heavily regulated financial product in our economy, and all this regulation and all this attention has gotten us a train wreck and a scandal that is beyond belief for somebody like me who has been watching and writing about the fund industry for about 35 years.

Where to start? Basically, it is conflict of interest. Conflict of interest, conflict of interest, conflict of interest. Fiduciary duty, fiduciary duty, fiduciary duty breaches. The bigger the fund, the more money under management, the more the advisor makes. Raising that money, bringing that money in, means getting dollars in the hands of people who sell the funds. When I was working at the SEC on mutual fund distribution in the summer of 1977, this quote came in, which I have never forgotten and have often repeated: "To close one's eyes to the reality"—this is from the industry—"that salesmen in the mutual fund industry have traditionally sold prod-

[1] The prepared statement of Mr. Freeman appears in the Appendix on page 266.

ucts which pay the most money is to regulate without a sense of what the industry is about."

Now, there has been talk about overcharging and fees, and let's talk about that. I have been criticized and called irresponsible by the ICI. And speaking of conflict of interest—you alluded to this earlier, Mr. Chairman—here is an entity that takes money from fund shareholders and uses that money unceasingly to protect the interests of sponsors who are exploiting those fund shareholders. I say the ICI epitomizes problems of conflict of interest in the mutual fund industry, and anything they say should be taken in light of that.

But let's talk about their criticisms. They say: "Oh, Freeman's got it wrong, he's too stupid, maybe, he's irresponsible. He's been dealing with this topic for 35 years. He's been teaching securities regulation in law school for 30 years. He's been writing about this for a long, long time. He's working with a guy who's a Ph.D. and a chartered financial analyst. But they just can't get to the bottom of it. They just can't figure it out."

Well, let's assume that is true. If we can't figure it out, who on Earth can? Your average investor? No. Your average State regulator? No. The SEC itself, where I used to work, have they figured it out? I question that.

Now, let's talk about the irresponsible statements in our report. We had a statement in our report that was to the effect that mutual fund shareholders—and this is the direct quote—"pay nearly twice as much as institutional investors for money management. And that calculation doesn't even include any front- or back-end sales charges you may also pony up." And that was about our finding, and it is about double. And you say, well, Freeman and Brown, they don't know any better. That quote came from Ruth Simon. It was published in *Money Magazine* and is in Footnote 10 of our article. That was published in *Money Magazine* in 1995. It is so well known that the funds have been gouging their shareholders that when the *Wall Street Journal* wrote a story about our article—which is unusual for national press to write about a law review article—they did it in 2001, and the headline was, "This is news? Study finds mutual fund shareholders being overcharged on fees." In other words, I mean, come on, guys, come up with something original.

What we cited in our article, besides Ruth Simon and a lot of data talking about profitability, in the article is some evidence that when fund management companies are sold out, they command double the multiple for other institutional management companies. The marketplace values the lucrativeness of mutual fund management when the marketplace buys out these people. But we also quoted and referred to the Wharton Report, going back 30 years—and you have heard references today—the Public Policy Implications Study. And what did those things find? What they found was the same thing we found: Fund shareholders being gouged, paying prices far in excess of other institutions.

Now, the question is—it has been raised. Mutual funds are all these little people and you get these big institutions, they should be paying less. Well, let's take a look very quickly at that one.

In the case of Alliance Fund, Alliance was charging the Alliance Fund shareholders 93 basis points, and Alliance was managing something like $16 billion. What was the fee? It was around $160 million a year for the Alliance Fund. The same management company using the same processes and the same theories and everything was managing a portfolio of about $900 million for the Wyoming Retirement Plan for 10 basis points. So the fund shareholders at Alliance are paying $160 million or so a year, and the people at the Wyoming Retirement Plan are paying around $900,000 for the same services.

Now, wouldn't you think some fund director might say to Alliance, "Why don't you give us a 10-basis-point price?" But that apparently hasn't happened.

One thing that has been alluded to, but not said expressly—it is in our article; Mr. Spitzer has referred to it previously. Most-favored-nation treatment. Every mutual fund director should require the advisor, if the advisor is selling similar services in the free market, should require the advisor to give the board those prices and to justify the price differential between the prices that are being charged in the open market to the Wyoming Retirement Plan and the prices that are being charged or would be charged to the fund's shareholders. In other words, you want 93 basis points from us to manage $16 billion, but you are only charging them 10 basis point to manage $900 million. You are going to make a lot more money. Would you explain to us why this makes any sense?

I could say a lot more. I will reserve my comments for answering questions.

Senator FITZGERALD. Well, I can tell this is going to be a lively question and answer session. I appreciate that, Professor Freeman. It was very good.

I would like to start with Mr. Stevens. Let's go back to the point that Professor Stevens raised, picking up on something that I said earlier.

Mr. STEVENS. Professor Freeman.

Senator FITZGERALD. I am sorry.

Mr. STEVENS. I am Stevens.

Senator FITZGERALD. I am sorry. Professor Freeman raised this issue, which I alluded to earlier, which is that dues to the ICI are paid by mutual fund companies by deducting money from mutual fund shareholders, and then the ICI gets all this money and, in effect, your interests are really adverse to mutual fund shareholders' in America, aren't they? You are a lobbying group that represents the managers of mutual funds and the mutual fund companies themselves, as opposed to the shareholders.

Mr. STEVENS. Mr. Chairman, I appreciate the chance to respond to this. It is almost a point of personal privilege on behalf of my client.

The ICI was organized in 1940, essentially at the request of the SEC, because when the 1940 Act was passed, it needed an interlocutor, an industry representative, in order to begin developing the highly complex series of rules that were necessary to implement the Act. At that time, the Institute was organized to represent the interest of funds and their advisors, and it has continued to do so.

One premise, though, of the critics of the ICI in this regard is—and I think it has been asserted numerous times today—that advisors' and funds' interests are antithetical across the board.

If you think about it for a moment, I think you would realize that is not the case. Certainly they may be antithetical with respect to the price. It is the fund shareholders' interest to get the lowest possible price, and perhaps the manager wants to get a higher one, perhaps even the highest possible. But with respect to many other areas, I think their interests are common.

For example, it is obviously in the managers' interest to get the best performance. Why? Not only because it serves the consumers best, but it is the best way that we know in this business of getting more consumers and attracting more assets. They have a joint interest in good shareholder service as well, for exactly the same reasons. Mutual fund investors are highly demanding in terms of the range and quality of the services. And, finally, to a very high degree, there is a common interest with respect to regulatory compliance. Either the fund or the advisor, or both, will pay the consequences if there isn't such compliance.

But now let me talk about what the ICI stands for and has stood for in that regard, and I speak from my own personal experience, but I think we could multiply the examples across a whole range.

First, for many years, the Institute was up here on behalf of funds and their shareholders and their advisors urging the Senate and House of Representatives to greatly increase appropriations for the Securities and Exchange Commission because of their concern that the growth of funds, the growth of advisors, investor dollars, and investments was far out-stripping anything that the SEC had to bring to bear to inspect, examine, and oversee the industry. Those calls are matters of record, and they went largely unheeded for a long period of time as funds continue to grow.

I congratulate the Senate for having appropriated just this week over $800 million to the SEC, and we are catching up and we are giving the regulators the resources they need. That had been a bedrock of the ICI's legislative policy for a long time.

But there are several other examples I can give you. One of the things that the SEC and the NASD both are rightly credited for and encouraged about is this notion that there should be point-of-sale disclosure of revenue sharing; that is to say, amounts that a mutual fund advisor out of its profits pays to a broker-dealer in connection with its marketing of the fund.

What has never been acknowledged by the SEC or the NASD—or, for that matter, even in the press—is that in 1996, 8 years ago, that was a regulatory recommendation that the ICI made to the NASD and they never acted on, and I will be happy to provide you information in that regard.

Another example—and, by the way, that was from my tenure as general counsel of the ICI.

Another example: the compliance rule. Many people here today, including Jack Bogle, have said what a great idea, we need compliance programs that are consistent throughout funds. And we agree, frankly. But the germ of that idea was advanced to the SEC almost 10 years ago by the ICI in a proposal that I personally worked on and was transmitted to the SEC, and the SEC did nothing about it for a long period of time until the current scandals.

Now, that is fine. I am not criticizing the SEC, and I am giving Chairman Donaldson all the credit for moving in the direction that he has. But it was an idea that came from the industry through the ICI, and we will provide information in that regard as well. And there are other examples, too: simplified disclosure for fund shareholders and reforms of the prospectus, new standards for personal investing, support for best practices with respect to the governance of funds.

These are not proposals that advanced the selfish interests of advisors. They advanced, in fact, the common interests of advisors and funds and their shareholders and were all, as a matter of record, things that the ICI supported.

So I reject the notion, frankly—and I kind of resent the ad hominem argument that is involved—that the ICI somehow or other is nefariously accepting some people's monies to advance another's causes.

With respect to the issue of dues, as a result of the history of the Institute, it is indeed true that there are different sources of funding. Some are paid by fund shareholders. Some are paid by fund advisors. And those decisions are made at the fund complex level, not at the level of the ICI.

Senator FITZGERALD. Professor Freeman, do you think ICI dues should have to be paid out of the advisor's own money as opposed to out of their shareholders' money?

Mr. FREEMAN. Yes, I think that that they are a lobbying organization for the advisors, for fund sponsors, and they ought to take that money and just be straight up about it, and not pretend that they are actually representing the interests of fund shareholders, because I don't see it.

Senator FITZGERALD. Mr. Plunkett, do you have a thought on that?

Mr. PLUNKETT. To the best of my knowledge, we don't have a position on this. I think Mr. Stevens raises an interesting point——

Senator FITZGERALD. I thought you were going to recommend that we pass a law imposing a one one-thousandth of a basis point fee on all mutual fund shareholders and give it to the Consumer Federation of America.

Mr. PLUNKETT. Oh, it wouldn't have to go to us. It could go to a shareholder directed organization. I think the point that there are economic—that interests do diverge at the basic economic level means that public policy-wise, the ICI and consumer interests often diverge. They don't always diverge but often do. And I think that is an important point to note since we are talking about public policy here.

Mr. STEVENS. Mr. Chairman, if I could just respond.

Senator FITZGERALD. Do you have any fund shareholders on your board, Mr. Stevens, at the ICI as opposed to fund advisors?

Mr. STEVENS. We have independent fund directors on the board. We do not have fund shareholders who are representatives on the board.

Senator FITZGERALD. OK.

Mr. STEVENS. But, Mr. Chairman, if I could just say, I think in order to resolve this issue of what the ICI stands for, you have to ask yourself in specific cases: What was the position that they took? I have offered to provide you the additional evidence, I suppose, of the public policy positions that the ICI has stood for.

It is also, I think, fairly clear in this current crisis, post-September 3, 2003, where the ICI has stood with respect to a whole range of issues. There has been no blinking there and no trying to log roll with respect to protecting advisors, much less ones who have fallen afoul of the law. It is the Institute, for example, who has recommended the hard 4 o'clock close, for which it has been criticized by many other participants in the industry for prescribing medicine that is simply too strong.

We also have recommend—and the SEC, I am pleased, is considering this—that there be a mandatory redemption fee for mutual fund investors who come in and out of a fund within a 5-day period to make it very clear that this is not a short-term transactional vehicle, it is for longer-term shareholders, and to put a friction cost in place that would prevent their being abused.

We have recommended stronger regulations with respect to the investments by fund insiders in their own shares so that there is oversight, so there is transparency in that regard. And, most fundamentally, we have said loudly and clearly from the very beginning, if any member, any participant in this industry has violated the law, they should have the book thrown at them. We make no apologies for that whatsoever and supported General Spitzer and Chairman Donaldson in the most aggressive enforcement activities that they are undertaking with respect to the industry.

Senator FITZGERALD. Senator Akaka.

Senator AKAKA. Thank you very much, Mr. Chairman. Again, I want to add my praise to you for holding this hearing.

Mr. Plunkett, in addition to improving the governance structure of mutual fund companies and increasing meaningful, relevant, and understandable disclosures, what should be done to improve the financial and economic literacy of investors? I ask this of you because you represent the Consumer Federation of America and what we want to do is help the consumers of this country.

Mr. PLUNKETT. Well, thank you, Senator Akaka, for the question. We have spent a lot of time on questions of investor education and financial literacy. The key here is to examine the experience of less sophisticated investors when developing educational programs. We know that a portion of investors are making sound decisions, either because they have the sophistication to do it on their own or because they are getting good financial advice from financial professionals. That is fine.

In looking at how to improve investor education, however, and how to improve disclosures in particular, we need to start by looking at the experience of those many investors who are making poor decisions. I am thinking here of the investor who winds up in an S&P 500 index fund with a 2-percent expense ratio, for example. We need to know what sources of information they are relying on and how they make decisions before we can educate them to make better decisions. And we believe any efforts in this area should start from a study of those issues.

Mr. LACKRITZ. Senator Akaka, could I intervene? I would say that improving investor education and financial literacy is one of the top priorities of our organization. We have a website that provides first-class investor education without selling anything, and describes the basic things people should know. It is available free to anyone. It is called siainvestor.org.

We also have a foundation for investor education, and we run a program in schools, an exercise in schools, that involves economic education that teaches kids from middle school through high school about the differences between saving and consumption, about interest rates, about compounding, about the difference between equities and debt, all that kind of thing. Currently, we have 550,000 kids every year that engage in this program, and we are trying to expand it. We have, I think, a program active in Hawaii, too. We would be happy to talk to you about that and see if we could help you see a demonstration of the program in a school.

Senator AKAKA. I am glad that you brought this up, and I will ask others to comment on this. Let me ask Mr. Stevens the same question I asked Mr. Plunkett. You are representing another side. What do you believe must be done to improve the financial and economic literacy among investors?

Mr. STEVENS. Well, It is a daunting challenge, Senator, I grant you that, and the Institute has many programs supporting investor education initiatives that are similar to those in the Securities Industry Association. And I grant you that in many respects mutual funds are complex products, so they are hard to know, hard to understand.

Our appetite as a government—and I am thinking now of the regime that the SEC administers—has been to devise a disclosure document, the prospectus, and as Jack Bogle said, throw everything including the kitchen sink in it and hope that people will read it and understand it.

The challenge is not so much making sure the information is out there. I grant you, it should be out there, and it should be accessible. But, beyond that, with respect to a more complex financial product, crafting a set of information which covers the key points that an investor needs to know, this was one of the things that we worked on extensively when I was at the ICI. It was called the profile prospectus. It was eventually adopted in the SEC rules in another way as the front end or summary of existing prospectuses, and it tried to select all the key information.

Much of what we are talking about here, by the way, it seems to me, while it is information that ought to be out there, I would agree with Mr. Bogle it is not necessarily information that is so key that an investor has to know it beforehand. Let me give you one example.

There has been a lot of emphasis on improved disclosure of transaction costs, and there is complexity about that, and the issue becomes how do you do that, because it is not just commission dollars. It is market impact. It is spreads on debt instruments. And so there is a big challenge in getting the information out there.

But all of the costs that are implicit in funds transaction in portfolio securities are already reflected in the performance information that an investor gets. It is all net of that because it is built into that number.

Now, ask yourself the question: In order to make a good mutual fund investment, do I have to know all of the details with respect to the transaction costs? Maybe not. Maybe there is a shorthand way of providing it. But if we begin putting hurdles like that in front of mutual fund investors, what I am afraid is we make it preternaturally more difficult to make good investing decisions. That is the challenge: Getting the information out, but also crafting it in a way that it is meaningful and communicates effectively with the investor public.

Senator AKAKA. Mr. Chairman, may I?

Let me ask Mr. Keil, it is quite clear that investors need to have additional information about the transaction costs of their mutual funds because the expense ratios fail to include them, and the brokerage commissions are buried in the statement of additional information, which investors are only given upon request. It is a lengthy and complicated document that does not easily facilitate comparison among funds.

Mr. Keil, in your statement you mentioned that trying to fully quantify brokerage costs in total, given every trading scenario, is "similar to attempting to nail"—and I wanted to say this—"Jell-O to a wall." What do you recommend to improve the disclosure of transaction costs in a meaningful, understandable way to investors?

Mr. KEIL. Well, let me make the point that I still stand behind my statement that you cannot quantify every last brokerage scenario to the satisfaction of most academics. But I think that the scenario, the way it exists today, is thoroughly inadequate. There is no way for an investor to quantify what they are paying in brokerage. There is just no way to do it.

The aggregate dollars, as you point out, are shown in the SAI, but let's face it, if it is a challenge to get the investors to read the prospectus cover to cover, they are going to go nowhere near the SAI. It is an ineffective document as far as disclosure is concerned.

I would make the statement that there are ways to quantify the different types of brokerage. Whether you segment them or put them in one number is another issue. But I would not recommend that once you take those dollars, you put them in the form of a ratio so that they are the same basis as an expense ratio. That should be included in the total expense ratio. We are really talking about apples and orange—total expense ratio, which is focused on operating expenses, or brokerage is truly transaction costs.

So from my perspective, the investor needs to be able to make the judgment call whether what they are paying in the brokerage costs is reasonable given the returns that they are being given by the fund itself.

Senator AKAKA. Mr. Chairman, my time has expired.

Senator FITZGERALD. Well, thank you. We are going to have to wrap up because I have been informed that a vote began at 2:30, and apparently the weather, as bad as it was this morning, I am told that it has deteriorated to the point that the Federal Government is going to be shutting down at 3 p.m. today. The Office of Personnel Management has put that advisory out. But I did not want to conclude this hearing without going back to the point on the Federal Thrift Savings Plan.

I have met with the executive director and others of the TSP. The back-office expenses for separating people's accounts and so forth, those are all included in the expense ratios for the TSP fund. In fact, that is most of the expense. The advisors' fee, I am not allowed to tell you how low it is because it is a confidential fee that was subject to bidding. At least that is my understanding. The fee is exceedingly low. Most of the expense ratio is for the cost of paying employees of the Agriculture Department down in Louisiana to do all the back-room functions. And I guess there are well over 100 of those people, and those costs are being paid by the fund shareholders, and they are paying full Federal Government benefits to those Agriculture Department employees, including Federal health insurance, sick leave, other leave, the TSP expenses for those Agriculture Department employees and so forth, which are probably much more expensive than the private sector.

It may be that the TSP fund could get their expenses even lower by not using the Agriculture Department and bidding out those back-room operations. The only things that may be taken care of internally by the Department—for example, I am a Member of the Senate. There is a Senate Financial Office that every year sends me a brochure and tells me how to contact the TSP, and they forward a form from the TSP to change your withholding amount. But I would think that most companies, if you work at IBM, the personnel office at IBM is going to be giving a similar transmittal to their employees, and then the employees will fill out that form, and it will actually go to a Hewitt and Associates or some company that does the back-room operations for IBM, and then it will be invested.

And I do think in my opening statement I was careful to make the comparison between the expense ratios of the TSP fund, which I noted were index funds, and I compared them to the average expense ratios as reported by Lipper for S&P 500 stock index funds. And last year, the TSP expense ratio was 11 basis points, and the average for all mutual funds was 63 basis points. That is just an enormous difference.

And so I think my point is valid, that we have created two regimes for investing—one for ourselves and one for the whole rest of the world—and I am not sure that is right.

On the 12b–1 fees, I do want to ask a question about that. A lot of investors think they need to get into a no-load mutual fund. They want to avoid a front-end load and they want to avoid a back-end load, and then they go into a fund that advertises no load, but that fund may have a 12b–1 fee, which is basically, as I understand it, a load paid over time. It is really compensation paid over time to the broker who put them into that fund. And I think, Mr. Keil, your report showed that 95 percent of 12b–1 fees wind up getting paid to the brokers who are distributing the funds.

Mr. KEIL. Well, let me give credit where credit is due. That actually is an ICI statistic where they did a survey of the fund companies themselves. There is not disclosure sufficient for us to quantify exactly how 12b–1 fees are used. It is not a disclosure requirement at this time.

Mr. STEVENS. Mr. Chairman, if I could clarify, my understanding is that under the NASD's rules—and the NASD is sort of the keeper of what you can and cannot call a no-load fund. If you have asset-based charges not in excess of 25 basis points, even if they are adopted under a Rule 12b–1 plan—and there are some advantages to doing so. Even if they are not under a Rule 12b–1 plan, you can still describe yourself as a no-load fund.

The point of the 25 basis points——

Senator FITZGERALD. Isn't that misleading? Because if you are essentially paying a load over time—in fact, you may be paying more of a load over time than you would just to pay the 500 bucks, or whatever it is, up front.

Mr. STEVENS. I think the NASD rule got to that point years ago because the 25 basis points typically is used to defray the cost of shareholder services, often recordkeeping, which would be a cost the fund would have to bear in many instances no matter what. It is not a classic sales charge, and they cut it off there, and they said anything more than that we will regard as a sales charge. And certainly any front-end sales charge, back-end sales charge, or level load, as it is called in the business, you could not be a no-load fund.

But the thinking of the NASD at that time was, as long as that asset-based charge is 25 basis points or less, that would be consistent with calling yourself a no-load because that would not be regarded as a sales load.

Mr. PLUNKETT. Mr. Chairman, I would like to say that we do think it is a deceptive practice, and as investors have become increasingly reluctant to pay front loads, brokers began looking for ways to offer funds that looked like no-load funds. That is how we got Class B shares. The broker still got his up-front commission paid out of fund company assets, and the fund company got the money back over time through 12b–1 fees. That is exactly what is happening here.

Mr. FREEMAN. Mr. Chairman, just very quickly, 12b–1 is a monument to the law of unintended consequences. It came in to try to help funds advertise and sell and get the word out. What it became in the 1980's and ever since is a mechanism used to sell Class B shares, to sell shares that have a load as if they were no-loads and to unfairly compete against no-load shares. That is how it is being used to a great extent out in practice, which is deceptive.

Senator FITZGERALD. And isn't it true when the SEC promulgated Rule 12b–1 to allow funds to charge a fee to compensate brokers for distributing their funds and to pay for advertising, the theory was that if the funds got bigger, expenses as a percentage of the assets would go down. Is there any evidence that fund expenses have gone down in the 24 years we have had Rule 12b–1?

Mr. FREEMAN. There is no proof that you can spend your way to economies. All the evidence is that 12b–1 fees, insofar as they are supposed to generate savings, are a dead weight cost and don't do it.

Senator FITZGERALD. Mr. Stevens, do you want to comment? You have got to be brief.

Mr. STEVENS. This is a long tale, but the bottom line is if you look at trends in distribution costs since the inception of Rule 12b–1, it has introduced a degree of flexibility in the way that these kinds of costs can be paid. That has put downward pressure on sales charges. It is true, many funds have adopted 12b–1 fees, but if you add the sales charges to the costs under Rule 12b–1, distribution costs experienced by individual shareholders have trended downward.

Now, that is what the ICI research indicates, and I think, Mr. Chairman, what may seem counterintuitive to you about this is that those costs covered by 12b–1 are going to be paid for some way because of the nature of the costs themselves. They represent the costs of the broker-dealer in terms of its marketing. They represent shareholder services. In many instances, they represent record-keeping.

If you were to abolish Rule 12b–1 tomorrow, you would not abolish the expenses; you would not abolish the fees. You would merely transfer them to some other place. Now, maybe that is a good idea, maybe it isn't. Mr. Plunkett here has said perhaps all of that should be taken out of the fund and put on the distributor, and that is certainly one way you could look at the problem. But 12b–1 pays for things that are going to be paid for no matter what. It provides a degree of flexibility in the way that they are paid for and transparency—it appears in the fee table, the 12b–1 charges—and oversight because the fund boards have got to superintend those costs under the SEC's rules.

Senator FITZGERALD. Professor Freeman, final comment.

Mr. FREEMAN. Very quickly, we do not have transparency. What we have is revenue sharing to the tune of $2 billion a year to get push money to the brokers, and that is coming out of the advisory fee, and it is coming out of overcharges. We have got directed brokerage, which is, I believe, illegal because the way to pay for sales activity is through a 12b–1 plan. We have a lot of funds that are already maxed out on that. Then they are using brokerage commissions to accomplish the same thing, double dipping and I think treating shareholders unfairly.

Senator FITZGERALD. Well, you have been a wonderful panel, and we appreciate it. All of you have been very articulate and vigorous spokesmen for your point of view.

That concludes our questions. I want to emphasize that the record will be kept open for additional materials until the close of business this Friday, January 30. So if you have any further submissions you would like to make available to the Subcommittee, we would appreciate it.

Thank you all very much. This hearing is adjourned.

[Whereupon, at 2:45 p.m., the Subcommittee was adjourned.]

APPENDIX

United States General Accounting Office

GAO

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

For Release on Delivery
Expected at 10:00 a.m. EST
Tuesday, January 27, 2004

MUTUAL FUNDS

Additional Disclosures Could Increase Transparency of Fees and Other Practices

Statement of Richard J. Hillman, Director,
Financial Markets and Community Investment

G A O
Accountability * Integrity * Reliability

GAO-04-317T

January 27, 2004

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Highlights

Highlights of GAO-04-317T, a testimony to the Chairman, Subcommittee on Financial Management, the Budget and International Security, Committee on Governmental Affairs, U S. Senate

MUTUAL FUNDS

Additional Disclosures Could Increase Transparency of Fees and Other Practices

Why GAO Did This Study

Concerns have been raised over whether the disclosures of mutual fund fees and other fund practices are sufficiently fair and transparent to investors. Our June 2003 report, *Mutual Funds: Greater Transparency Needed in Disclosures to Investors*, GAO-03-763, reviewed (1) how mutual funds disclose their fees and related trading costs and options for improving these disclosures, (2) changes in how mutual funds pay for the sale of fund shares and how the changes in these practices are affecting investors, and (3) the benefits of and the concerns over mutual funds' use of soft dollars. This testimony summarizes the results of our report and discusses certain events that have occurred since it was issued.

What GAO Recommends

GAO recommends that SEC consider the benefits of requiring additional disclosure relating to mutual fund fees and evaluate ways to provide more information that investors could use to evaluate the conflicts of interest arising from payments funds make to broker-dealers and fund advisers' use of soft dollars. SEC generally agreed with the contents of our report and indicated that it will consider the recommendations in this report carefully in determining how best to inform investors about the importance of fees and other disclosures.

www.gao.gov/cgi-bin/getrpt?GAO-04-317T

To view the full report, including the scope and methodology, click on the link above. For more information, contact Richard Hillman at (202) 512-8678 or hillmanr@gao.gov.

What GAO Found

Although mutual funds disclose considerable information about their costs to investors, the amount of fees and expenses that each investor specifically pays on their mutual fund shares are currently disclosed as percentages of fund assets, whereas most other financial services disclose the actual costs to the purchaser in dollar terms. SEC staff has proposed requiring funds to disclose additional information that could be used to compare fees across funds. However, SEC is not proposing that funds disclose the specific dollar amount of fees paid by each investor nor is it proposing to require that any fee disclosures be made in the account statements that investors receive. Although some of these additional disclosures could be costly and data on their benefits to investors was not generally available, less costly alternatives exist that could increase the transparency and investor awareness of mutual funds fees, making consideration of additional fee disclosures worthwhile.

Changes in how mutual funds pay intermediaries to sell fund shares have benefited investors but have also raised concerns. Since 1980, mutual funds, under SEC Rule 12b-1, have been allowed to use fund assets to pay for certain marketing expenses. Over time the use of these fees has evolved to provide investors greater flexibility in choosing how to pay for the services of individual financial professionals that advise them on fund purchases. Another increasingly common marketing practice called revenue sharing involves fund investment advisers making additional payments to the broker-dealers that distribute their funds' shares. However, these payments may cause the broker-dealers receiving them to limit the fund choices they offer to investors and conflict with their obligation to recommend the most suitable funds. Regulators acknowledged that the current disclosure regulations might not always result in complete information about these payments being disclosed to investors.

Under soft dollar arrangements, mutual fund investment advisers use part of the brokerage commissions they pay to broker-dealers for executing trades to obtain research and other services. Although industry participants said that soft dollars allow fund advisers access to a wider range of research than may otherwise be available and provide other benefits, these arrangements also can create incentives for investment advisers to trade excessively to obtain more soft dollar services, thereby increasing fund shareholders' costs. SEC staff has recommended various changes that would increase transparency by expanding advisers' disclosure of their use of soft dollars. By acting on the staff's recommendations SEC would provide fund investors and directors with needed information about how their funds' advisers are using soft dollars.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here to discuss GAO's work on the disclosure of mutual fund fees and the need for other disclosures of mutual fund practices. The fees and other costs that mutual fund investors pay as part of owning fund shares can significantly affect their investment returns. In addition, changes over time in how mutual funds pay intermediaries to sell fund shares have also raised concerns. As a result, it is appropriate to debate whether the disclosures of mutual fund fees and fund marketing practices are sufficiently transparent and fair to investors.

Today, I will summarize the results from our report entitled Mutual Funds: Greater Transparency Needed in Disclosures to Investors, GAO-03-763 (Washington, D.C.: June 9, 2003). Specifically, I will discuss (1) mutual fund fee disclosures and opportunities for improving these disclosures, (2) the potential conflicts that arise when mutual fund advisers pay broker-dealers to sell fund shares, and (3) the benefits and concerns over fund advisers' use of soft dollars. I will also provide information relating to certain events that have occurred since our June 2003 report was issued.

In summary:

The results of our work suggest a need to consider ways to increase the transparency of mutual fund fees and other fund practices. Mutual funds disclose considerable information about their costs to investors, including presenting the operating expense fees that they charge investors as a percentage of fund assets and providing hypothetical examples of the amount of fees that an investor can expect to pay over various time periods. However, unlike many other financial products and services, mutual funds do not disclose to individual investors the specific dollar amount of fees that are paid on their fund shares. The Securities and Exchange Commission (SEC) has proposed that mutual funds make additional disclosures to investors that would provide more information that investors could use to compare fees across funds. However, SEC is not proposing that funds disclose the specific dollar amount of fees paid by each investor nor is it proposing to require that any fee disclosures be made in the account statements that inform investors of the number and value of the mutual fund shares they own. Our report recommends that SEC consider requiring mutual funds to make additional disclosures to investors, including considering requiring funds to specifically disclose fees in dollars to each investor in quarterly account statements. SEC has agreed to consider requiring such disclosures but was unsure that the benefits of implementing specific dollar disclosures outweighed the costs to produce such disclosures. However, we estimate that spreading these implementation costs across all investor accounts might not represent a large outlay on a per investor basis. Our report also discusses less costly alternatives that could also prove beneficial to investors and spur increased competition among mutual funds on the basis of fees.

The work that we conducted for our report also found that 12b-1 fees, which allow fund companies to deduct certain distribution expenses such as sales commissions from fund assets, can raise costs to investors but also provide additional ways for investors to pay for investment advice. Our work also found that mutual fund advisers have been increasingly engaged in a practice known as revenue sharing under which they make additional payments to the broker-dealers that sell their fund shares. Although we found that the impact of these payments on the expenses of fund investors was uncertain, these payments can create conflicts between the interests of broker-dealers and their customers that could limit the choices of funds that these broker-dealers offer investors. However, under current disclosure requirements investors may not always be explicitly informed that their broker-dealer, who is obligated to recommend only suitable investments based on the investor's financial condition, is also receiving payments to sell particular funds. Our report recommends that more disclosure be made to investors about any revenue sharing payments their broker-dealers are receiving. On January 14, 2004, SEC proposed new rules and rule amendments designed to enhance the information that broker-dealers provide to their customers concerning conflicts of interest that arise from the sale of mutual funds.

We also reviewed a practice known as soft dollars, in which a mutual fund adviser uses fund assets to pay commissions to broker-dealers for executing trades in securities for the mutual fund's portfolio but also receives research or other brokerage services as part of the transaction. These soft dollar arrangements can result in mutual fund advisers obtaining research or other services, including research from third party independent research firms, that can benefit the investors in their funds. However, these arrangements also create a conflict of interest that could result in increased expenses to fund shareholders if a fund adviser trades excessively to obtain additional soft dollar research or chooses broker-dealers more on the basis of their soft dollar offerings than their ability to execute trades efficiently. SEC has addressed soft dollar practices in the past and recommended actions could provide additional information to fund directors and investors, but has not yet acted on some of its own recommendations. Our report recommends that more disclosure be made to mutual fund directors and investors to allow them to better evaluate the benefits and potential disadvantages of their fund adviser's use of soft dollars.

Finally, since September 2003, federal and state authorities' widening investigation of illegal late trading and improper timing of fund trades has involved a growing number of prominent mutual fund companies and brokerage firms. To address these abusive practices, regulators are considering the merits of various proposals that have been put forth. In addition, in November 2003, the House of Representatives acted on legislation that addresses abusive trading and various other mutual fund issues and legislation was introduced in the Senate. The House of Representatives passed H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act of 2003. H.R. 2420's purpose is to (1) improve transparency of mutual fund fees and costs and (2) improve corporate governance and management integrity of mutual funds. Also in November 2003, three bills addressing mutual fund concerns were introduced in the Senate. The Mutual Fund Transparency Act of 2003, S. 1822, would require disclosure of financial relationships between brokers and mutual fund companies and of certain brokerage commissions paid by mutual fund companies. S. 1958, the Mutual Fund Investor Protection Act of 2003, was introduced to prevent the practice of late trading by mutual funds, and for other purposes. S. 1971, the Mutual Fund Investor Confidence Restoration Act of 2003 seeks to improve transparency relating to the fees and costs that mutual fund investors incur and to improve corporate governance of mutual funds.

Additional Disclosure of Mutual Fund Costs Might Benefit Investors

Although mutual funds already disclose considerable information about the fees they charge, our report recommends that SEC consider requiring that mutual funds make additional disclosures to investors about fees in the account statements that investors receive. Mutual funds currently provide information about the fees they charge investors as an operating expense ratio that shows as a percentage of fund assets all the fees and other expenses that the fund adviser deducts from the assets of the fund. Mutual funds also are required to present a hypothetical example that shows in dollar terms what investors could expect to pay in fees if they invested $10,000 in a fund and held it for various periods. It is important to understand the fees charged by a mutual fund because fees can significantly affect investment returns of the fund over the long term. For example, over a 20-year period a $10,000 investment in a fund earning 8 percent annually, with a 1-percent expense ratio, would be worth $38,122; but with a 2-percent expense ratio it would be worth $31,117—over $7,000 less.

Unlike many other financial products, mutual funds do not provide investors with information about the specific dollar amounts of the fees that have been deducted from the value of their shares. Table 1 shows that many other financial products do present their costs in specific dollar amounts.

Table 1: Fee Disclosure Practices for Selected Financial Services or Products

Type of product or service	Disclosure requirement
Mutual funds	Mutual funds show the operating expenses as percentages of fund assets and dollar amounts for hypothetical investment amounts based on estimated future expenses in the prospectus.
Deposit accounts	Depository institutions are required to disclose itemized fees, in dollar amounts, on periodic statements.
Bank trust services	Although covered by varying state laws, regulatory and association officials for banks indicated that trust service charges are generally shown as specific dollar amounts.
Investment services provided to individual investment accounts (such as those managed by a financial planner)	When the provider has the right to deduct fees and other charges directly from the investor's account, the dollar amounts of such charges are required to be disclosed to the investor.
Wrap accounts[a]	Provider is required to disclose dollar amount of fees on investors' statements.
Stock purchases	Broker-dealers are required to report specific dollar amounts charged as commissions to investors.
Mortgage financing	Mortgage lenders are required to provide at time of settlement a statement containing information on the annual percentage rate paid on the outstanding balance, and the total dollar amount of any finance charges, the amount financed, and the total of all payments required.
Credit cards	Lenders are required to disclose the annual percentage rate paid for purchases and cash advances, and the dollar amounts of these charges appear on cardholder statements.

Source: GAO analysis of applicable disclosure regulations, rules, and industry practices.

[a]In a wrap account, a customer receives investment advisory and brokerage execution services from a broker-dealer or other financial intermediary for a "wrapped" fee that is not based on transactions in the customer's account.

Although mutual funds do not disclose their costs to each individual investor in specific dollars, the disclosures that they make do exceed those of many products. For example, purchasers of fixed annuities are not told of the expenses associated with investing in such products. Some industry participants and others including SEC also cite the example of bank savings accounts, which pay stated interest rates to their holders but do not explain how much profit or expenses the bank incurs to offer such products. While this is true, we do not believe this is an analogous comparison to mutual fund fees because the operating expenses of the bank are not paid using the funds of the savings account holder and are therefore not explicit costs to the investor like the fees on a mutual fund.

A number of alternatives have been proposed for improving the disclosure of mutual fund fees, that could provide additional information to fund investors. In December 2002, SEC released proposed rule amendments, which include a requirement that mutual funds make additional disclosures about their expenses.[1] This information would be presented to investors in the annual and semiannual reports prepared by mutual funds. Specifically, mutual funds would be required to disclose the cost in dollars associated with an investment of $10,000 that earned the fund's actual return and incurred the fund's actual expenses paid during the period. In addition, SEC also proposed that mutual funds be required to disclose the cost in dollars, based on the fund's actual expenses, of a $10,000 investment that earned a standardized return of 5 percent. If these disclosures become mandatory, investors will have additional information that could be directly compared across funds. By placing the disclosures in funds' annual and semiannual reports, SEC staff also indicated that it will facilitate prospective investors comparing funds' expenses before making a purchase decision.

However, SEC's proposal would not require mutual funds to disclose to each investor the specific amount of fees in dollars that are paid on the shares they own. As result, investors will not receive information on the costs of mutual fund investing in the same way they see the costs of many other financial products and services that they may use. In addition, SEC did not propose that mutual funds provide information relating to fees in the quarterly or even more frequent account statements that provide investors with the number and value of their mutual fund shares. In a 1997 survey of how investors obtain information about their funds, the Investment Company Institute (ICI) indicated that, to shareholders, the account statement is probably the most important communication that they receive

[1]"Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Securities and Exchange Commission," Release Nos. 33-8164; 34-47023; IC-2587068 (Dec. 18, 2002).

from a mutual fund company and that nearly all shareholders use such statements to monitor their mutual funds.

SEC and industry participants have indicated that the total cost of providing specific dollar fee disclosures might be significant; however, we found that the cost might not represent a large outlay on a per investor basis. As we reported in our March 2003 statement for the record to the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, House Committee on Financial Services, ICI commissioned a large accounting firm to survey mutual fund companies about the costs of producing such disclosures.[2] Receiving responses from broker-dealers, mutual fund service providers, and fund companies representing approximately 77 percent of total industry assets as of June 30, 2000, this study estimated that the aggregated estimated costs for the survey respondents to implement specific dollar disclosures in shareholder account statements would exceed $200 million, and the annual costs of compliance would be about $66 million. Although the ICI study included information from some broker-dealers and fund service providers, it did not include the reportedly significant costs that all broker-dealers and other third-party financial institutions that maintain accounts on behalf of individual mutual fund shareholders could incur. However, using available information on mutual fund assets and accounts from ICI and spreading such costs across all investor accounts indicates that the additional expenses to any one investor are minimal. Specifically, at the end of 2001, ICI reported that mutual fund assets totaled $6.975 trillion. If mutual fund companies charged, for example, the entire $266 million cost of implementing the disclosures to investors in the first year, then dividing this additional cost by the total assets outstanding at the end of 2001 would increase the average fee by 0.0038 percent or about one-third of a basis point. In addition, ICI reported that the $6.975 trillion in total assets was held in over 248 million mutual fund accounts, equating to an average account of just over $28,000. Therefore, implementing these disclosures

[2]U.S. General Accounting Office, *Mutual Funds: Information on Trends in Fees and Their Related Disclosure*, GAO-03-551T (Washington, D.C.: Mar. 12, 2003).

would add $1.07 to the average $184 that these accounts would pay in total operating expense fees each year—an increase of six-tenths of a percent.[3]

In addition, other less costly alternatives are also available that could increase investor awareness of the fees they are paying on their mutual funds by providing them with information on the fees they pay in the quarterly statements that provide information on an investor's share balance and account value. For example, one alternative that would not likely be overly expensive would be to require these quarterly statements to present the information—the dollar amount of a fund's fees based on a set investment amount—that SEC has proposed be added to mutual fund semiannual reports. Doing so would place this additional fee disclosure in the document generally considered to be of the most interest to investors. An even less costly alternative could be to require quarterly statements to also include a notice that reminds investors that they pay fees and to check their prospectus and with their financial adviser for more information. In September 2003, SEC amended fund advertising rules, which require funds to state in advertisements that investors should consider a fund's fees before investing and directs investors to consult their funds' prospectus.[4] However, also including this information in the quarterly statement could increase investor awareness of the impact that fees have on their mutual fund's returns. H.R. 2420 would require that funds disclose in the quarterly statement or other appropriate shareholder report an estimated amount of the fees an investor would have to pay on each investment of $1,000. S. 1958, like H.R. 2420, would require disclosure of fees paid on each $1,000 invested. S. 1971, among other disclosures, would require that funds disclose the actual cost borne by each shareholder for the operating expenses of the fund.

SEC's current proposal, while offering some advantages, does not make mutual funds comparable to other products and provide information in the

[3]To determine these amounts, we used the operating expense ratios that ICI estimated in its September 2002 fee study—which reported average expense ratios of 0.88 percent for equity funds, 0.57 percent for bond funds, and 0.32 percent for money market funds. By weighting each of these by the total assets invested in each fund type, we calculated that the weighted average expense ratio for all funds was 0.66 percent. Using this average expense ratio, the average account size of $28,000 would pay $184 in fees. The additional expense of implementing specific dollar disclosures of 0.0038 percent would therefore add $1.07 to this amount.

[4]Final Rule: Amendments to Investment Company Advertising Rules, Securities and Exchange Commission, Release Nos. 33-8294; 34-48558; IC-26195 (Sep. 29, 2003).

document that is most relevant to investors—the quarterly account statement. Our report recommends that SEC consider requiring additional disclosures relating to fees be made to investors in the account statement. In addition to providing specific dollar disclosures, we also noted that investors could be provided with a variety of other disclosures about the fees they pay on mutual funds that would have a range of implementation costs, including some that would be less costly than providing specific dollar disclosures. However, seeing the specific dollar amount paid on shares owned could be the incentive that some investors need to take action to compare their fund's expenses to those of other funds and make more informed investment decisions on this basis. Such disclosures may also increasingly motivate fund companies to respond competitively by lowering fees. Because the disclosures that SEC is currently proposing be included in mutual fund annual and semiannual reports could also prove beneficial, it could choose to require disclosures in these documents and the account statements, which would provide both prospective and existing investors in mutual funds access to valuable information about the costs of investing in funds.

Disclosures of Trading Costs Could Benefit Investors

Academics and other industry observers have also called for increased disclosure of mutual fund brokerage commissions and other trading costs that are not currently included in fund expense ratios. In an academic study we reviewed that looked at brokerage commission costs, the authors urged that investors pay increased attention to such costs.[5] For example, the study noted that investors seeking to choose their funds on the basis of expenses should also consider reviewing trading costs as relevant information because the impact of these unobservable trading costs is comparable to the more observable expense ratio. The authors of another study noted that research shows that all expenses can reduce returns so attention should be paid to fund trading costs, including brokerage commissions, and that these costs should not be relegated to being disclosed only in mutual funds' Statement of Additional Information.[6]

[5]J.M.R. Chalmers, R.M. Edelen, and G.B. Kadlec, "Mutual Fund Trading Costs," Rodney L. White Center for Financial Research, The Wharton School, University of Pennsylvania (Nov. 2, 1999).

[6]M. Livingston and E.S. O'Neal, "Mutual Fund Brokerage Commissions," *Journal of Financial Research* (Summer 1996).

Mutual fund officials raised various concerns about expanding the disclosure of brokerage commissions and trading costs in general. Some officials said that requiring funds to present additional information about brokerage commissions by including such costs in the fund's operating expense ratios would not present information to investors that could be easily compared across funds. For example, funds that invest in securities on the New York Stock Exchange (NYSE), for which commissions are usually paid, would pay more in total commissions than would funds that invest primarily in securities listed on NASDAQ because the broker-dealers offering such securities are usually compensated by spreads rather than explicit commissions. Similarly, most bond fund transactions are subject to markups rather than explicit commissions. If funds were required to disclose the costs of trades that involve spreads, officials noted that such amounts would be subject to estimation errors. Officials at one fund company told us that it would be difficult for fund companies to produce a percentage figure for other trading costs outside of commissions because no agreed upon methodology for quantifying market impact costs, spreads, and markup costs exists within the industry. Other industry participants told us that due to the complexity of calculating such figures, trading cost disclosure is likely to confuse investors. For example funds that attempt to mimic the performance of certain stock indexes, such as the Standard & Poors 500 stock index, and thus limit their investments to just these securities have lower brokerage commissions because they trade less. In contrast, other funds may employ a strategy that requires them to trade frequently and thus would have higher brokerage commissions. However, choosing among these funds on the basis of their relative trading costs may not be the best approach for an investor because of the differences in these two types of strategies.

To improve the disclosure of trading costs to investors, the House-passed H.R. 2420 would require mutual fund companies to make more prominent their portfolio turnover disclosure which, by measuring the extent to which the assets in a fund are bought and sold, provides an indirect measure of transaction costs for a fund. The bill directs funds to include this disclosure in a document that is more widely read than the prospectus or Statement of Additional Information, and would require fund companies to provide a description of the effect of high portfolio turnover rates on fund expenses and performance. H.R 2420 also requires SEC to issue a concept release examining the issue of portfolio transaction costs. S. 1822 would require mutual funds to disclose brokerage commissions as part of fund expenses. S. 1958 would require SEC to issue a concept release on disclosure of portfolio transaction costs. S. 1971 would require funds to disclose the estimated expenses paid for costs associated with management of the fund that reduces the funds overall value, including brokerage commissions, revenue sharing and directed brokerage arrangements, transactions costs and other fees. In December 2003, SEC issued a concept release to solicit views on how SEC could improve the information that mutual funds disclose about their portfolio transaction costs.[7]

Changes in Some Fund Distribution Practices Likely Beneficial But Others Raise Potential Conflicts of Interest

The way that investors pay for the advice of financial professionals about their mutual funds has evolved over time. Approximately 80 percent of mutual fund purchases are made through broker-dealers or other financial professionals, such as financial planners and pension plan administrators. Previously, the compensation that these financial professionals received for assisting investors with mutual fund purchases were paid by either charging investors a sales charge or load or by paying for such expenses out of the investment adviser's own profits.

However, in 1980, SEC adopted rule 12b-1 under the Investment Company Act to help funds counter a period of net redemptions by allowing them to use fund assets to pay the expenses associated with the distribution of fund shares. Rule 12b-1 plans were envisioned as temporary measures to be used during periods of declining assets. Any activity that is primarily intended to result in the sale of mutual fund shares must be included as a 12b-1 expense and can include advertising; compensation of underwriters, dealers, and sales personnel; printing and mailing prospectuses to persons other than current shareholders; and printing and mailing sales literature. These fees are called 12b-1 fees after the rule that allows fund assets to be used to pay for fund marketing and distribution expenses.

NASD, whose rules govern the distribution of fund shares by broker dealers, limits the annual rate at which 12b-1 fees may be paid to broker-dealers to no more than 0.75 percent of a fund's average net assets per year. Funds are allowed to include an additional service fee of up to 0.25 percent of average net assets each year to compensate sales professionals for providing ongoing services to investors or for maintaining their accounts. Therefore, 12b-1 fees included in a fund's total expense ratio are limited to a maximum of 1 percent per year. Rule 12b-1 provides investors

[7]Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, release Nos 33-8349; 34-48952; IC-26313; File No. S7-29-03 (Dec. 19, 2003).

an alternative way of paying for investment advice and purchases of fund shares. Apart from 12b-1 fees, brokers can be paid with sales charges called "loads"; "front-end" loads are applied when shares in a fund are purchased and "back-end" loads when shares are redeemed. With a 12b-1 plan, the fund can finance the broker's compensation with installments deducted from fund assets over a period of several years. Thus, 12b-1 plans allow investors to consider the time-related objectives of their investment and possibly earn returns on the full amount of the money they have to invest, rather than have a portion of their investment immediately deducted to pay their broker.

Rule 12b-1 has also made it possible for fund companies to market fund shares through a variety of share classes designed to help meet the different objectives of investors. For example, Class A shares might charge front-end loads to compensate brokers and may offer discounts called breakpoints for larger purchases of fund shares. Class B shares, alternatively, might not have front-end loads, but would impose asset-based 12b-1 fees to finance broker compensation over several years. Class B shares also might have deferred back-end loads if shares are redeemed within a certain number of years and might convert to Class A shares if held a certain number of years, such as 7 or 8 years. Class C shares might have a higher 12b-1 fee, but generally would not impose any front-end or back-end loads. While Class A shares might be more attractive to larger, more sophisticated investors who wanted to take advantage of the breakpoints, smaller investors, depending on how long they plan to hold the shares, might prefer Class B or C shares because no sales charges would be deducted from their initial investments.

Although providing alternative means for investors to pay for the advice of financial professionals, some concerns exist over the impact of 12b-1 fees on investors' costs. For example, our June 2003 report discussed academic studies that found that funds with 12b-1 plans had higher management fees and expenses. Questions involving funds with 12b-1 fees have also been raised over whether some investors are paying too much for their funds depending on which share class they purchase. For example, SEC recently brought a case against a major broker dealer that it accused of inappropriately selling mutual fund B shares, which have higher 12b-1 fees, to investors who would have been better off purchasing A shares that had much lower 12b-1 fees. Also, in March 2003, NASD, NYSE, and SEC staff reported on the results of jointly administered examinations of 43 registered broker-dealers that sell mutual funds with a front-end load. The examinations found that most of the brokerage firms examined, in some instances, did not provide customers with breakpoint discounts for which they appeared to have been eligible.

Revenue Sharing Raises Conflict of Interest Concerns

One mutual fund distribution practice—called revenue sharing—that has become increasingly common raises potential conflicts of interest between broker-dealers and their mutual fund investor customers. Broker-dealers, whose extensive distribution networks and large staffs of financial professionals who work directly with and make investment recommendations to investors, have increasingly required mutual funds to make additional payments to compensate their firms beyond the sales loads and 12b-1 fees. These payments, called revenue sharing payments, come from the adviser's profits and may supplement distribution-related payments from fund assets. According to an article in one trade journal, revenue sharing payments made by major fund companies to broker-dealers may total as much as $2 billion per year. According to the officials of a mutual fund research organization, about 80 percent of fund companies that partner with major broker-dealers make cash revenue sharing payments. For example, some broker-dealers have narrowed their offerings of funds or created preferred lists that include the funds of just six or seven fund companies that then become the funds that receive the most marketing by these broker-dealers. In order to be selected as one of the preferred fund families on these lists, the mutual fund adviser often is required to compensate the broker-dealer firms with revenue sharing payments.

One of the concerns raised about revenue sharing payments is the effect on overall fund expenses. A 2001 research organization report on fund distribution practices noted that the extent to which revenue sharing might affect other fees that funds charge, such as 12b-1 fees or management fees, was uncertain. For example, the report noted that it was not clear whether the increase in revenue sharing payments increased any fund's fees, but also noted that by reducing fund adviser profits, revenue sharing would likely prevent advisers from lowering their fees. In addition, fund directors normally would not question revenue sharing arrangements paid from the adviser's profits. In the course of reviewing advisory contracts, fund directors consider the adviser's profits not taking into account marketing and distribution expenses, which also could prevent advisers from shifting these costs to the fund.

Revenue sharing payments may also create conflicts of interest between broker-dealers and their customers. By receiving compensation to emphasize the marketing of particular funds, broker-dealers and their sales representatives may have incentives to offer funds for reasons other than the needs of the investor. For example, revenue sharing arrangements might unduly focus the attention of broker-dealers on particular mutual funds, reducing the number of funds considered as part of an investment decision–potentially leading to inferior investment choices and potentially reducing fee competition among funds. Finally, concerns have been raised that revenue sharing arrangements might conflict with securities self-regulatory organization rules requiring that brokers recommend purchasing a security only after ensuring that the investment is suitable given the investor's financial situation and risk profile.

Although revenue sharing payments can create conflicts of interest between broker-dealers and their clients, the extent to which broker-dealers disclose to their clients that their firms receive such payments from fund advisers is not clear. Rule 10b-10 under the Securities Exchange Act of 1934 requires, among other things, that broker-dealers provide customers with information about third-party compensation that broker-dealers receive in connection with securities transactions. While broker-dealers generally satisfy the 10b-10 requirements by providing customers with written "confirmations," the rule does not specifically require broker-dealers to provide the required information about third-party compensation related to mutual fund purchases in any particular document. SEC staff told us that they interpret rule 10b-10 to permit broker-dealers to disclose third-party compensation related to mutual fund purchases through delivery of a fund prospectus that discusses the compensation. However, investors would not receive a confirmation and might not view a prospectus until after purchasing mutual fund shares.

As a result of these concerns, our report recommends that SEC evaluate ways to provide more information to investors about the revenue sharing payments that funds make to broker-dealers. Having additional disclosures made at the time that fund shares are recommended about the compensation that a broker-dealer receives from fund companies could provide investors with more complete information to consider when making their investment decision. To address revenue sharing issues, we were pleased to see that a recent NASD rule proposal would require broker-dealers to disclose in writing when the customer first opens an account or purchases mutual fund shares compensation that they receive from fund companies for providing their funds "shelf space" or preference over other funds. On January 14, 2004, SEC proposed new rules and rule amendments designed to enhance the information that broker-dealers provide to their customers. H.R. 2420 would require fund directors to review revenue sharing arrangements consistent with their fiduciary duty to the fund. H.R. 2420 also would require funds to disclose revenue sharing arrangements and require brokers to disclose whether they have received any financial incentives to sell a particular fund or class of shares. S. 1822 would require brokers to disclose in writing any compensation received in connection with a customer's purchase of mutual fund shares. S. 1971 would require fund companies and investment advisers to fully disclose certain sales practices, including revenue sharing and directed brokerage arrangements, shareholder eligibility for breakpoint discounts, and the value of research and other services paid for as part of brokerage commissions.

Soft Dollar Arrangements Provide Benefits, but Could Adversely Impact Investors

Soft dollar arrangements allow fund investment advisers to obtain research and brokerage services that could potentially benefit fund investors but could also increase investors' costs. When investment advisers buy or sell securities for a fund, they may have to pay the broker-dealers that execute these trades a commission using fund assets. In return for these brokerage commissions, many broker-dealers provide advisers with a bundle of services, including trade execution, access to analysts and traders, and research products.

Some industry participants argue that the use of soft dollars benefits investors in various ways. The research that the fund adviser obtains can directly benefit a fund's investors if the adviser uses it to select securities for purchase or sale by the fund. The prevalence of soft dollar arrangements also allows specialized, independent research to flourish, thereby providing money managers a wider choice of investment ideas. As a result, this research could contribute to better fund performance. The proliferation of research available as a result of soft dollars might also have other benefits. For example, an investment adviser official told us that the research on smaller companies helps create a more efficient market for such companies' securities, resulting in greater market liquidity and lower spreads, which would benefit all investors including those in mutual funds.

Although the research and brokerage services that fund advisers obtain through the use of soft dollars could benefit a mutual fund investor, this practice also could increase investors' costs and create potential conflicts of interest that could harm fund investors. For example, soft dollars could cause investors to pay higher brokerage commissions than they otherwise would, because advisers might choose broker-dealers on the basis of soft dollar products and services, not trade execution quality. One academic study shows that trades executed by broker-dealers that specialize in providing soft dollar products and services tend to be more expensive than those executed through other broker-dealers, including full-service broker-dealers.[8] Soft dollar arrangements could also encourage advisers to trade more in order to pay for more soft dollar products and services. Overtrading would cause investors to pay more in brokerage commissions than they otherwise would. These arrangements might also tempt advisers to "over-consume" research because they are not paying for it directly. In turn, advisers might have less incentive to negotiate lower commissions, resulting in investors paying more for trades.

Under the Investment Advisers Act of 1940, advisers must disclose details of their soft dollar arrangements in Part II of Form ADV, which investment advisers use to register with SEC and must send to their advisory clients. However, this form is not provided to the shareholders of a mutual fund, although the information about the soft dollar practices that the adviser uses for particular funds are required to be included in the Statement of Additional Information that funds prepare, which is available to investors upon request. Specifically, Form ADV requires advisers to describe the factors considered in selecting brokers and determining the reasonableness of their commissions. If the value of the products, research, and services given to the adviser affects the choice of brokers or the brokerage commission paid, the adviser must also describe the products, research and services and whether clients might pay commissions higher than those obtainable from other brokers in return for those products.

In a series of regulatory examinations performed in 1998, SEC staff found examples of problems relating to investment advisers' use of soft dollars, although far fewer problems were attributable to mutual fund advisers. In response, SEC staff issued a report that included proposals to address the potential conflicts created by these arrangements, including recommending that investment advisers keep better records and disclose more information about their use of soft dollars. Although the recommendations could increase the transparency of these arrangements and help fund directors and investors better evaluate advisers' use of soft dollars, SEC has yet to take action on some of its proposed recommendations.

[8] J.S. Conrad, K.M Johnson, and S. Wahal, "Institutional Trading and Soft Dollars," *Journal of Finance* (February 2001).

As a result, our June 2003 report recommends that SEC evaluate ways to provide additional information to fund directors and investors on their fund advisers' use of soft dollars. SEC relies on disclosure of information as a primary means of addressing potential conflicts between investors and financial professionals. However, because SEC has not acted to more fully address soft dollar-related concerns, investors and mutual fund directors have less complete and transparent information with which to evaluate the benefits and potential disadvantages of their fund adviser's use of soft dollars.

To address the inherent conflicts of interest with respect to soft dollar arrangements, H.R. 2420 would

- require SEC to issue rules mandating disclosure of information about soft dollar arrangements;
- require fund advisers to submit to the fund's board of directors an annual report on these arrangements, and require the fund to provide shareholders with a summary of that report in its annual report to shareholders;
- impose a fiduciary duty on the fund's board of directors to review soft dollar arrangements;
- direct SEC to issue rules to require enhanced recordkeeping of soft dollar arrangements; and
- require 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.

S. 1822 would discourage use of soft dollars by requiring that funds calculate their value and disclose it along with other fund expenses. S. 1971 also would require disclosure of soft dollar arrangements and the value of the services provided. Also, it would require that SEC conduct a study of the use of soft dollar arrangements by investment advisers.

Various Scandals Involving Mutual Funds Surfaced in 2003

Since we issued our report in June 2003, various allegations of misconduct and abusive practices involving mutual funds have come to light. In early September 2003, the Attorney General of the State of New York filed charges against a hedge fund manager for arranging with several mutual fund companies to improperly trade in fund shares and profiting at the expense of other fund shareholders. Since then federal and state authorities' widening investigation of illegal late trading and improper timing of fund trades has involved a growing number of prominent mutual fund companies and brokerage firms.

The problems involving late trading arise when some investors are able to purchase or sell mutual fund shares after the 4:00 pm Eastern Time close of U.S. securities markets, the time at which funds price their shares. Under current mutual fund regulations, orders for mutual fund shares received after 4:00 pm are required by regulation to be priced at the next day's price.[9] An investor permitted to engage in late trading could be buying or selling shares at the 4:00 pm price knowing of developments in the financial markets that occurred after 4:00 pm, thus unfairly taking advantage of opportunities not available to other fund shareholders. Clearly, to ensure compliance with the law, funds should have effective internal controls in place to prevent abusive late trading. Regulators are considering a rule change requiring that an order to purchase or redeem fund shares be received by the fund, its designated transfer agent, or a registered securities clearing agency, by the time that the fund establishes for calculating its net asset value in order to receive that day's price.

The problems involving market timing occur when certain fund investors are able to take advantage of temporary disparities between the share value of a fund and the values of the underlying assets in the fund's portfolio. For example, such disparities can arise when U.S. mutual funds use old prices for their foreign assets even though events have occurred overseas that will likely cause significant movements in the prices of those assets when their home markets open. Market timing, although not illegal, can be unfair to funds' long-term investors because it provides the opportunity for selected fund investors to profit from fund assets at the expense of fund long-term investors. To address these issues, regulators are considering the merits of various proposals that have been put forth to

[9] SEC rule 22c-1, promulgated under the Investment Company Act of 1940, prohibits the purchase or sale of mutual fund shares except at a price based on current net asset value of such shares that is next calculated after receipt of a buy or sell order.

discourage market timing, such as mandatory redemption fees or fair value pricing of fund shares.[10]

To protect fund investors from such unfair trading practices H.R. 2420 would, with limited exceptions, require that all trades be placed with funds by 4:00 pm and includes provisions to eliminate conflicts of interest in portfolio management, ban short-term trading by insiders, allow higher redemption fees to discourage short-term trading, and encourage wider use of fair value pricing to eliminate stale prices that makes market timing profitable. S. 1958 would require that fund companies receive orders prior to the time they price their shares. S. 1958 would also increase penalties for late trading and require funds to explicitly disclose their market timing policies and procedures. S.1971 also would restrict the placing of trades after hours, require funds to have internal controls in place and compliance programs to prevent abusive trading, and require wider use of fair value pricing.

In conclusion, GAO believes that various changes to current disclosures and other practices would benefit fund investors. Additional disclosures of mutual fund fees could help increase the awareness of investors of the fees they pay and encourage greater competition among funds on the basis of these fees. Likewise, better disclosure of the costs funds incur to distribute their shares and of the costs and benefits of funds' use of soft dollar research activities could provide investors with more complete information to consider when making their investment decision. In light of recent scandals involving late trading and market timing, various reforms to mutual fund rules will also likely be necessary to better protect the interests of all mutual fund investors.

[10]Fair value pricing is a process that mutual funds use to value fund shares in the absence of current market values, such as for assets traded in foreign markets.

This concludes my prepared statement and I would be happy to respond to questions.

Contacts and Acknowledgements

For further information regarding this testimony, please contact Cody J. Goebel at (202) 512-8678. Individuals making key contributions to this testimony include Toayoa Aldridge and David Tarosky.

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.
January 27, 2004

Thank you for inviting me back to testify before this committee. This committee's hearing this past November played an important role in focusing attention on the conflicts inherent in an industry where directors were beholden to management. That hearing also started the process of crafting solutions to protect the $7 trillion Americans have invested in mutual funds.

Several of the proposals that seemed radical when I discussed them in November have already become conventional wisdom. Requiring mutual funds to have truly independent directors and an independent board chairman is now a centerpiece of every reform proposal. There is now also widespread recognition that mutual funds directors must be given the staff and resources needed to allow them to effectively oversee the management companies that run the funds' day-to-day operations.

Many reformers also recognize that mutual fund compliance officers should report to the fund's independent directors and not to the mangers whose activities are being monitored and reviewed. Perhaps most significantly, there is universal agreement that the disclosures provided to mutual fund customers are inadequate and several competing proposals address this problem. I continue to believe that the proper approach would be to provide each investor with an itemized statement of the actual costs charged to his or her account. This would provide mutual fund customers with the information necessary to engage in true comparison shopping.

That is the good news. The bad news is that the industry and many of its apologists are still opposing true reform in the area that most directly impacts investors: advisory fees.

As I indicated when I was here last November, in 2002 mutual fund investors paid advisory fees of more than $50 billion and other management fees of nearly $20 billion. That is in addition to the tens of billions of dollars in marketing fees and trading costs imposed by the fund industry.

The advisory fees that mutual funds charge their shareholders greatly exceed those charged to institutional customers. If mutual fund customers were charged the lower rate for advisory fees paid by institutional investors, they would save more than $10 billion each year.

The industry and its apologists have asked whether there is a link between the advisory fees charged to investors and the late trading and market timing practices that were the initial focus of my investigation. As I stated to Senators Sarbanes and Shelby when I testified before their committee, the answer is yes.

Both the improper trading and the exorbitant advisory fees are a consequence of a desire by managers to enrich themselves at the expense of investors and an inability or unwillingness on the part of directors to protect investors. This can be demonstrated by the fact that the managers who permitted late trading and market timing in many instances did so in return for increased investments in other funds that they managed. As one mutual fund manager frankly admitted in an email uncovered by my office: "I have no interest in building a business around market timers, but at the same time I do not want to turn away $10-20 million!"

Mutual fund directors and managers breached their duties to investors in every conceivable manner, and we must pursue every manifestation of that breach. This includes breaches of duty that allowed managers to overcharge investors.

When I was last before this committee I spoke in generalized terms about the advisory fee overcharges imposed on investors. Now that our investigation has progressed, I'd like to talk specifically about the advisory fees charged by two fund complexes, Putnam and Alliance.

In 2002, Putnam managed approximately $279 billion for mutual fund and institutional investors. Our investigation revealed that Putnam charged mutual fund investors significantly higher advisory fees than those charged to institutional investors. Here are the specifics:

Putnam's mutual fund investors were charged 40% more for advisory services than Putnam's institutional investors. In dollar terms, what this fee disparity means is that in 2002 Putnam mutual fund investors paid $290 million more in advisory fees than they would have paid had they been charged the rate given to Putnam's institutional clients.

There was a similar disparity in the advisory fees charged by Alliance. Once again, mutual fund investors were charged significantly higher advisory fees than institutional investors. Specifically, Alliance's mutual fund investors paid advisory fees that were twice those paid by institutional investors. In dollar terms, this means that Alliance investors paid more than $200 million dollars more in advisory fees than they would have paid had they been charged the rate given to Alliance's institutional clients.

Because of these findings, I refused to join in a settlement with Putnam that did not provide investors with some form of compensation for the advisory fee overcharges they incurred. Similarly, my office's settlement with Alliance requires them to return $350 million to investors by way of a five-year, twenty percent reduction in their advisory fees.

These actions have lead my critics to accuse me of engaging in "rate-setting." That charge is false. Requiring mutual funds to return to investors money that should never have been taken from them is not "rate-setting." It is what regulators across the country do every day when they uncover evidence that consumers have been ripped-off, and it is what I will continue to do as I uncover more evidence that mutual fund investors have been cheated.

When the charge of rate-setting fell flat, the industry turned to a more audacious argument in defense of their advisory fees. Earlier this month, the Investment Company Institute issued a report that attempted to rebut the evidence showing that mutual fund investors pay more than institutional investors for advisory services. The report focuses significant attention on an academic article published in the Journal of Corporation Law by Professors Freeman and Brown.

Professor Freeman is testifying on a later panel and does not need my assistance to defend his work. But he is due our thanks for shedding light on an abusive practice that takes billions of dollars each year from the pockets of average families saving for a new home or their children's education. Thank you, Professor Freeman.

The ICI's conclusion that mutual fund investors don't pay more than institutional investors for advisory services was misleading or worse. It was not based on data showing what mutual funds charge for advisory services. Instead, the ICI relied exclusively on data concerning the fees that subadvisors -- the outside advisors occasionally hired by mutual fund managers to give investment advice -- charge management companies.

There are three reasons why it is inappropriate to rely on data concerning subadvisors. First, fewer than 20% of all mutual funds employ subadvisors. Indeed, after the ICI released its report, Business Week noted that as few as 7% of mutual funds employ subadvisors.

Second, unlike most mutual fund fees where directors rubber stamp their affiliated management company's request, the fees charged by subadvisors are the product of an arms length negotiation between disinterested parties.

Third, the few mutual funds that employ subadvisors often impose their own costs on top of those of the subadvisor. For example, if the subadvisor charges the fund thirty basis points, the fund will tack on its own "premium" of twenty or thirty basis points and charge investors the combined amount. The ICI report used the amount charged by the subadvisors, without accounting for the "premiums" tacked on by the mutual funds and passed on to shareholders. The result is that even in mutual funds that are subadvised, shareholders pay more for advisory services than the actual cost for that service incurred by the management company.

Thus, the ICI report takes a number that reflects a narrow slice of the industry and is the product of arms length negotiation, ignores the mark-up imposed by mutual funds and then attempts to pass that number off as representative of the entire industry. For shame.

I know that the ICI has a representative testifying on a later panel. I hope the committee will explore the issue of subadvised fees, particularly the premiums that the funds impose. My sense is that these "premiums" are often as much or more than the fees charged by the subadvisor itself. This raises the question of what service is being provided to justify these premiums. In the coming weeks, my office may take a closer look at that question.

When discussing advisory fees, the challenge is not in determining the scope of the problem but in crafting an appropriate solution. I would like to ask this committee to consider a proposal endorsed a few weeks ago by the treasurers of California and North Carolina and by the New York State comptroller.

This proposal that would require all mutual fund fee contracts to contain breakpoints providing economies of scale savings to shareholders, and would require mutual fund boards to justify the fees in an analysis published in the fund's annual report.

The analysis must include a comparison of the fees charged to institutional investors, a review of the management company's pre-tax profit and a detailed itemization of the costs of the various services, including investment advice, marketing and advertising, operations and administration.

I believe that this proposal, if enacted, would lead to savings of billions or more each year. I hope that the committee will give it serious consideration.

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

January 27, 2004

Good morning, Chairman Fitzgerald and members of the Subcommittee. Thank you for inviting me to speak today.

March 21, 2004, less than two months from today, will mark the 80th anniversary of America's first mutual fund. Organized in Boston, Massachusetts Investors Trust (MIT) was a Massachusetts trust managed by its own trustees, who held the power "in their absolute and uncontrolled discretion" to invest its assets. The trustees were to be compensated at "the current bank rate for trustees," 6% of the investment income earned by the trust.

Our industry began, then, with the formation of a truly *mutual* mutual fund, one organized, operated and managed, not by a separate management company with its own commercial interests, but by its own trustees; compensated not on the basis of the trust's *principal*, but, under traditional fiduciary standards, its *income*.

We use the word *Alpha* to describe the first event in a series, and the word *Omega* to describe the last event, the end of the series or its final development. To state what must be obvious, however, MIT's Alpha was followed by the development of a very different mode of fund organization. Today, the industry's almost universal *modus operandi* is not individual *funds* but fund *complexes;* they are managed not by their own trustees but by external corporations; they encompass not only investment management but also administration, operations, distribution, and marketing. The model of the 1924 Alpha *mutual fund*, then, has been replaced

Note: The opinions expressed in this speech 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 Boston College School of Law on January 21, 2004.

by the 2004 Omega mutual fund *complex*—a term that, all those years ago, would have somehow seemed jarring or inappropriate.

But "the national public interest and the interest of investors"—the focus of our industry's guiding statute, the Investment Company Act of 1940—precludes our acceptance of today's almost universally-accepted industry structure—today's Omega model—as the end of mutual fund development. Why? Because the reality is that this structure has been shaped, increasingly and almost unremittingly, to *serve* the interest of fund managers, a *disservice to* the public interest and the interest of fund shareholders.

Sharply rising fund costs have widened the shortfall by which fund returns have lagged the returns earned in the financial markets; the age-old wisdom of long-term investing has been importantly crowded out by the folly of short-term speculation; and "product marketing" has superceded investment management as our highest value. The recent fund scandals provide tangible evidence of the triumph of managers capitalism over owners capitalism in mutual fund America, an unhappy parallel to what we have observed in corporate America itself.

These developments are indisputable, and they fly in the face of the very language of the Investment Company Act: Mutual funds must be "organized, operated, and managed" in the interests of their shareowners rather than in the interests of their "investment advisers and underwriters (distributors)"—a policy now honored more in the breach than in the observance. It is high time for a *new* Omega, an industry structure that would, paradoxically enough, parallel the Alpha structure under which MIT was created nearly eighty years ago.

The Development of MIT

Almost from its inception, MIT was a remarkable success. While in its first few years the going was slow, assets had soared to $3.3 million by the end of 1926. As the boom of the late 1920s continued, it flourished. It earned a return of 88% for its investors in 1926-28, only to lose 63% of their capital in the bust that followed in 1929-1932. But as the market recovered, its assets grew apace—to $128 million by 1936, and to $277 million by 1949, the largest stock fund in the industry throughout that entire period. MIT would maintain that rank until 1975, when its assets reached a total of $1.15 *billion*—a truly amazing half-century of preeminence.

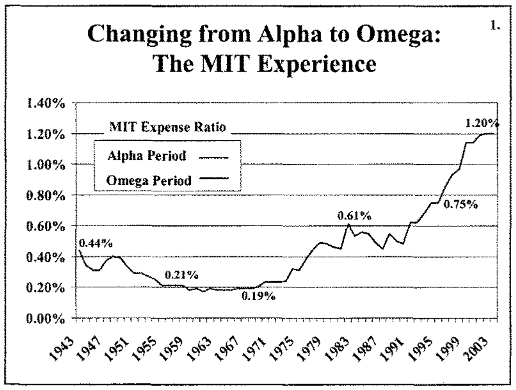
To its enviable status as both the oldest and largest mutual fund, MIT added the luster of consistently ranking as the lowest-cost fund. Its trustees soon reduced that original 6% fee to 5% of income, and then, in 1949, to 3.5%. Measuring its costs as a percentage of fund assets (now the conventional way we report expenses), the Trust's expense ratio fell from 0.50% in the early years to 0.39% in 1949, to a fairly steady 0.19% during 1960-1969. During that entire period MIT was publicly-offered through stock brokers by an underwriter originally named Learoyd-Foster, later to become Vance, Sanders & Co. Managed by its own trustees and unaffiliated with its distributor, the truly mutual structure of Massachusetts Investors Trust played a major role in its sustained leadership of the industry.

As 1969 began, then, MIT was an industry maverick. It stood for trusteeship, and did not engage in salesmanship. It kept its costs at rock-bottom levels. Its portfolio was broadly diversified and had little turnover. It invested for the long-term, and so did the shareholders who purchased its shares. And while virtually every other fund in the industry operated under the conventional structure with an external "management company" assuming full responsibility for its operations, investment advice, and share distribution in return for an *asset*-related—not *income*-related—fee paid by existing investors and a share of the sales loads paid by its new investors, MIT held to its own high standards and prospered—a success story, in its own way, for the idea that mutuality worked.

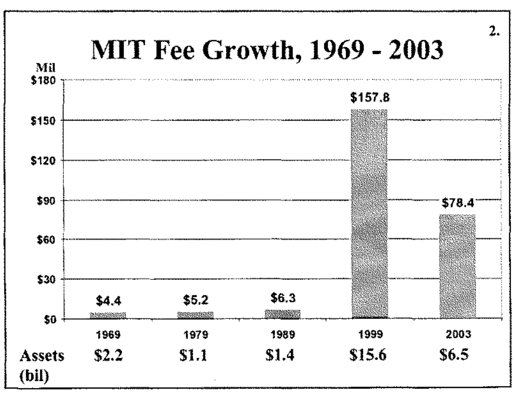
MIT – From Alpha to Omega

During 1969, however, the structure changed. The trustees solicited proxies from the shareholders of MIT (and its sister fund, Massachusetts Investors Growth Stock Fund—originally named "Massachusetts Investors Second Fund") for the approval to "demutualize" and adopt the conventional external management structure. When the shareholders approved the proposal, the Trust became a member of a fund family that adopted the name "Massachusetts Financial Services" (MFS). If MIT was a fund that for nearly a half-century had stood for something unique, in 1969 it became one of the crowd.

Was that change from Alpha to Omega good or bad? We can say unequivocally that, in terms of the fees it generated for its managers, it was *good*. We can also say unequivocally that in terms of the costs borne by its shareholders, it was *bad*. That 0.19% expense ratio in 1968 doubled to 0.39% in 1976, and doubled again to 0.75% in 1994, continuing to rise to 0.97% in 1998 and to 1.20% in 2003. **Exhibit 1**. And that old limit of 3.5% of income the trustees put into place in 1949? It was long gone. In 2002, in fact, MIT's expenses consumed precisely 80.4% of the trust's income.



But these ratios greatly *understate* the increase in the Trusts' costs. For even as its assets were growing, so were its fee *rates*, resulting in enormous increases in the *dollar amounts* of fees paid. With assets of $2.2 billion in 1969, MIT's management fees (including some relatively small operating expenses) totaled $4.4 million. **Exhibit 2.** Even a decade later in 1979, although the Trust's assets had *declined* by 50% to $1.1 billion after the 1973-74 market crash and the troubled times faced by the fund industry, fees had actually *risen* to $5.2 million. In 1989, with assets at $1.4 billion, fees continued to rise, to $6.3 million. And in 1999, when assets soared to $15.6 billion, fees totaled $158 million. While the Trust's assets had grown *seven-fold* since MIT demutualized in 1969, its fees had increased *36 times* over. (Assets slumped to $6.5 billion last year, with fees totaling nearly $80 million.)



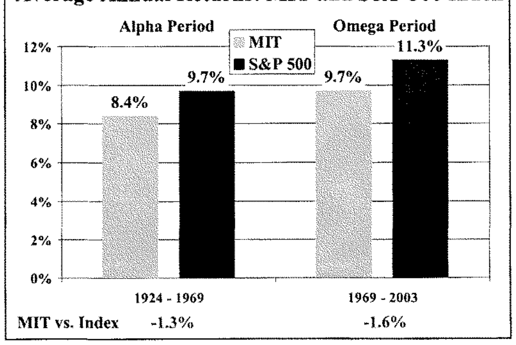
MIT's Long-Term Investment Record

What effect did the new structure have on MIT's shareholders? It is not difficult to measure. For MIT was the prototypical mutual fund, widely-diversified among about 100 blue-chip stocks and, unsurprisingly, provided returns that closely paralleled those of the Standard & Poor's 500 Stock Index (a 90-stock index until 1957), with an average correlation (R^2) of 0.94 that has remained remarkably steady over its entire 80-year history. Given the tautology that the gross return of the stock market, minus the costs of financial intermediation, equals the net return earned by market participants, it would be surprising if the rising costs that followed MIT's demutualization was not accompanied by a deterioration in the returns enjoyed by its shareowners.

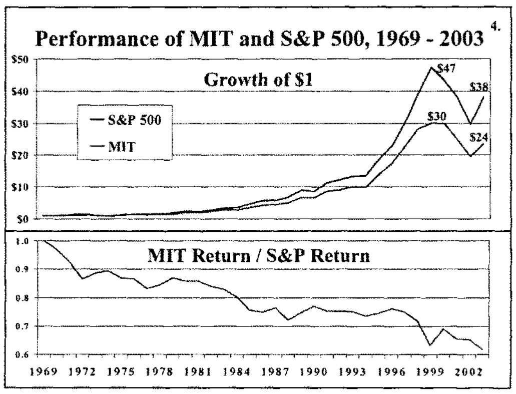
No surprise, then. The Trust's relative returns declined. During its mutual era (1925-1969), the Trust's average annual return of 8.4% lagged the Index return of 9.7%, by 1.3% per year. **Exhibit 3.** (Because the Index return ignores the real world costs of investing, of course, that shortfall may not be surprising.) But *after* demutualization (1969-2003), its average annual return of 9.7% lagged the Index return of 11.3% by 1.6% per year—an 0.3% reduction that exactly matches the increase in its average expense ratio from 0.3% in the 1925-1969 period to 0.6% in 1969-2003. (The ratio has risen to an estimated 1.2% in 2003, suggesting a much wider lag in the years ahead.)

3.

Average Annual Returns: MIT and S&P 500 Index



This increase in the shortfall in MIT annual returns during the Trust's 34-year Omega period may seem trivial. But it is not. **Exhibit 4.** Thanks to the miracle of compounding *returns*, each $1 initially invested in the Standard & Poor's Index at the end of 1969 would have been valued at $38 at the end of 2003. Confronted by the tyranny of compounding *costs* over that long period, however, each $1 invested in Massachusetts Investors Trust would have had a final value of just $23.60—a 38% loss of principal in relative terms.



The Wellington Group – From Omega to Alpha

Even as MIT was abandoning its Alpha mutual structure in favor of an externally-managed Omega structure in 1969, the stage was being set for another firm to take precisely the opposite action. Philadelphia's Wellington Group—eleven associated mutual funds with assets of some $2.4 billion (over $1 billion behind the then-combined total of $3.5 billion for MIT and its sister growth fund)—was operated by Wellington Management Company, then largely owned by its executives but with public shareholders as well. Its stock had recently sold at an all-time high of $50 per share, nearly three times its initial public offering price of $18 in 1960. Despite the travail that followed the demise of the Go-Go years, the stock market was again rallying, on the way to its then all-time high early in 1973, and the company was prospering.

With the so-called "currency" that its public stock had made available, Wellington Management had merged with the Boston investment counsel firm of Thorndike, Doran, Paine and Lewis, Inc., in 1967. TDP&L was also the manager of Ivest Fund, a "go-go" fund that was one of the industry's premier performers during that era of speculation, and it soon became a major generator of the Wellington Group's capital inflows. And yet, even as MIT had just gone in the opposite direction, the Wellington CEO (and also the Chairman and President of Wellington *funds*)[1] was pondering whether this Omega structure was the optimal one for the funds' shareholders, and whether a change to the recently-vanished Alpha structure would improve both the lot of its fund shareholders as well as the firm's competitive position in the industry.

In September 1971, he went public with his concerns. Speaking at the annual meeting of the firm's partners, he talked about the possibility of mutualization, beginning his remarks with a 1934 quotation from Justice Harlan Fiske Stone: "Most of the mistakes and major faults of the financial era that has just drawn to a close will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters' . . . Those who serve nominally as trustees but consider only last the interests of those who funds they command suggest how far we have ignored the necessary implications of that principle."

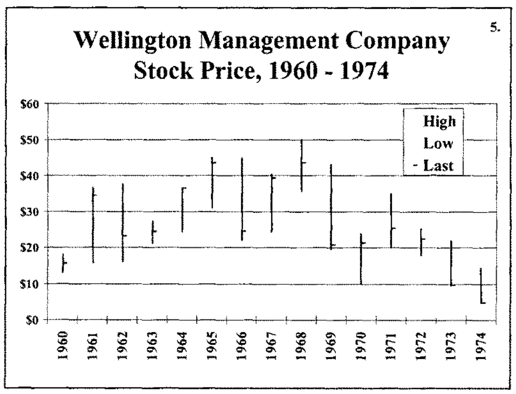
The Wellington CEO endorsed that point of view, and revealed what he described as "an ancient prejudice of mine: *All things considered, it is undesirable for professional enterprises to have public shareholders*. Indeed it is possible to envision circumstances in which the pressure for earnings growth engendered by public ownership is antithetical to the responsible operation of a professional organization. Although the field of money management has elements of both a business and a profession, any conflicts between the two must, finally, be reconciled in favor of the client."

He then tranced on some ideas about how such a reconciliation might be achieved: (1) "a mutualization, whereby the funds acquire the management company;" (2) "internalization, whereby the active executives own the management company, with contracts negotiated on a 'cost-plus' basis, with incentives for both performance and efficiency, but without the ability to capitalize earnings through public sale;" and (3) limited internalization, with funds "made self-sustaining with respect to administration and distribution, but with external investment mangers."

Omega to Alpha

[1] It was I who served in these positions, but I feel more comfortable using the third person format. This combination of seemingly conflicting roles, was then, and remains now, the industry norm.

Within three years, the CEO was put in a position in which he would not only *talk the talk* about mutualization, but would *walk the walk.* Even before the 1973-74 bear market began, Wellington's business had begun to deteriorate and the cash *inflows* of the Wellington funds, $280 million in 1967, had by 1973 turned to cash *outflows* of $300 million. The speculative funds created by the firm were suffering serious capital erosion, and most would be merged out of existence before the decade was out. Assets of the conservative Wellington Fund flagship had tumbled from $2 billion in 1965 to less than $1 billion, on the way to $480 million in 1980. Earnings of $2.52 per share in 1968 would drop to $1.14 in 1974, and the stock price had fallen to $9.75 per share, on its way to a low of $4.87. **Exhibit 5.** This concatenation of dire events was enough to cause the happy partnership formed by the 1967 merger to fall apart, and Wellington Management Company's CEO got the axe on January 23, 1974. But he remained as chairman of the funds, with their largely separate (and independent) board of directors.



Shortly before the firing, the handwriting was on the wall, as it were, suggesting the nature of the change that might be in store. On January 12, 1974, the CEO had submitted a proposal to the *mutual fund* board of directors to mutualize the funds, and operate under an internally-managed structure. "I propose," he wrote, "to have the Wellington Group of mutual funds acquire Wellington Management Company and its business assets . . . The Funds would pay an estimated $6 million (the adjusted market capitalization of the company's stock[2]) and would receive liquid and fixed assets of $4 million, with the remaining $2 million representing

[2] Under the proposal, the Funds would acquire only Wellington's *mutual fund* business. Its counseling business would have been returned to the pre-merger partners.

the 'going concern' value (or goodwill) of the enterprise . . . Wellington Management would become a wholly-owned subsidiary of the funds and would serve as investment adviser and distributor on an 'at-cost' basis, resulting in estimated savings of $2 to $3 million per year."

One need only understand the stunningly high profit margins of the investment management business in order to imagine a less-than-*one-year*(!) payback of the net acquisition cost of $2 million. While Wellington's stock price had tumbled, and its fee revenues had declined, the firm's pre-tax profit margin nonetheless remained at a healthy 33%. (Revenues $9.6 million, expenses $6.4 million, profits $3.2 million). While the fund chairman openly acknowledged that such a conversion to mutual status was "unprecedented in the mutual fund industry," the cautious fund board was interested enough to ask him to expand the scope of his proposal and undertake "a comprehensive review of the best means by which the funds could obtain advisory, management and administrative services at the lowest reasonable costs to the fund shareholders." The board also asked Wellington Management Company to produce a similar study.

By March 11, the chairman's first report was completed. Entitled "The Future Structure of the Wellington Group of Investment Companies," the report offered seven structural options, of which the board decided to focus on these four:

1. **Status Quo—the continuation of the existing relationships.**
2. **Internal Administration—administration by the funds themselves; distribution and investment advice from Wellington Management.**
3. **Internal Administration and Distribution—with only investment advice from Wellington.**
4. **Mutualization—acquisition by the funds of all of Wellington's fund-related activities.**

The Future Structure study spelled out the ultimate objective: *Independence.* The goal was "to give the funds an appropriate amount of corporate, business, and economic independence," the chairman wrote, noting that such a structure was clearly contemplated by the Investment Company Act of 1940. But such independence, his study added, had proved to be an illusion in the industry, with "funds being little more than corporate shells . . . with no ability to conduct their own affairs . . . This structure has been the accepted norm for the mutual fund industry for more than fifty years."

"The issue we face," he bluntly concluded, "is whether a structure so traditional, so long accepted, so satisfactory for our infant industry as it grew during a time of less stringent ethical and legal standards, is really the optimal structure for these times and for the future—or whether the funds should seek the greater control over their own destiny so clearly implied by the word *independence*." While the fund chairman clearly preferred his original proposal of mutualization, he was prepared to begin with less, concluding the study with these words, "perhaps, then, the issue is not *whether*, but only *when* the Wellington Group will become completely independent."

As it would soon turn out, he would have to be content with less than full mutualization. After much study, even more contention, and debate that sometimes seemed to be endless, the board made its decision on June 11, 1974. It chose the least disruptive option, #2, establishing the funds' own administrative staff under the direction of its operating officers, who would also be responsible, as the board's counsel, former SEC Commissioner Richard B. Smith wrote, "for monitoring and evaluating the external (investment advisory and distributors) services provided" by Wellington Management. The decision, the counselor added, "was *not* envisaged as a 'first step' to internalize additional functions, but as a structure that . . . can be expected to be continued into the future."

Enter Vanguard

Late in the summer, to the chairman's amazement and disappointment, the board agreed that Wellington Management Company would retain its name. While Wellington Fund would also retain *its* name, a new name would have to be found for the administrative company. In September, he proposed to call the new company "Vanguard" and, after more contention, the board approved the name. The Vanguard Group, Inc. was incorporated on September 24, 1974. Early in 1975, the SEC cleared, without apparent difficulty, the funds' proxy statements proposing the change; the fund shareholders approved it; and Vanguard, a wholly-owned subsidiary of the funds operating on an at-cost basis, began operations on May 1, 1975.

But no sooner than the ink was dry on the various agreements, things began to change. With the funds controlling only one leg—and, arguably, the least important leg—of the operations/investment management/distribution tripod on which any fund complex rests, the chairman began to have second thoughts. As he would later write, "It was a victory of sorts, but, I feared, a Pyrrhic victory . . . I had realized all along that the narrow mandate that precluded our engaging in portfolio management and distribution services would give Vanguard insufficient power to control its destiny . . . Why? Because success in the fund field is *not* driven by how well the funds are administered. Though their affairs must be supervised and controlled with dedication, skill, and precision, success is determined by what kinds of funds are created, by how they are managed, by whether superior investment returns are attained, and by how—and how effectively—the funds are marketed and distributed. We had been given one-third of the fund loaf, as it were, but it was the least important third. It was the other two-thirds that would make us or break us."

The next one-third of the loaf was seized quickly. The newly-named Vanguard Group's entry into the investment management arena came in a groundbreaking way. Only a few short months after the firm began operations, the board of the funds approved the creation of an index fund, modeled on the Standard & Poor's 500 Stock Index. It was incorporated late in 1975. When its initial public offering was completed in August 1976, it had raised a disappointing $11 million. But the world's first index mutual fund had come into existence. It is now the largest mutual fund in the world.

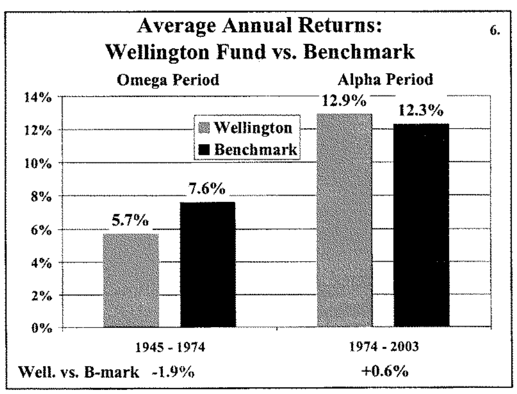
Only five years after that halting entry into what was, arguably, equity investment management, the firm assumed full responsibility for the management of Vanguard's bond and money market funds. A decade later, Vanguard began to also manage equity funds that relied on quantitative techniques rather than fundamental analysis. A variety of external advisers continue to manage Vanguard's actively-managed equity and balanced funds, now constituting some $180 billion of the Group's $700 billion of assets. (Wellington Management continues to manage Wellington Fund, as it has throughout the fund's now-75 year history.)

Improved Returns in a Full-Fledged Alpha Complex

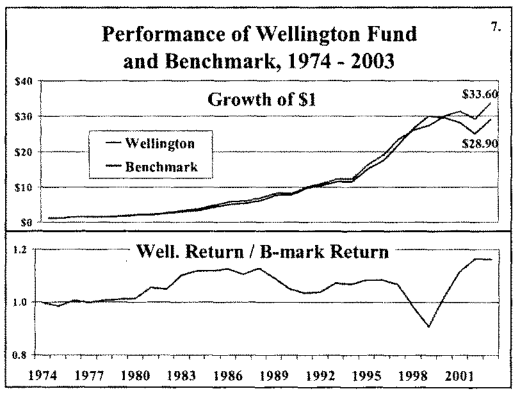
The final one-third of the mutual fund loaf was acquired only five months after the index fund IPO had brought investment management under Vanguard's aegis. On February 9, 1977, yet another unprecedented decision brought share distribution into the fold. After yet another contentious debate in a politically-charged environment, and by the narrowest of margins, the fund board accepted the chairman's recommendation that the funds terminate their distribution agreements with Wellington Management, eliminate all sales charges, and abandon the broker-dealer distribution system that had distributed Wellington shares for nearly a half-century. Overnight, Vanguard had eliminated its entire distribution system, and moved from the seller-driven, load-fund channel to the buyer-driven, no-load channel. Narrow as the mandate was, it set the fledgling organization on a new and unprecedented course.

What would the flourishing of Vanguard into a full-fledged Alpha complex—its full mutualization—mean to its fund investors? First, it would mean far lower fund operating expenses, with the group's weighted expense ratio tumbling from an average of 0.67% in 1975 to 0.26% in 2002—a reduction of more than 60%. Second, it would mean that the earlier 8½% front-end load—and the performance drag on shareholder returns inevitably entailed by that initial sales charge—would be forever removed. And since gross returns in the financial markets, minus costs, equal the net returns earned by investors, this slashing of costs was virtually certain to enhance shareholder returns.

And that's just what Vanguard's change from Omega to Alpha did. What followed over the subsequent 29 years was a major enhancement in the *absolute* returns (sheer good luck!) and the *relative* returns earned by Wellington Fund. Specifically, this balanced fund provided an annual return of 12.9% from 1974-2003, actually *outpacing* the 12.3% annual return of its unmanaged (and cost-free) benchmark—35% Lehman Aggregate Bond Index, 65% Standard & Poor's 500 Stock Index, an allocation comparable to Wellington's—and by a wider margin the 11.1% rate of return earned by the average balanced fund. **Exhibit 6.** During the comparable prior period (1945-1974) under the Omega structure, the Fund's return of just 5.7% had actually *lagged* the benchmark return of 7.6% by a full 1.9 percentage points per year.



Part of that near-miraculous 2.5 percentage point *annual* improvement in relative returns—a staggering margin—was related to lower costs. The Fund's average expense ratio, low enough in the earlier period at 0.56%, fell 20% to 0.45%, and the sales charge drag was eliminated. But the largest part of the improvement arose from a 1978 change in the Fund's investment strategy, in which the *Fund's* management directed its reluctant adviser to return Wellington to its traditional conservative, income-oriented policies from which it had strayed during the late 1960's and 1970s. Result: by the end of 2003, each $1 invested in Wellington Fund in 1974 would have grown to $33.60. **Exhibit 7.** The same investment in the balanced index benchmark, on the other hand, would have grown to just $28.90. (A similar investment in the average balanced fund would have grown to just $20.96—about 40% *below* Wellington's value.) The lower chart presents a stunning contrast with the lower chart on Exhibit 4 on page 6.



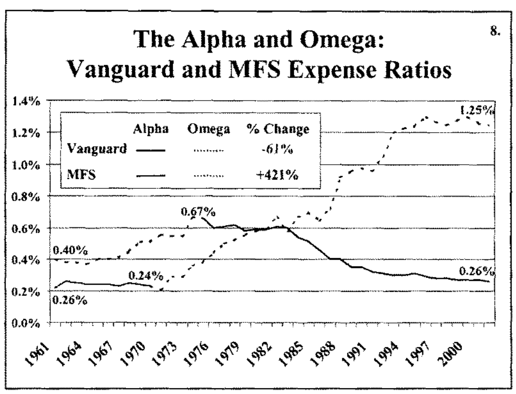
Other than the direct impact of costs, it is not easy to characterize "cause and effect" in the attribution of investment performance. While Wellington Fund's return to its conservative investment tradition was a major benefit, the new Alpha structure itself, under which Wellington Management became an external investment adviser that *had* to perform in order to retain its independent client, could well have itself provided a major benefit. While we can't be certain, the development of the arms-length relationship that is part of the Alpha model clearly did no harm.

Alpha vs. Omega: Lower Costs and Higher Market Share

Whatever the case, we do know that there is a powerful and pervasive relationship between expense ratios and fund net returns. We know, for example, that the correlation coefficient of the ten-year returns of individual equity funds and their costs is a remarkably impressive *negative* 0.60. We also know that during *each* of the past two decades the returns of the equity funds in the *low-cost* quartile have consistently outpaced the returns of funds in the *high-cost* quartile by an enormous margin of about 2½% per year. *The higher the cost, the lower the return.* And it is crystal clear that the Alpha model of fund operations is, well, cheap, while the Omega model is dear.

The contrast in costs could hardly be sharper than in the two fund complexes we have just considered. Both were dominated by a single mutual fund until the 1960s, before becoming more and more diversified fund complexes thereafter. Both had roughly comparable assets under management up until the 1980s—in the hundreds of millions in the 1950s, then the billions in the 1960s and 1970s, growing to the tens of billions in the 1980s. Then their paths diverged. While Massachusetts Financial Services enjoyed solid asset growth to some $94 billion at the market's peak in 2000, Vanguard grew even faster, then overseeing some $560 billion of assets.

Late in their Alpha period, the asset-weighted expense ratio of the MFS funds averaged less than 0.25%. Under its new Omega model, the MFS ratio jumped to 0.67% in 1984, to 0.92% in 1988, to 1.20% in 1993, and to 1.25% in 2002, an *increase* of 421% for the full period. **Exhibit 8.** By way of contrast, late in their Omega period the Vanguard funds' ratio averaged about 0.60%. Under its new Alpha structure, the Vanguard ratio tumbled to 0.54% in 1984, to 0.40% in 1988, and to 0.30% in 1993, continuing to drop in 2002 to just 0.26%, a *reduction* of 61% from the pre-Alpha rate.

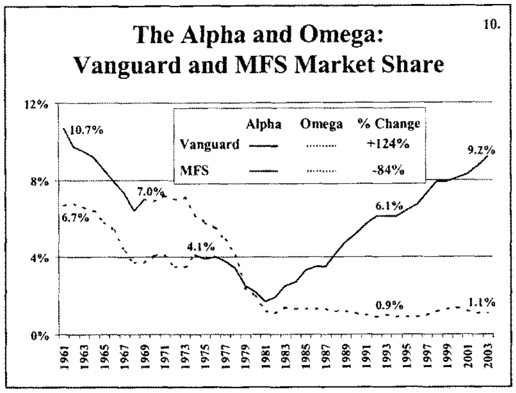


These ratios may seem diminutive and trivial, but they are not. They entail hundreds of millions, even billions, of dollars. In 2003, the assets of the Omega MFS funds totaled $78 billion, and their 1.25% expense ratios, including management fees, 12b-1 fees, and operating costs, totaled $975 million. Had their earlier 0.25% ratio prevailed, those costs would have been just $195 million, a remarkable $780 *million*(!)saving. **Exhibit 9.** Again by way of contrast, assets of the Alpha Vanguard funds totaled $667 billion in 2003; with expenses of $1.7 billion, the expense ratio was 0.26%. Had the earlier 0.60% ratio under its Omega structure prevailed, Vanguard's expenses would otherwise have been $4.0 billion, representing $2.3 *billion* of additional costs that would have been incurred by its fund shareholders.

The Manifestation of the Alpha Benefit 9.

	MFS	Vanguard
2003 Assets	**$78 B**	**$667 B**
Omega Exp. Ratio	**1.25%**	**0.60%**
Fees Generated	**$975 M**	**$4,000 M**
Alpha Exp. Ratio	**0.25%**	**0.26%**
Fees Generated	**$195 M**	**$1,700 M**
Savings Under Alpha Structure	**$780 M** (projected)	**$2,300 M** (actual)

Even as Vanguard, under its Alpha structure, did *good* in building value for its fund shareholders, it did *well* in implementing its business strategy. Assets under management have grown from $1.4 billion in 1974 to nearly $700 billion currently, and its share of mutual fund industry assets has soared. While a late entry into the money market business resulted in a plunge in its market share from 3.5% in 1974 to 1.7% in 1981, the rise since then has been unremitting, consistent, and powerful. **Exhibit 10.** As 2004 begins, Vanguard's share of industry assets stands at 9.2%—by far the largest market share increase achieved by any mutual fund firm.



The growth of MFS assets, too, has been awesome—from \$3.3 billion in 1969, when it abandoned its original Alpha structure, to \$78 billion currently. But its original 7.0% market share began to shrink within a few years after the change, falling to just 1.1% in 1982, where it remains today. To the extent that we can measure it, then, under the Omega strategy—which is of course the strategy that is pervasive in the industry—the MFS transition from its original roots has not only resulted in increased costs and reduced returns for its fund shareholders, but proved to be a losing strategy in the highly competitive mutual fund marketplace.

Nonetheless, the Omega strategy does have something very important going for it: It is immensely profitable for the funds' *managers*. Immediately after its demutualization in 1969, MFS remained a private company, with its profits divided among its own executives and employees. But in 1981, in a curious twist, the firm sold itself to Sun Life of Canada, which remains its owner today (MFS executives now hold about 8% of its stock). According to Sun Life's financial statements, the pre-tax earnings of MFS during the five year period 1998-2002, totaled \$1,924,000,000, certainly a splendid return on their initial (but undisclosed) capital investment—a near \$2 billion gold mine for the Sun Life shareholders.

Tested in the Crucible

Both the Alpha fund model and the Omega fund model have been tested over almost the entire 80-year history of the industry. (1970-1974 was the only period in which no Alpha model existed.) The 45-year preeminence that MIT achieved from 1924 to 1969, to say nothing of the flourishing of Vanguard almost from the day it was created, hardly suggest major flaws in the Alpha model. Yet the economics of the business remain a major stumbling block to the creation of new Alpha organizations. If funds are run at cost, after all, there are no profits for the management company owners. It is hardly surprising, then, that Vanguard's structure has yet to be copied, or even imitated.

It is a curious paradox that the transformation of MFS from the Alpha model to the Omega model was accomplished with apparent ease. Vanguard's conversion from Omega to Alpha, however, was fraught not only with contention and debate, but with regulatory opposition. While the internalization of the *administration* of the Wellington funds was straight-forward, and even the internalization of the *management* of the index fund raised no regulatory eyebrows, the decision to internalize *distribution* was a bombshell. It was opposed by a Wellington Fund shareholder, who called for—and received—a formal SEC administrative hearing, which, was said to be the longest hearing in the history of the Investment Company Act, lasting, if memory serves, something like ten full days in court, and a long period of examination by the regulators. Finally, in July 1978, after considering the issues, the Administrative Law Judge who presided at the hearing made his decision on our application for the Vanguard funds to jointly assume financial and administrative responsibility for the promotion and distribution of our shares: *Rejection*! We were back to square one.

At issue was a long history during which the SEC had successfully argued that funds could not spend their own assets on distribution. (Clearly all major fund complexes were making such expenditures, but it was successfully, if problematically, argued that the managers were paying the distribution costs out of their own profits.) Shortly after we made the no-load decision in February 1977, we had asked for an exemption that would allow the funds to spend a limited amount (a maximum of 0.20% of net assets) on distribution. While our argument in favor of this plan was somewhat technical, it came down to the fact that while we would spend $1.3 million on distribution, we would simultaneously slash by $2.1 million the annual advisory fees paid to Wellington Management for that purpose: Assuming responsibility for distribution would result, not in a cost to the funds' shareholders, but in a net *savings* of $800,000 per year.

Happily, the SEC had allowed us to temporarily pursue our distribution plan pending Commission and fund shareholder approval. So Vanguard had in fact been running the distribution system since 1977. Despite his rejection of our plan, the judge gave us the opportunity to amend it, and after making a few technical changes, we resubmitted it early in

1980. With this sword of Damocles suspended above us during this long period, we blithely pursued our distribution activities. The threatening sword was finally removed on February 25, 1981, when the Commission at last rendered its decision.

The decision was a home run for Vanguard! Far better than any characterization I could use to describe the decision, the Commission's words speak for themselves:

> "The Vanguard plan is consistent with the provisions, policies and purposes of the Act. It actually furthers the Act's objectives by ensuring that the Funds' directors, with more specific information at their disposal concerning the cost and performance of each service rendered to the Funds, are better able to evaluate the quality of those services.
>
> "The plan will foster improved disclosure to shareholders, enabling them to make a more informed judgment as to the Funds' operations. In addition, the plan clearly enhances the Funds' independence, permitting them to change investment advisers more readily as conditions may dictate. The plan also benefits each fund within a reasonable range of fairness.
>
> "Specifically, the Vanguard plan promotes a healthy and viable mutual fund complex within which each fund can better prosper; enables the Funds to realize substantial savings from advisory fee reductions; promotes savings from economies of scale; and provides the Funds with direct and conflict-free control over distribution functions.
>
> "Accordingly, we deem it appropriate to grant the application before us."

The decision was unanimous. We had at last formally completed our move from the original Omega model under which we had operated for nearly a half-century, to a full-fledged Alpha mutual fund model. Our joy was profound and unrestrained, and our optimism about the future was boundless.

An Elementary Principle, Too Often Ignored

The Commission's decision, in its own blunt words, was based on *"one of the 1940 Act's basic policies: that funds should be managed and operated in the best interest of their shareholders, rather than in the interests of advisers, underwriters, or others."* And that would also seem to be the most elementary principle of the common law as it relates to fiduciary duty and trusteeship. And yet it must have been obvious to the Commissioners that while they had just approved our Alpha model, the entire rest of the industry was operating under an Omega model in which the advisers and underwriters—the funds' management companies—were in the driver's seat.

Fully 15 years earlier, in fact, the SEC had vigorously recommended legislative changes that were designed to restore a better balance of interest between shareholders and managers. In *Public Policy Implications of Investment Company Growth*, a report to the House Committee on Interstate and Foreign Commerce dated December 2, 1966, the Commission pointedly noted that "internally managed companies which had their own staff had significantly lower management costs than externally managed funds compensated by fees based on a fixed percentage of the fund's assets."

After considering the level of fund fees ($130 million a year seemed large in 1966; but by 2003, fees had soared to $32 *billion*), the far lower fee rates paid by pension plans and internally managed funds, the then-average 48%(!) pre-tax profit margin earned by publicly-held management companies, and the effective control advisers held over their funds, as well as "the absence of competitive pressures, the limitations of disclosure, the ineffectiveness of shareholder voting rights, and the obstacles to more effective action by the independent directors," the SEC recommended the adoption of a "statutory standard of reasonableness," which it described as a "basic fiduciary standard that would make clear that those who derive benefits from their fiduciary relationships with investment companies cannot charge more for services than if they were dealing with them at arm's length."

The SEC described reasonableness as "a clearly expressed and readily enforceable standard that would measure the fairness of compensation paid for services furnished by those who occupy a fiduciary relationship" to the mutual funds they manage. This standard "would *not* be measured merely by the cost of comparable services to individual investors or by the fees charged by other externally managed investment companies . . . (but by) the costs of management services to internally managed funds and to pension funds and other non-fund clients . . . (and) their benefit to fund shareholders . . . (including) sustained investment performance."

"The Commission is not prepared to recommend at this time the more drastic statutory requirement of compulsory internalization and the performance of services at cost," the SEC report added, for it "might be more costly for smaller funds . . . or could be insufficient to provide an adequate full time staff . . . (and) might prove a determent to the promotion of new investment companies." Accordingly, the Commission believed that, "an alternative to the more drastic solution of compulsory internalization should be given a fair trial." If the standard of reasonableness does not "resolve the problems in management compensation that exist . . . *then more sweeping steps might deserve to be considered.*"

Alas, the Commission's "reasonableness" proposal was never put to the test. The industry fought hard, and lobbied the Congress vigorously. Finally, five years later, in the Investment Company Amendments Act of 1970, the Commission had to settle for a weak provision in which the investment adviser was charged with "a fiduciary duty with respect to the compensation for services," with damages limited to the actual compensation received, and with no definition of what might constitute reasonableness. And even 33 years later, "more sweeping steps" have yet to be considered.

In its 1966 report, the SEC had also expressed concerns about the growing trend of sales of management companies to other firms at prices far above book value, transfers the Commission opined, that have "some elements of the sale of a fiduciary office, (which is) *strictly prohibited under Common Law.*" It also expressed a concern about earlier "widespread 'trafficking' in advisory contracts." The Commission recommended that the sale of a management company could not take place if it came with "any expense or implied understanding . . . likely to impose *additional* burdens on the fund." (Italics supplied.) The implication that funds were *already* bearing heavy burdens would have been lost on few observers, and even that protection was diluted in the subsequent legislation.

Had the initial SEC recommendations prevailed, they may well have aborted the accelerating trend toward higher fund expense ratios that today seems endemic in the fund industry. The *unweighted* expense ratio of 0.87% for the average equity fund that concerned the Commission in 1965 has risen by 86%, to 1.62%. (For those who think that *asset-weighted* expense ratios are a better test, the increase was from 0.51% to 0.95%—the same 86% increase!)

But we deceive ourselves when we look at fee *rates* instead of fee *dollars*. When applied to the burgeoning assets of equity funds ($26.3 *billion* in 1965 and $3.36 *trillion* in 2003), equity fund expenses have leaped from $134 million in 1965 to an estimated $31.9 billion in 2003. **Exhibit 11**. That fund expenses have risen 238-fold(!) since 1965, nearly double the 128-fold increase in equity fund assets. In a field in which, as today's lone Alpha fund complex demonstrates, the economies of scale in fund operations are truly staggering, it is a truly astonishing anomaly.

Where are the Economies of Scale? 11.

	1965	2003	Change
Total Equity Assets	**$26.3 B**	**$3,361 B**	+128 x
Average Exp. Ratio	**0.87%**	**1.62%**	**+86%**
Wtd.· Exp. Ratio	**0.51%**	**0.95%**	**+86%**
Fees Generated	**$134 M**	**$31,900 M**	**+238 x**

Weighted by fund assets.
Fees generated uses weighted average.

Further, the SEC's 1966 concern about trafficking in advisory contracts could hardly have been more prescient. Although a number of fund management firms had gone public with IPOs by then, the large majority remained privately-held. Today, only *six*(!) privately-held firms remain (seven if we include Vanguard) among the largest 50 fund managers. Another seven are publicly-held, and fully 36 are owned by giant financial conglomerates, from Sun Life and Marsh and McLennan, to Deutsche Bank, and AXA, to Citicorp and J.P. Morgan. With these consummate *business* firms in control, it is small wonder that the idea of fund management as a *profession* is gradually receding. Using the words I used in my 1971 speech, these firms are "the financial heirs of the (original mutual fund) entrepreneurs . . . if it is a burden to (fund shareholders) to be served by a public enterprise, should this burden exist in perpetuity?"

Apparently the burden *should.* For such trafficking takes place with the tacit consent of fund directors, who seem all too willing to ignore the burdens imposed on funds that are part of giant conglomerates—firms whose overriding goal is a return on *their* capital, even at the expense of the returns on the *fund shareholders'* capital. When such transfers are proposed, fund directors could easily insist on fee reductions—or even mutualization—but they have *never* done so. In a recent sale (for $3.2 billion!) of a large fund manager to Lehman Brothers, the earlier fee structure remained intact. So far, at least, the directors seem disinclined to act even when a scandal-ridden firm is on the auction block (Strong Management) or is already part of a conglomerate (Putnam, which has delivered nearly $4 billion of pre-tax profits to Marsh and McLennan over the past five years.) The idea that "the burdens of public ownership *should* exist in perpetuity" has yet to be challenged.

It Is Time For Change

It is time for change in the mutual fund industry. We need to rebalance the scale on which the respective interests of fund managers and fund shareholders are weighed. Despite the express language of the 1940 Act that arguably calls for *all* of the weight to be on the side of fund shareholders, it is the managers' side of the scale that is virtually touching the ground. To get a preponderance of the weight on the shareholders' side, we need Congress to mandate: (1) an independent fund board chairman; (2) no more than a single management company director; (3) a fund staff or independent consultant that provides objective information to the board; and (4) a federal standard that, using the Act's present formulation, provides that *directors have a fiduciary duty to assure that* "funds are organized, operated, and managed in the interests of their shareholders" rather than in the interests of "their advisers and distributors." (The italicized language would be added to the statute.)

As I wrote five years ago in *Common Sense on Mutual Funds,* changes such as these would at long last allow independent directors "to become ferocious advocates for the rights and interests of the mutual fund shareholders they represent . . . they would negotiate aggressively with the fund adviser . . . they would demand performance-related fees that enrich managers only as fund investors are themselves enriched . . . They would challenge the use of 12b-1 distribution fees . . . and no longer rubber-stamp gimmick funds cooked-up by marketing executives . . . becoming the fiduciaries they are supposed to be under the law."

Alternatively, and perhaps even more desirably, I then argued, the industry may require "a radical restructuring—the mutualization of at least part of the mutual fund industry . . . Funds—or at least large fund families—would run themselves; and the huge profits now earned by external managers would be diverted to the shareholders . . . they wouldn't waste money on costly marketing companies designed to bring in new investors at the expense of existing investors. With lower costs, they would produce higher returns and/or assume lower risks. But regardless of the exact structure—(a new) conventional form or a truly mutual form—an arrangement in which fund shareholders and their directors are in working control of a fund will lead . . . to an industry that will enhance economic value for fund shareholders." And it is in that direction that this industry must at last move.

How to Get from Omega to Alpha

During its 45 years of existence, the Alpha operating model instituted by MIT nearly 80 years ago worked well for its shareholders. Similarly, during Vanguard's soon-to-be 30 years of existence, our Alpha model has resulted in amazingly low costs for shareholders, and generally superior returns compared to peer funds, to say nothing of a spectacular (and unmatched) record of asset growth and enhanced market share. As an illustration of a demonstrably winning strategy for fund shareholders, our Alpha model has met the test of time.

Of course, we have enjoyed an advantage some of our rivals have described as "unfair." Since the fund shareholders own Vanguard—lock, stock, and barrel—*none* of their investment returns have had to be diverted to the owners of a management company—private, public, or financial conglomerate, whatever the case may be. Put another way, our structure has been an essential element in the returns that our shareholders have enjoyed. It shouldn't surprise anyone, for as the economist Peter Bernstein has observed, "What happens to the wealth of individual investors cannot be separated from the structure of the industry that manages those assets."

With MIT long since having abandoned the Alpha model, Vanguard alone has remained to test it. With this single exception, it is the Omega model that prevails. *But I simply cannot accept that today's model can be, as the word "Omega" suggests, the final stage of the mutual fund industry's development.* That this model has ill-served fund investors could hardly be more obvious. This industry's present high level of operating and transaction costs have led—as they must—to a lag in the returns of the average equity fund of some three percentage points per year behind the stock market itself over the past two decades, with similar cost-related lags for the industry's bond funds and money market funds. And our focus on asset-gathering and marketing has helped to create an even larger lag—at least *another* six or eight percentage points behind the returns of the stock market itself, there for the taking—for the average equity fund *shareholder*.

I have no illusions that a return of industry to its original Alpha model will be easy—not in the face of the powerful forces that are entrenched in this industry and whose economic interests are at stake. But I believe that this is the direction in which shareholders, competition, regulation, and legislation will move. While we won't get all the way to that goal in my lifetime, and maybe not even in my children's, I'm certain that investors will not ignore their own economic interests *forever*.

However, if Congress acts to impose on fund directors the responsibilities that so many of us believe they have always held but rarely exercised, I see no reason that full mutualization should be mandated by law. As long as advisory firms are owned by managers who act responsibly and put the interests of their fund shareholders first, and who make manifest their dedication to that proposition in their actions—self-imposed limits on fees and on marketing activities, focus on long-term investment strategies, and superior service to their shareholders—mutualization hardly need be considered. On the other hand, when a fund complex reaches a certain size or age—when it has become more *business* than *profession*—it is high time to demand that mutualization—the Alpha model—be placed on the board agenda, and honestly and objectively considered. It won't be easily done, of course, and literally *no one* in this industry knows as well as I do the obstacles that may be faced in reaching that goal. But if there is a will, there will be a way.

Structure, Strategy, and Spirit

Yet please understand me: While the Omega structure has caused many of the mutual fund industry's serious shortcomings in serving our shareholders, the Alpha structure is hardly a panacea that will cure them. For a mutualization *structure* in which interests of fund shareholders are placed front and center is, in and of itself, not enough. Without the proper *strategy,* such a structure will lead nowhere. In the ideal, the strategy of mutualization would emphasize low operating costs and more, well, Spartan operations, a minimization of the dead weight of marketing costs, and investment policies for stock, bond, and money market funds alike that focus on the wisdom of long-term investing rather than on the folly of short term speculation.

Strategy, alas, does not necessarily follow structure. One need only look at the life insurance field to see how its sensible mutual structure, finally, came to fail. With their heavy emphasis on sales and their apparent lack of concern about costs, nearly all of the giant mutual life insurance companies relinquished the *strategy* of service to policyholders long before they abandoned their original Alpha *structure,* and this dominant industry of a half-century ago has lost much of its earlier appeal to American families.

But even more than *structure* and *strategy* to get today's Omega mutual fund industry back to its Alpha origins, we need the *spirit* of mutuality—a spirit of trusteeship, a spirit of fiduciary duty, an all-encompassing spirit of *stewardship*—a spirit of service to the 90 million shareholders who have entrusted the mutual fund industry with their hard-earned dollars. As the recent scandals show, we need regulation to curb our avarice. As our record since the publication of the SEC's 1966 report has made clear, we need legislation to improve our governance structure, a major step towards the ideal Alpha structure whose development I have described today. But no regulation, no legislation, can mandate a spirit of trusting and being trusted. Trust must come from within the character of the organization—whether Omega or Alpha—and those firms that evince the spirit of trust will ultimately dominate the mutual fund field. Our industry's future depends on the simple recognition that the management of Other People's Money is a loyal duty and solemn trust.

TESTIMONY OF PETER T. SCANNELL

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

January 27, 2004

Mr. Chairman,
Committee Members and
Senators,

I would like to thank you for this extraordinary opportunity to come before you and share my experience as both an "insider" and "outsider" in the Mutual Fund Industry.

If I were told a year ago that I would be present at a Senate Sub-Committee Hearing concerning abuses in the Mutual Fund Industry I would not have believed it possible.

I was already aware of market timing abuses at Putnam Investments, and had been since April 2000. My fear was that market timing in a mutual fund, whose prospectus clearly states it is a prohibited transaction, was occurring throughout the industry. This was a seemingly accepted practice for those investors with influence and money and I believed that any attempt to by me to expose market timing would be dismissed.

For years there has been a "conspiracy of silence" in the Mutual Fund Industry – "no news was good news" for both the industry and regulators. A tangled web has been woven and it is imperative that we fully understand the scope and depth of these abuses. We have a window of opportunity, "a once in an Investor's Lifetime Opportunity" to address the integrity of this industry and to make sure that every step will be taken to protect the American Investor.

Senators, would you please indulge me for a few moments so that I can relate to you the circumstances that bring me here today. It is important that you have an idea of who I am and why I would be the first person inside a mutual fund company to come forward with allegations of abuses and fiduciary failure.

You cannot imagine the magnitude of this burden, coming forward with these abuses knowing full well of the possible ramifications. I put my welfare and the welfare of my family aside because of the importance of these events. There are thousands of decent, honest and hard working Putnam employees who live in the area I call my home, and most if not all, had no knowledge of the abuses I speak of; their lives may be greatly impacted as well. For both the senior management personnel who resigned and those who remain at Putnam who had a significant role in the perpetuation of these fund abuses, there need to be severe consequences.

I had hoped and prayed that these abuses would be discovered by those responsible for regulating the industry or that someone in senior management would say "enough is enough" and come clean. That never happened either before or after the scandal broke. But month, after month, after month, market timing flourished in one of the most volatile markets in history.

In 1999, my wife Teresa and I had all the challenges we could handle. We were living in Quincy, Massachusetts, "the City of Presidents", expecting our first child, renovating a New England farm house in Weymouth, Massachusetts which had been built in the 1800s, and we were about to bring to trial a case against a CPA, financial planner, who we had discovered defrauding our family and many other families of hundreds of thousands of dollars.

Teresa and I also had our share of tragedy as well during this time. My father in-law Paul Quinton died suddenly from a heart attack, my sister in-law Joan Scannell died of breast cancer and my next youngest brother, suffering from a traumatic brain injury, was being moved from one rehabilitation center to another because of the substandard care that he received. David had been the victim of a hit and run drunk driver. He remains to this day, unfortunately, a semi-comatose quadriplegic. David's primary care giver is my seventy six year old mother, Barbara Scannell who put an addition on her home out of frustration and determination that the institutions that were available to Dave would lead to an even more torturous life than he had already.

In October of 1999 we were blessed with our son Paul and had moved into our home in Weymouth. I was still battling with alcoholism and knew I needed a career change. I had been in the restaurant business for years and my talent for selecting the best Barbarescos and Barolos was no longer amusing.

We were fortunate enough to have had our family friend and attorney, Stephen Follansbee recover before trial most of our investments from the "Ponzi Scheme" in which our family and others had become unwitting victims. This was not a "get rich quick scheme" but rather victimization of elderly individuals and families who believed their life savings were being invested in government backed securities. **We were robbed, we fought back and we won**.

Now with a different Financial Advisor handling our investments in a diversified portfolio in funds like Janus, Invesco and Strong, we decided that we need to better educate ourselves - trust needed to be earned and we trusted only ourselves at the time.

In March of 2000 I was looking into the possibility of becoming a financial advisor when the opportunity to work for Putnam investments arose. I knew that I would be starting in an entry level position in their call center. I was told that this position would give me the experience to learn first hand how a mutual fund company worked and that the opportunity to advance and become a licensed NASD representative was mine to earn.

My first exposure to market timing at Putnam Investments occurred almost immediately after having completed three week of intensive training for my position as a call center representative. My initial responsibilities included exchanging funds for participants in our defined contribution plans, as well as Taft-Hartley plans (union retirement plans). The Joint Industry Board of Electricians was the first plan that I was exposed to who had members actively market timing two Putnam funds that mirrored the NASDAQ. Every day in the spring and summer of 2000 that saw movement in the NASDAQ, whether it be up or down, we would receive scores of requests from the JIB members to move their entire balances in or out of either Putnam New Opportunity Fund (PNOPX) or OTC and Emerging Growth Fund.

The NASDAQ's volatility nearly doubled in 2000. 1999 had 62 day with a shift of 2% or more, (24% of trading days). 2000 had 136 days with a shift of 2% or more, (54% of trading days). Unfortunately for the JIB members the NASDAQ was moving in the wrong direction and would never provide enough recovery to cover its losses. The JIB members were hard working blue collar workers who mistakenly believed this scenario would bring about gains but the NASDAQ continued to be uncooperative. Many members just did not understand that they were losing huge amounts of their hard earned retirement balances. I and other call center representative would constantly inform our supervisors and of this activity, concerned over the devastating losses the members practicing these prohibited transactions were incurring. We felt that Putnam had a fiduciary responsibility to stop them from further damaging themselves, unaware at that time that the unwitting long term shareholder was being hurt as well. What we were allowing to occur would be similar to a pharmacist filling a patient's prescription which stated clearly that no refills remain, over and over again knowing full well the damage it could cause.

The call center representatives cared very much about the financial well being of the JIB members, as well as all of our clients. As the Markets were plunging in 2000, Putnam wanted us to convey to our clients the importance of diversification and the suitability of their investment choices given their years to retirement. But never were we told we could discourage our clients from "market timing." Nobody was sure what to do and it became obvious that discussions about market timing were met with deaf ears. We continually tried to do the right thing and were disturbed that every time we would bring up market timing and the damaged it caused to our supervisors we were told that there is not a system in place to detect that activity. Putnam employees that I came in contact with on a daily basis and who because of their positions were exposed to market timing bought that excuse for awhile, it eased our pain.[1]

[1] **Market timing is frequent trading by short-term investors sometimes hoping to exploit fund share prices that lag behind the value of the underlying securities assets.** Market timing is not illegal. However, many mutual funds discourage the practice because it can drive up fund management costs, reduce profits available to shareholders, affect the amount of cash a fund has on hand, impact asset allocation, and impact the fund's tax efficiency. Many fund prospectuses state that market timing, or excessive trading, does not serve shareholders' interests. Thus, by employing this strategy, many fund companies actually violated their prospectuses, which serve as contracts between funds and investors. Total assets for all mutual funds as of the second quarter of 2003 are $12.36 trillion, and equity funds balances are approximately $4.735 trillion. It is estimated that the cost to shareholders from market timing activities are $4 billion annually.

After a time the JIB members who were market timing went away, their losses so great they reached a point where they "had enough" and quit the practice. On more than one occasion I would receive a call from one of the JIB members telling me of their woe. An example of one member's losses is as follows:

Original balance $171,220.92,
428 exchanges later he had lost $78,962.32.

That is the kind of damage that occurred. It was heart wrenching when I had contact with them later on and they would say things like, "I can't believe how much I lost – I'm going to have to work another five years, and another member who told me he has to keep hiding his statement so that his wife won't find out. They learned an expensive lesson.

What a shame that market timing wasn't addressed at that time.

In early April of 2001, my father, David Scannell, was dying of leukemia under the care of a hospice group in the front living room of my parent's home. I had informed my team's supervisor that I would be out a few days because of my Dad's impending death. So, there I was in our living room, with Dad in a bed in front of the fireplace, and my brother Dave, Dad's namesake, in the addition off of the side of our home. I was determined to keep my demons at bay - but one suddenly gripped me tightly. There on the mantle was the morphine and syringe that I dreamed about injecting into my brother, putting him out of his misery; having not already done this I considered my biggest failure. At that moment my Dad had opened his eyes and very quietly told me that I have my own family's future to think about and that I needed to take care of that problem at work. I had told my Dad in a conversation that previous winter that three things would trouble me on an almost daily basis; my concern that I might pick up a drink, how troubled I was that I let Dave down – we treat dogs in this Country better than we treat human beings, and somehow I had to find away to get Putnam to stop the market timing that had sapped me of the pride I took in my new career. Dad died peacefully the next morning.

Life at Putnam went on and the pressure began to mount. Putnam's funds were underperforming our peers. The markets continued to decline and there was no stop in sight. My role at Putnam continued to evolve and many of us were becoming licensed NASD representatives. The training at Putnam was the best in the industry, the opportunity for advancement was there for those willing to put in the work. I received both my Series 6 and

Series 63 NASD licenses in 2001 and was looking toward a career path that would provide me with stability and dignity. Where I was going to find that at Putnam, I was not sure.

Sometime in the fall of 2001 I became aware of another group of market timers who also happened to be union members, but they didn't need my help. The Boilermakers Local 5 members had a different and far more successful strategy. They were using an international fund and timing it against US markets. The same scenario started occurring again. The Preferred Specialist Group, of which I had become a member after successfully completing my exams, became aware of this market timing strategy.

We knew of all sorts of individual market timers in many of the over 2000 plans we managed but this group was on to something quite different and for their self-interest, quite effective. I began tracking this group on an "Excel Spreadsheet" and was aware from that moment on I would become someone who would be closely monitored. Every conversation we had on the phone was recorded and our monitors were evaluated. That was the primary job of our supervisors. Every aspect of our computer activity was also monitored from "the bridge," an elevated area looking out over all the various levels of call center representatives.

We were constantly complaining to our supervisors and they were beginning to feel the heat. The Boilermakers were making a killing. As an example, there was one member whose balance in July of 2000 was $525,800.55 and in sixteen months after 542 exchanges it grew to $1,472,214.01.[2]

The Preferred Specialist Group was becoming a very savvy group. We researched and tracked the market timing activity and shared this information at lunch. Through my research I learned market timers were in fact pillaging the profits of the long term shareholder.

Unfortunately managers gave us the same lame excuse we had heard before

[2] Half of the customer's basis was due to market timing gains. My ability to research back further had been shut off without explanation.

> "Putnam does not have a system in place to discover market timers - it's a manual process." [3]

Whenever I had a break I did as much research as I could on market timing and found out that it is not a practice that was unknown in the industry. I had uncovered internal documents that show Putnam was concerned about Market timing back in March of 2000, coincidently the month that I started, and I tracked market timing transfers back as far as I could, which was 1998.

In January of 2002 I decided to address the issue of market timing detection at Putnam Investments. I needed to prove to myself that of course Putnam had the ability to detect market timing and that it evidently was used selectively. I intentionally replicated market timing like transactions in a number of Putnam's international funds over the course of the next few months making eighteen transfers using multiple funds. I did not want to be successful at it; in fact I wanted the transaction history to show that I was just trying to draw attention. The net effect of my personal transactions was a loss to my account, but I had to prove to myself and others that Putnam had systems in place to prevent market timing abuses.

In early May of 2002, I received a memorandum that told me in so many words to stop market timing. This confirmed to me what I had long suspected. I now could prove that Putnam "selectively tracked" market timing. I emailed the Sr. Vice President who had sent the memo to me and we had a brief email discussion about market timing and how it was a "prohibited transaction." Unfortunately he was smart enough not to take the bait at the time. I was sticking my neck out far enough and needed to possess more documentation before I could confront senior management.

In July of 2002, Putnam was having an update of its Siebel System Software (a marketing and tracking program) for the Preferred Specialist Group. It was to take place over the weekend and on that Friday one of the supervisors asked me for my passwords to all the programs I use, Seibel, my Lotus Notes, Putnam on Line, and another. I asked who needed them and why he needed them all and not just my Siebel. He did not respond. I knew something was not right. This was not just for the update. It was 4:00PM and my work week was over, so I reluctantly gave them to him, having no choice at the time. I now knew for

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[3] I have given regulators the Putnam emails documenting those statements.

sure that the supervisors were trying to more closely monitor my interest in market timing at Putnam.

In August of 2002, I and those who also were concerned about the Boilermakers market timing could not believe the numbers that were being generated by this group of ten members in the 1,000 member union plan. **They had exchanged more than HALF A BILLION DOLLARS with gains of close to TWO MILLION DOLLARS**. The International Voyager Fund was having a portion of its gains, which should be shared amongst the entire shareholders of the fund, being extracted for a few. What did these guys have going on with Putnam would allow them to continue rolling this snowball, and it was just starting to pick up some real steam.

On another August day the Preferred Services Specialist Group in Norwood, Massachusetts was visited by the Managing Director of Defined Contribution Plan Administration. He evidently came to see first hand what functions we were performing to retain assets at Putnam, a high priority given the incredible flight from Putnam Funds. Asset retention was priority number one for our group and second to it was enrollment. We needed every possible employee in our plans to participate and we started flying members of our group around the country to educate, encourage, and most importantly to enroll in their 401K.

The Managing Director sat down with a fellow PSS representative, who I shared a cubicle with, and plugged in his phone to the representative's computer and waited for the first call to be routed to our group. We would take care of various clients that meet certain criteria – and one criterion that routed them to our group was a large balance in their 401K. I believe the very first call that popped on the representative's computer screen was one of the most prolific market timers we knew of, a Boilermaker with over a million dollars in his account. The representative addressed the member by name and when I heard it I immediately positioned myself so that I could watch the show. The PSS representative very quickly and efficiently took care of his request to exchange 100% of his account balance out of the International Voyager Fund and into the Stable Value Fund (a GIC fund). The representative confirmed it again and gave him his confirmation number. When the call was completed the Managing Director took off his head set and asked the representative what the member was trying to achieve with the transaction.

The representative, who was as red as a tomato at the time, told him that the member was one of the most successful market timers we have at Putnam and tried quickly to show the Managing Director the member's transaction history. With that information being shared, the Managing Director wanted to see no more and he abruptly got up from his seat, looked at his assistant, and said there should be "short term trading fees" (STTF) on this account and scurried out of there with his assistant trailing. I then looked at the fellow PSS representative and said "we finally have someone from senior management who knows, we know, they know."

In September of 2002, the games continued and market timing never missed a beat. We never heard any directive from senior management that market timing was going to be addressed or that short term trading fees were going to be assessed to anyone transferring out of a fund within a 90 day period after having transferred into the fund as the prospectus states for the International Voyager Fund. The snowball kept on rolling along, picking up more steam and profits.

Later that month we had a Preferred Specialist meeting with our Norwood team. Present at this meeting were the SVP and Director of the call center, another SVP, a human resource representative and the Preferred Specialist Group numbering about twelve. This meeting was to inform us that our bonus criteria and base compensation was going to change in January. [4]

Once our Senior VP and Directing manager shared the new program with us, he asked us if we had any questions. Previous to this meeting, a supervisor attending the meeting sent us an e-mail directing us that we must e-mail in advance to him any questions that may be brought up at the meeting. This was always done whenever we had a meeting with senior management. One of the Preferred Specialists attending took the Senior VP up on his offer to voice any concerns we may have. She inquired about market timing and the Boilermakers getting rich doing nothing but market timing International Voyager. Another representative asked before the SVP/Director had a chance to respond, why did we not put the same restrictions on Boilermakers as "Flour Hanford Plan" asked Putnam to implement. The Plan wanted to put exchange restrictions of no less than 15 day in and out of any particular fund; they had caught wind of their employee's market timing. Evidently management at Flour Hanford felt it was a great distraction at the work place. The SVP/director became quite uncomfortable and said **"Listen, it isn't CRIMINAL"** and quickly tried to change the subject without addressing the suggestion. When the SVP/Dir. said it isn't CRIMINAL, it was my turn to become very flushed. I turned and looked at my other SVP to see what his reaction would be and was he was staring at directly at me - he was obviously not pleased with the remark.

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[4] And as always not for the better, Larry Lasser's bonus you know.

About a week after that meeting one of the PSS representatives on my team put together a spread sheet to track market timing in any of our Plans. He brought it to the AVP we reported to and told him this should help and why don't we email it out to the call center. That PSS representative was as frustrated as I was with the market timing that was taking place at Putnam. The AVP was up against the wall when this was suggested in front of others and he sent the spreadsheet out to the floor via email. I am not sure as to how many representatives it was sent.

This all stemmed from the fact that management continued to tell us that this was a manual process and the email that was sent repeated that worn out piece of disinformation[5]. Management knew I had been tracking the Boilermakers and other market timers, but the Boilermaker stood out like a sore thumb. Putnam was aggressively seeking out union business and was quite successful acquiring those accounts. I would get troubled glances from those supervisors returning from "the bridge." At this time I was occupied studying for my six hour series 7 exam (I received my license in November). I did take the AVP up on his email and transferred some of market timers from my own spreadsheet to the one that was sent out; I also copied it to another representative whom I could trust so that it could not have been said that it was never received.

My email with the spreadsheet of the ten Boilermaker market timing was never acknowledged, not verbally or by email. I decided to confront the AVP face to face. When he was passing my desk I stopped him and asked what he thought and what he had done with my spreadsheet. He was very terse, and quickly told me that the information I compiled was against company policy and that I was not to bring up customer accounts without their knowledge - they had to be on the phone. I looked at him with utter contempt and told him it's quite clear that Putnam has no desire to stop these prohibited exchanges. He was furious with me and didn't have a clue of how to respond other than to walk away. That was very satisfying at the time.

A few days after that one of my team members next to me got up from his desk, after having executed another million dollar market timing exchange for a known market timer, to confront the same AVP as I did and ask him about the spreadsheet he made and how effective it was in helping Putnam putting a stop to market timing. I saw him talking with the AVP in front of other supervisors and return to his desk quite upset and very frustrated. I asked what transpired, and he told me in so many words that if we were to stop them from

[5] I have provided the regulators that email.

market timing that we might lose the plan and others. The Taft-Hartley Plans were becoming very lucrative for Putnam. It was not long after this that my team member who confronted the AVP asked for a transfer and it was accepted. That was unusual, the PSS representative had his 6, 63, and 7 NASD licenses and we were very valuable in our department and we were required to commit to our positions for a period of time.

After my teammate left I felt a lot more exposed, my unwitting corroborator and original supporter in the fight to have market timing end at Putnam was no longer beside me, both literally and figuratively.

No other PSS representatives were willing to stick their necks out as far as my partner and certainly not as far as I had. I was in very deep and I remember discussing this with my brother Jay who is an attorney with the Quincy District Court. He said I better be very careful that I don't get myself killed. I told him he was dramatizing.

One day while I was updating my market timing spreadsheet and completing the demographic information of the market timers I was tracking I noticed behind one of my windows a web site I without thinking had searched for on line and at work months earlier. The web site page was up on my screen. The web site was www.whistleblower.org/protect. I had no idea how that got on my screen but knew that someone did. This event was the final push I needed to follow through with the issue.
For me, someone had drawn a line in the sand.

From December of 2002 forward, I was very nervous during for obvious reasons. I knew I needed to find a document which I had found months earlier but did not dare print out at the time. When I tried to find the site deep within my bookmarks it was now restricted; just as was my ability to go back in anyone's account and perform a Transaction History. This was now restricted beyond July, 2000; I used to be able to go back as far as 1998. The internal document I was searching for confirmed the Putnam was aware back in March of 2000 that market timing involving some specific Putnam funds was having a detrimental effect on the long term shareholder of those funds.

I spent the next few weeks looking for those documents and one day in the beginning of January I found them. The documents in the site were compelling. They would give insight to Putnam's preferential treatment of some market timers and show which market timers would be assessed the STTF (short term trading fee) that would make market timing not quite as lucrative.

Bottom line, if you want to market time you needed to get in a Putnam 401K or IRA. If not, you may or may not have STTF assessed to your account.

One day late in January, 2003, I got up the nerve to print these documents from my computer; which was the only computer to which I had access. The printer was across the floor next to the supervisor's and AVP's area. I managed to accomplish while seemingly undetected during our business day. I knew soon enough they might confront me with my intentions but they also knew they could do nothing to me. The next day when I returned to work nothing out of the ordinary occurred. I had some time to organize the data.

About a week later I signed on to my computer and began servicing clients when in between calls I heard the AVP whom I had earlier confronted and a couple of supervisors discussing something that was amusing them all while looking in my direction. It was Thursday, January 30, 2003. For some reason, feeling frustration, resentment, anger, I got up and went over to address the AVP while the others moved away but still were within earshot of what I was about to say. I told the AVP that I will no longer accept transfer requests from known market timers. The AVP responded very seriously and told me "I had to do what I had to do, but that I should be very careful".

The following day I was preparing to take all the information I had compiled. It was a select and concise anthology of the abuses that I and many others witnessed yet could do nothing to stop without getting terminated.

We all knew it was obvious with the senior management response to our complaints that market timing would be here to stay until some regulator stopped it. Somehow I was going to find a way to deliver these document to the NASD who licensed me, the SEC who should have been discovering these abuses, or maybe the New York Attorney General Elliot Spitzer who was building quite a reputation for someone who is willing to take a stand - refusing to let the Broker/dealers and Mutual Fund Companies bully and take advantage of the trust the investor has put in them.

I was deeply concerned that this issue may be pervasive throughout the Mutual Fund Industry, Putnam being one of the largest Mutual Fund Companies in the world; if they are willing to accept and maybe even promote this behavior by not assessing any STTFs then there had to be many others as all my research suggested. The day ended. I left the building discreetly with the documents that should blow any regulator away. Every thing that I witnesses could be corroborated by many, the internal documents were the smoking gun, and the account numbers were the needle in the haystack. It was so simple, so very clear, I made sure that my presentation to a regulator would be dream come true if truly cared about their neighbor, The American Investor. I drove home looking constantly in my rear view mirror. I remember laughing out loud at how paranoid I was – actually I was shaking I was so scared. I wondered what did I get myself into – soon I would find out.

Sunday, February 2, 2003, I left my home for a meeting I attend regularly after having dinner with my wife and mother in-law and her house guest from Chile. I stopped at a Dunkin Donuts and got a cup of coffee before arriving at the church. I sat in my car for a few minutes finishing my coffee and listening to the end of the game. The night was cold, with blowing sleet and snow. Suddenly, without warning my car door was opened and I was being grabbed by my jacket and dragged out of the door, I still had my seat belt on and struggled to face my attacker.

As I looked up I could see a large burly man with a full beard, wearing a New York Yankee's cap and grey sweatshirt that had "Boilermakers Local 5" emblazoned across the chest area in large bold letters. This was happening in split seconds when I felt something smashing down on my head while he was strangely talking very loud but furious. He said " I better shut the f___ up" and repeated this and some reference to my working at Putnam a number of times while smashing my head repeatedly, and my left hand, which instinctively I was using to shield my head, repeatedly with what the police told me latter was a brick. The next thing I remember was a policeman reaching into my car to shut the engine off and then an EMT was trying to ask me questions. Blood was splattered against the inside of my driver's door and there was a big gash in the door's upholstery. I was shaking uncontrollably and I was incredibly cold and wet.

I was taken by ambulance to Quincy City Medical Center's emergency room and treated appropriately – CAT scans, X-rays, all the while being treated for hypothermia. Evidently I had been hanging out of my driver's side door held up by my seat belt for almost an hour before help arrived.

When my wife arrived at the hospital and the pieces of what happened started to fall into place, I was asked by a nurse if I had taken any drugs or alcohol. I told them that I was in fact a recovering alcoholic and had not had a drink in almost a year. Then I asked them if they would conduct a drug and alcohol test so there would be no doubt. She was very sympathetic and understood my rationale for wanting one. It later came up negative. I answered some questions from the police that are in their report, but I was not coherent enough to continue. They asked for my permission to take my car to Quincy Police Headquarters' so that the detectives could fingerprint it and further investigate. I was released from the hospital late that evening and returned home with my wife.

The following day after waking up with great difficulty I received a phone call from Detective Maloney of the Quincy City Police. He asked me if I was able to come to the station to answer some questions. When I sat at his desk he told me that no fingerprints or evidence was found that could lead to the identity of my attacker. I was told that this was a major crime and was concerned that this was such a violent act not typical of the area. He also said that he was concerned that my cell phone and wallet, containing cash and credit cards, were not taken despite being on the passenger's seat in plan sight. He asked me if I had any enemies that may have committed this act and I said that I was unaware of any. Then he asked me if anybody who knew where I was may have committed this act, and I said no. I was afraid that if I told the police that I believed the attack was related to my being employed by Putnam Investments that it may put me in further danger. After this horrific attack I am suffering with disturbing neurological problems including headaches, confusion, dizziness, and great difficulty waking-up in the morning as well deeply disturbing emotional trauma, all of which I am currently being treated for.

The following day I told my wife I knew why I was attacked and who may be responsible. I had somewhat informed Teresa of what was going on during the last six months of 2002 at Putnam. After talking with my family including my brother, Attorney Jay Scannell, it was suggested that I put together all of the documents I had and find a law firm familiar with securities law.

After a few weeks and making a few contacts, I was referred to Tom Dwyer of Dwyer and Collora. There in Tom Dwyer's office, with one of his partners Jody Newman, I presented them with the time line I had put together documenting my experiences at Putnam Investments. Tom's first reaction threw me back in my chair. Tom thought that I may have to go to the FBI and maybe into the Federal Witness Protection Program. I told Tom right then and there that my family has already sacrificed too much and that going into hiding would be not be an option. I need to go to the SEC, they are the regulators who would want this Goliath, how they had missed this baffled me to no end, surely this would be of great interest them.

Jody Newman was advising me from that point on, her expertise was in employment law, but that was not my main concern at the time. I needed to get this burden off my back and onto the shoulders where it belonged, the SEC. It was in March that Jody first made contact with the SEC. The following is a time line of my dealing with that Commission.

3/26/2003	Jody Newman e-mails SEC lawyer.
3/31/2003	Jody has telephone conference with SEC lawyer.
4/10/2003	Jody has telephone conference with David Bergers, Assistant District Administrator, Boston District Office. Lets Bergers know that I am interested in identity secret. Agrees to meet with Jody, and get an idea of what this is all about.
4/14/2003	Jody meets at The Boston District Office on 73 Tremont Street. Present at the at the meeting, David Bergers, Philip Koski, Suzanne (investigator). Jody shares with them the prospectuses of the funds involved and so too the firm involved. They agree to look into the issue and may wish to meet with me in the near future.
4/15/2003	Jody has telephone conference with David Bergers.
4/22/2003	Jody has various communications with the SEC
4/23/2003	Jody has various communications with the SEC
4/24/2003	Jody has communication with SEC, they finally agree to meet with me.
4/28/2003	Jody and I meet at 73 Tremont St offices of the SEC with Bergers, Koski, and Suzanne (investigator). I provide the SEC with internal documents, market timer's account numbers, emails, and my experience at Putnam Investments. (the very information that MA regulators acted upon only hours after having them in their possession.) We meet for about an hour, then they thank me for my courage and would get back to me.
5/9/2003	Jody has telephone conference with David Bergers, Nothing to report.

For a number of months there was no communication from the SEC. I was still aware that market timing continued at Putnam investment and could not believe that the SEC was not acting on what I believed any reasonable regulator would consider being compelling evidence. Putnam Investments had some very disturbing practices blatantly being allowed to continue and the SEC for some unknown reason did not care.

I could not just walk away after all I had been through and knew very well that there must be some regulator who would consider what I compiled to be damning evidence. That is when I asked Michael Collora to contact Massachusetts Secretary of State, William Galvin's office to set up a meeting with his regulators.

On September 11, 2003, in the offices of Dwight and Collora, I met with Matthew Nestor, Massachusetts Deputy Secretary of State and Brian Lantagne, Chief of Securities Enforcement. It took Matt Nestor about fifteen minutes reviewing my spreadsheet to understand the enormity of the issue at hand. Matt and Brian both were awestruck at the story I told and realized that with the documents I presented something terribly wrong was occurring at Putnam. When I told Matt that I had been to the SEC and never heard back from he looked at me and said that's not going to be the case with Galvin's Office.

We spent close to three hours going over the internal documents, emails, spreadsheet and my market timing outline. It's not that it was a significant amount of material, It didn't need to be. I just had to be sure that my experiences in the two and half years I worked at Putnam be completely understood. I told Matt he had to understand that the people I worked with, the rank and file, were as disturbed as I was that Putnam's senior management lacked so much character and back bone that they allowed the CEO to obliterate the reputation of all those at Putnam who **did** have the Investor's interest First.

The following week I met with Tom Dwyer, Michael Collora, and Jody Newman. I was concerned that I had been unaware that their firm represented the two Prudential broker charged with trading abuses. I declined any further representation. Every step of the way for me there have been some peculiar coincidences.
When the Scandal broke, Putnam's senior management dug in with a strategy that they hoped would buy them time. How unfortunate that those under Larry Lasser were willing to risk sinking the ship with denial after denial at the CEOs direction. They did not know that he would be the first in his lifeboat rather than sticking around to walk the plank. They were so out of touch with the utter frustration and contempt the American Worker/Investor has for those who keep on trying to line their pockets at their expense.

Every single day, the Taxpayer, who is the Worker, who is the Investor, is getting nickled and dimed to death. Through no fault of their own, they are being scammed on such a regular basis their heads are spinning. Day in and day out the American worker is trying to eke out a living, trying to be responsible for their retirement needs. They are well aware that they will be the major and hopefully not the only contributor to their retirement.

One of the most disturbing matters for me still remains, and that is the treatment I have received from the very Commission that should be honoring my efforts. I have put exposing market timing in the Mutual Fund Industry above my own welfare and the welfare of my family – who knows what the future holds for us. For the SEC's Stephen Cutler to dismiss me as one of the "one thousand tips" they receive a day was outrageous, adding insult to injury.

It is even more of a concern that the SEC wishes I never existed. They have been quoted in the press as saying I was "a disgruntled market timer," that I met with them in January instead of April, and then they claimed I met with them in May instead of April. The reason they wish I would go away is that they were at Putnam Investments doing 'routine regulatory' work the very day I was in their Boston offices giving them the complete details about the market timing at Putnam.

They refused to look at the "can of worms" I had delivered to their door. Now the question that comes to mind is how is it possible they would not even try to open it. All they had to do, so very simply, was bring up just one of the accounts that I provided. But they have there ways, midnight phone tips two days before I meet with state regulators gets them back in the game. It was peculiar how quickly they settled with Putnam Investment without Putnam admitting to any guilt. Something is very wrong with this picture, maybe someone should talk the Massachusetts SEC official that very quietly resigned and hopes to 'fade into anonymity.'

I want to share my thoughts on a few subjects that concern us today. The 401K, IRA , Taft-Hartley plan, dollar cost averaging workers are the very life blood of our economy. To think that a few of many who make up the Mutual Fund Industry think that the contributions entrusted are theirs to divvy up amongst themselves is OUTRAGEOUS.

The longer it takes Mutual Fund Companies that have come under scrutiny to address their past, the longer it will take them to move ahead, if they can move ahead at all. For a CEO to leave a company like Putnam Investments in such a horrendous position, risking the livelihood of all the innocent rank and file has to be CRIMINAL. And for those who thought market timing is no real problem, well think again.

After I read Stanford University's Eric Zitzewitz' study on market timing, I was not shocked; my understanding of human nature and experience at Putnam Investment led me to believe market timing abuses must be widespread. But there was one question that he did not address which I believed I knew the answer to but I needed someone of his expertise to validate it for me. I called Eric at Colombia University and asked him quite simply:

> **"Did market timing in the last five years contribute to the historic volatility we have experienced affecting all markets?"**
>
> **Eric's answer was "Sure it did, but it would be unquantifiable."**

In conclusion, we have let a select group affect our markets in a way we cannot fully measure. That is a very troubling thought.

Mutual Fund trading abuse can be curtailed with appropriate regulation. But there is one form of uncovering abuses that has yet to be suggested. As the Federal Government has in place a very effective "Whistleblower Statute" for the monies we entrust the government to spend, so too there should be replicated a statute for the Securities Industry.

The Sarbanes-Oxley Act of 2002 will not inspire those who may want to come forward but are not willing to risk their careers and maybe more. Every regulator I have spoken to said, "Peter, it's going to take insiders like you make a difference." It's the proverbial needle in a haystack, and with the technology available today as well as the future technologies which will be magnified thousands of times, we can make a difference. Maybe the next person to step up to the plate may have even more to offer than a former waiter from Boston's North End.

The SEVEN TRILLION DOLLARS the AMERICAN WORKERS have invested in the Mutual Fund Industry should be considered a NATIONAL TREASURE and treated as such. It is one of our citizens' GREATEST NATIONAL RESOURSES, and PLUNDERING it for the benefit of those so undeserving should be a CRIME.

I have been dismissed by a CPA, a CEO, and the SEC and all of them more likely than not regret it. I was BASHED IN THE HEAD for the AMERICAN WORKER.

Now, Senators, is your once in an INVESTOR"S LIFETIME OPPORTUNITY for you to level the playing field. I remember Matt Nestor saying that he worked on the "side of the angels" and to do that effectively you must think like the devil. Let us not close the back door to have the offenders slip in the side window.

Thank you once again for allowing me to present these issues for your consideration. It is a privilege and an honor for me to do so.

U.S. Senate Committee on Governmental Affairs

Subcommittee on Financial Management, the Budget, and International Security

Oversight Hearing on Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors

Testimony by James Nesfield and Ian Grigg
27th January, 2004

Mutual Funds and Financial Flaws

Abstract. Mutual funds are vulnerable to abuses involving *market timing* and *late trading*. Primarily, this is due to a failure of governance, and the delayed nature of settlement of both payments and transfers. This vulnerability is only exploited over time, through a progression of small steps that, individually, raise no alarm, but in sum, cross the line of acceptable behaviour. Solutions to the abuses will be found not in more regulation, but in open governance and a move towards real time gross settlement.

Introduction

Mutual funds, and the advent of *market timing* and *late trading* abuses are much in the news. Today's topicality makes them worthy of study, but we must bear in mind that the flaws found within this sector are in no way unique to the mutual funds industry.

Indeed, we propose that the underpinnings of the mutual funds affair are equally applicable to our entire financial structure. Mutual funds, today, are the tip of the iceberg.

Progression

The progression from honest and efficient behaviour to the questionable events of the recent past is one of small, baby-like steps. No staff member of a financial firm sets out originally to break a law or, to help another break a law.

Each step is only a small change, from one posture to the next, and in comparison with the next or the last, an honest insider has great difficulty in seeing where each step is taking him or her. It is a slow process of inclusion and indoctrination that pulls the helpers into the web woven by the beneficiary of a crime. But in sum, these steps take the mutual funds sector over the line of acceptable behaviour.

Background

The observations herein are based on decades in back office finance work, specific experience over 3 years in the "capacity" business, and our search for a better solution [FC7].

Our search for a better solution culminated in the December, 2002 filing of a comprehensive package for a real time gross settlement ("RTGS") exchange and settlement system with the U.S. Securities and Exchange Commission ("SEC").

Layout

The situation is far too complex to do justice in one paper, or in one session. But, it is possible to show the essence of the progression, in three steps. These are, in turn, a) the development of capacity, b) the offering of market timing privileges, and c) the acceptance of late trades. We will describe each step, in turn, in the first section.

This progressive exploitation could not have taken place without some inherent weaknesses in the system. We believe that this weakness is a combination of governance failure and delayed settlement. The idle time that occurs between the signalling of intent to trade, and the final transfers are completed represents fertile ground for fraud. And, the lack of a good governance model permits that fraud to take place. This situation is described in the second section.

In the final, concluding section, we propose the way forward. Out solutions are predicated on the complexity of the modern financial system, and the need to address the fundamental failure of trust in a complex system. As time goes on, these premises become more true.

I. Mutual Funds and how they are Gamed

The exploitation of the flaws and weaknesses inherent in mutual funds derive from quite innocent beginnings. Yet, the flaws are so fundamental that, in three steps, the system can be totally perverted.

a. The development of capacity,

b. the offering of market timing privileges, and

c. the acceptance of late trades.

We will describe each in turn [Firms].

I.a Capacity

A Mutual Fund is fundamentally an investment, and offers returns based on long term placement of funds. Therefore, most funds benefit from having fairly simply and fairly slow records keeping.

In practice, cash settlement can take days, as wires delay in clearing, and funds are misrouted or lost. Underlying assets can take much longer, sometimes months to convert into cash.

This means that most funds need to maintain a working balance of cash so as to handle redemption orders. Generally, the cash maintained in these accounts is large enough to handle the average redemption order, but not larger ones.

When a mutual fund experiences a large redemption, it is in trouble. As the underlying fund assets need to be sold, and as they may experience a delayed settlement, sometimes exceeding the redemption period originally promised, there is a shortfall.

For years, enterprising funds have solved this by negotiating *capacity*: up-front lines of credit for large amounts. These credit lines are available to be secured by the underlying assets, and in effect, represent buyers-on-demand for the fund to tap when in need.

In this way, for a fee, a fund can handle a big redemption order even if the underlying assets take a while to sell.

I.b Market Timing

The nature of market timing is that of using information in one market to make winning trades in another. In the mutual fund industry, this often occurs when, for example, a fund specialising in instruments in one market updates its daily price (known as the Net Asset Value, or NAV) based on movements in the value of its portfolio, but other, more dominant and larger instruments or markets can predict the fund's assets.

Protecting the Shareholders

When it comes to mutual funds, their reason for existence is to make money for the shareholders over the long run. They offer the ability to combine smaller holdings (generally from \$50,000 up to \$1,000,000) into a larger pool.

They do this by investing the pool over the longer term, so as to overcome the frictional costs incurred when the investment is first made.

To protect themselves for the benefit of all shareholders, mutual funds will often discourage any attempts at market timing. Any shareholders that try and engage in market timing might meet a variety of difficulties, such as having the trade declined, or even having their account closed.

> A hypothetical AsianFund invests in the rice futures market in Hong Kong. The market opens at 9am local time, which is well after the closing of the New York rice market, a much bigger market.
>
> Prices on close in NY indicate the movement of rice futures in Hong Kong the next morning, information that is available to all. But, AsianFund does not use this information, instead it relies on the prices of the Hong Kong market to calculate its NAV.
>
> A smart market timer notices the correlation between the leading NY market, and the following HK market. He can put in an order to buy AsianFund shares on today's NAV, predicting that the price set at the 4pm NY close will drive up AsianFund units by several hundred basis points. He then sells a few days later at a profit.

The Link to Capacity

And, herein lies the link to capacity: those with large amounts of on-demand cash, standing ready to cover for large redemption orders, are only willing to do so at a price. Such capital, on call, does not come cheaply.

But, it is somewhat inconvenient to pay the price of that capital. By one means or another, the capacity providers and advisory firms that own the fund negotiate special dispensation to permit some trading that makes better use of the capacity.

This works for the advisory firm, because it obviates the need to offer large fees to the capacity provider, thus avoiding embarrassing entries on the balance sheet. And it works for the capacity provider, because as well as making a few basis points on a static loan for a few weeks, he or she can get in there and take some percentage points of profit over a short term market shift.

Both parties win. So, what's the problem?

Market Timing is Essential to the Financial System

Market timing is not illegal, nor wrong, in the general case. Market timing is a standard practice in all sectors of the financial field. It involves a risk taker watching the market closely, and taking advantage of movements in one market that have not reached another market as yet.

Another name is *arbitrage*; either way, it is an essential part of the financial structure. Arbitrageurs put their capital on the line, and make a profit on these inefficiencies. In this way, they move information from one market to another, and they move prices into line.

Arbitrage - or market timing - is the very essence of the efficient market hypothesis, the work by Harry Markowitz that underpins most of modern finance. Markowitz's theory asserts that the market prices are efficient, and, an efficient market delivers the best prices for retail investors. Only if market timers work at - and profit by - bringing markets into phase are the prices efficient and fair for investors.

Where market timing by mutual funds is of questionable nature is that the mutual fund was set up to not encourage fast, timing trades. In fact, ordinary shareholders are actively discouraged.

Advisory firms have thus created two classes of users - those that can "time the fund," and those that cannot. In effect, capacity providers are offered a package deal, or a quantity discount, that is simply not available to smaller players.

Again, there is nothing wrong with offering a package deal or a quantity discount. What is questionable is that the deal is neither offered to all, nor even standardised across those it is offered to. We do not need to dwell on whether fairness in contract terms is an issue here - the lack of documentation, scrutiny and openness of the timing deal raises serious questions of governance and fiduciary duty.

What went wrong?

What limits are placed on the market timer by the fund advisory firm? How much, how often, and at what cost to the fund? Where do the profits come from? What is this deal, anyway?

Let's skip the detailed analysis of fees and commissions and go right to the profits that the market timer is after. We can consider two equivalent funds, one with a market timer, and one without. The first gets hit with a fast trade that catches a shift up in prices, and the market timer cashes out with profits. The second fund suffers no such action.

The difference will be on the balance sheet. The first fund's balance sheet will show a dip in the Net Asset Value ("NAV"), equal to the profits taken out by the market timer. The second balance sheet shows a higher NAV, as no such profits were taken out. Thus, the remaining shareholders paid the profits of the market timer, in proportion to their holdings.

If we then recall that the advisory firm is remunerated partly on the value of the assets under management (typically 2% per annum), and also on a percentage fee of trades made, we now have both parties in alignment: the market timer wants maximum market timing, and the advisory firm is very happy to see lots of large, commission-rich trades.

From the small beginning of long term investments and a need for occasional big capacity hits, the funds have progressed into permitting short term market timing trades for special traders. The result is a deep, profitable and hidden transfer of value from one group of shareholders to another.

From being long term vehicles suitable for all shareholders, they have migrated slowly, special deal by special deal, into being siphons for the benefit of market timers.

This egregious result is not strictly illegal. No regulations were broken. And, often, the agreements held between shareholders and advisory firms do not forbid market timing. The advisory firms of funds are acting as their commissions tell them to act. It is only the actions and customs of these advisory firms that have created two classes of investor, one to play by the rules, and one to play by another set of rules that lets them benefit at the expense of the first class.

I.c Late Trading

In time, market timing becomes routine. The advisory firm realises that the market timer is contributing significant cash flow to the funds operations, through percentage trading fees. The minor inconvenience of shareholder losses is forgotten in the fight to keep ahead of the game, as far as the cost of the fund is concerned.

As the market timer builds a strong relationship with the advisory firm, often with the board of management of the firm, he or she detects further opportunities.

Subaccounting

As outlined, mutual funds benefit from having very simple records keeping. This task is often referred to as *subaccounting*, which refers to the combining of many shareholder accounts into one *omnibus account*, for the benefit of all shareholders.

Often, in order to further reduce costs, the entire subaccounting task will be outsourced to a brokerage firm that already has the systems in place. As the brokerage only reports net movements, the omnibus account, for simplicity, the advisory firm is further insulated from the activities of any one shareholder.

Clearly, there is a danger here, and brokerages might be expected to monitor for shareholder abuses such as market timing. But, whatever might be agreed up front, there is no incentive, and no checking or auditing, that encourages the brokerage to take on this tricky role for the advisory firm - like the advisory firm, the brokerage is remunerated on the fees generated by the trades.

Slowness of the system

In order to operate the subaccounting system, a manager at an advisory firm might need to manually enter in each trade. Often, this is done as an end of day task. If the day was busy, the task can be deferred until the following morning.

Of course, this means that shareholders' new orders that were entered in have to have pre-dated times allocated to them. In this way, when the records for a trade are entered the next morning, the time and date can be entered in retrospectively.

In order to manage the fund's price and sales, the price is adjusted daily, and a time for last orders is set, commonly 4pm New York time, on the trading day.

This is the market timer's new opportunity. Even though he or she can successfully predict the fund's NAV based on other market movements, capital is still at risk if the prediction proves wrong.

In the game of market timing, every hour counts. If the market timer can convince the hapless manager to back-date an order, the trade can be made more reliable. In fact, the market timer can even conceivably conduct the perfect arbitrage - a risk free purchase and sale for profit - by organising a trade to be accepted after the new price is guaranteed.

Hence, *late trading* is waiting until an arbitrage is guaranteed, or nearly so, and then submitting an order that is back-dated to before the close time, in order to get the better price. Of course, if the price moved the other way, the trade is simply not submitted.

By watching for the opening of the primary market, and guaranteeing the opening price, the trade is then entered into the mutual fund's subaccounting with a time and date back-dated to the previous day's price. As this is merely the act of a manager's entry, it is easy to achieve, and impossible to detect, as many trades are entered in this fashion.

Breach of Contract and Fiduciary Duty

How did this come about? The structures that were put in place, and the very strong relationships that were built up between the advisory firm and the market timer permitted extraordinary, but small steps to be taken in the favour of these special customers.

The market timer was already special. For the support staff conducting the work of entering trades, it was simply one more little quirk. It made no odds to the support staff what time was put on the order, as each staff member probably was not aware of when the order was really received.

The only difference between late trading and market timing, results wise, is that the profits are more reliable in late trading. In exactly the same way, a transfer occurs from the other shareholders to the late trader, for the amount of the profits, less the fees.

Again, late trading is not against trading regulations, for the simple reason that mutual funds are an unregulated sector of financial activity, and regulations are not directly applicable.

However, late trading is clearly a breach of fiduciary duty by the fund's advisory firm. Further, it is almost certainly a breach of contract, as the date for last orders, commonly 4pm each trading day, is a clearly stated and applied term, and that has been breached for some and not for others.

II. Problems at the Core

Any problem of the magnitude and breadth of the mutual funds scandal rides on several problems, not one alone. Below, we identify two issues that we believe are at the core of these issues.

II.a Governance

The obvious problem that afflicts mutual funds is a lack of governance - the protections normally put in place to keep safe the shareholders' assets against the current theft manipulated by outsiders and insiders working together.

Governance is the set of techniques that a firm employs to protect the shareholders' assets from all insider risks and threats. In this case, the mutual funds employed the least set of techniques they could get away with. This left the funds wide open to abuse.

Start-up Governance

As before, the failure of governance derives from benign and honest beginnings.

As a fund starts up, scrutiny is high, and the reputation of the firm is on the line for its good management - both, of the profits generated by the assets, and of the assets themselves.

Each new customer, and there are many in the early days, may closely scrutinise the fund, and depart quickly at the slightest sign of laxity on behalf of those managing the fund. This shareholder scrutiny acts in two opposing ways. Firstly, it reduces the scope for fraud, and thus reduces the risk need for strong governance. Secondly, it raises the profile of governance, and thus increases the marketing desire for more governance.

The result is a decrease in the level of risk, and an additional high attention to governance. The governance that is put in place therefore has a very high effectiveness, and an early start-up fund is governed to a level well in excess of needs.

Additional factors are that costs are higher in the early days, yet the uncertainty of the fund's survival as a business is also high. Further, there are fewer assets. In the early days of a fund's life, a low level of governance would in fact be a very economic and sensible compromise.

These factors combine to make more cost-effective but lower level of governance highly potent, and a reasonable compromise in the start-up phase of a fund, even as firms tend to over-exceed those levels. To which extent each factor wins out and drives the governance equation is a matter for each individual firm. The generality remains, that funds are probably safest during their start-up phase.

Risks Grow as Governance Shrinks

But, governance is costly - and as such it is a cost to be borne by the shareholder. What was an efficient compromise in earlier days becomes inadequate in later days. What was supported as a marketing tool becomes a cost to be cut.

With success, and with time, governance shrinks, as measured against the assets to protect. Once a fund is into its third year, for example, it is generally profitable for the advisory firm. New customers are rarer, and existing customers are less attentive, so there is less need to impress them.

The asset base is larger and needs more protection. Yet, the pressure is on to reduce costs, so as to return more directly to stakeholders. Staff changes occur, and the overall investment "feel" changes to a more relaxed, long term approach.

And, the risks of insider fraud rise commensurately. Yet, in contrast to the rising risk of insider fraud, it is generally seen as ridiculous to propose that more money be spent on protecting the assets at this later point. The attitude now is one of the assets having been safe for the life of the fund, and they will be safe for the future.

The fund's governance switches, over time, small step by small step, from a zealous, over done approach in the high-scrutiny "take-off" phase, over to a lax, substandard, "holding pattern" in later life.

The Standard of Governance

Governance standards are normally set by regulators. Yet, the mutual funds sector is unregulated.

There are two possible avenues for governance to arise within the unregulated mutual funds sector: either they copy governance techniques from the existing regulated finance sector, or they develop them from scratch.

As the vast majority of mutual fund activity is run by financial industry insiders (be it major firms or individuals with a track record in that field) the governance has generally been borrowed from the regulated sector.

Governance by Mutual Funds

Mutual funds are generally governed with three tools: Firstly, a custodian is appointed to hold the assets. Generally, the custodian holds a subaccount at DTC with the assets of the fund in it.

Secondly, a transfer agent will be appointed to manage the shareholders. Each shareholder's details will be held in a subaccount, and each buy and sell will cause changes to those subaccounts.

More than likely, the transfer agent is a titular role only, as the agent is generally a captive, wholly owned subsidiary of the mutual fund, and operates out of the same office with only titular staff and assets. Further, the real shareholder management is generally outsourced to intermediary customers such as brokerages. The transfer agent then only sees the omnibus account of each intermediary, and not the individual shareholders.

Thirdly, an auditor is employed to scrutinise the books, generally once per year.

Governance *de novo*

In contrast to the above, there are fields of securities issuance that are unregulated, and have been denied or estranged from the benefits of a regulator's advice. These issuers have chosen to take an alternate path, Governance *de novo*.

This field includes issuers of digital gold currencies As this sector has a well developed sense of governance *de novo*, it is described here as a comparison to the governance of the mutual funds industry.

In this sector, firms employ the following techniques [5PM].

The issuer (the firm, in this model) stores the customers' assets - generally gold bars - in a trustworthy repository for precious metals. The issuer appoints an independent co-signatory who monitors those assets. Each redemption out of the repository then requires signs-off by the co-signatory. A manager is employed by the issuer to initiate the day-to-day activities of draw-downs and expansions.

Governance *de novo* goes further. In a well-governed but unregulated issuance, the digital derivative assets are totally separated from the underlying assets, role-wise. The above separation of roles over digital governance is thus duplicated. Governance partners in one side strive to have no access nor control to the assets of the other side.

A firm that meets good standards of governance will place the subaccounting system (generally, Internet servers) under the scrutiny and management of an independent operator. Further, a special subaccount will be created to permit the addition of new *float* and this account will be placed in the hands of a further, reliable and trustworthy person. Only that independent person, known as the Mint, will be responsible for creating new digital assets, as bars are acquired, or for retiring digital assets in the reverse process. Again, a manager will be appointed internally by the issuer to manage the day-to-day changes to the float.

With such techniques, each governance partner's role is simplified as each has only one task to perform. Unlike the case in sectors that are effected by regulatory governance, partners strive to not conduct more than one role [Float].

Public Scrutiny - the Fifth Party

The above model refers to four parties for each of the digital and physical assets, being the Issuer (common to both), and his appointed daily Manager, Mint/Co-signatory over assets, and the Repository/Operator.

Such an arrangement is as subvertible as any other, as the Issuer is capable of appointing insiders to the roles. It is the fifth party, the public, to whom we rely upon to scrutinise the changes over time, and to encourage eternal vigilance.

In a well-governed unregulated issuance, the asset base is a published and promulgated data point [Bars]. On the digital side of the balance sheet, the derivative issue is also published. This includes and publicises the size of the total derivative issued amount, and might also include managerial and other special accounts ("treasury"). All customer assets would be listed as one combined entry.

In this way the public is added to the above governance roles as a dynamic scrutinising presence: Customers can conduct their own audits on the balance sheet and compare the digital assets with the published accounts of bar holdings.

For this reason, the model is often called *open governance*, to reflect the role of the public in auditing the issuance.

In the informal world of digital gold currencies, the public is highly active. Scrutiny is ever-present, and often borders on the antagonistic. Independent customers of the services spark debate and trouble at the least sign of danger. These governance vigilantes often face vitriolic attacks by proxy agents and threats of litigation by immature issuers.

Under open governance, each issuer knows that every action will suffer the private auditing of not only the customers but also competitive and jealous noise generated by other issuers, as well. Under open governance, the standard is to improve governance as time passes and assets grow.

Under these circumstances, some DGCs have employed governance arrangements that exceed those of the biggest and best governed firms in the regulated securities industry, yet their total assets under management are often smaller than the bonuses paid to the advisory firm managers.

II.b Delayed Settlement

The less-obvious problem that left the mutual funds wide-open to abuse was the settlement system, and its basis in delayed payments and asset transfers.

Delayed settlement is a fundamental problem that underlies this case. And, almost every other risk - systemic, legal, operational, credit - inside the financial system today derives from its presence from the delayed settlement of payments, shares transfers, and trades.

How Settlement in Mutual Funds Occurs

Orders by a customer to buy and sell shares in a mutual fund go through a complicated settlement process. A simplified, salient description of the settlement of the shares is below, solely drawn out of for the purposes of highlighting the potential for fraud.

1. An order to buy or sell comes into a brokerage, from a customer.

2. The brokerage enters each order to buy or sell into a list of orders.

3. In general, at any time after 4pm and before about 11.30am on the next trading day, the brokerage sends a *netted order* via Fundserv to the mutual fund, showing the combined effect of all orders for all customers of this one brokerage. The broker may elect to send each order individually, or multiple groups.

4. The mutual fund collects the many orders from the brokerage, and confirms them as they come in [Rejects].

5. Around midday, on the next day, the mutual fund aggregates all orders, and calculates a net redemption / growth position. This is addressed by drawing down or increasing the cash subaccount within the total portfolio [Adjust].

6. The mutual fund calculates the daily NAV based on the value of the portfolio and the number of shares in existence. This then forms the price for all of the trades in the next 24 hour period.

Most brokerages and other intermediaries maintain omnibus accounts [Int]. These accounts aggregate all the orders and assets of their customers, rather than using the subaccounting features that may be available via the mutual fund's transfer agent [Sub].

When does the Customer's Subaccount Change?

What is missing in the above scenario is the step of transferring the purchased mutual funds into the subaccount of the customer. In theory, this should happen before 4pm, on the day following the order placement, as confirmed and accepted by the mutual fund.

In practice, it can happen, and does generally happen, before that time. That is, the broker transfers new units into the customer's subaccount according to some local convenience, and plausibly as early as the moment when the order was originally placed.

Herein lies a core flaw in the system - the broker can create and destroy apparent units of shares of a mutual fund. In fact, the broker's accounts are totally separate from the mutual funds' accounts; the loop between new trades being accepted at the mutual fund, and shares being moved into and out of brokerages' subaccounts is never closed.

What this means is that there is no necessary connection between the brokerage accounts and the mutual fund issuance accounts. In fact, there is no necessary connection between the brokerage's omnibus account and own subaccounts. In effect, in accounting terms, any given issue is run over a series of single-entry books, spread over multiple administration entities, and linked by manual procedures.

In the industry parlance, shares in mutual funds are not *perfected* [SIPC]. The real positions of brokers and of funds then rely on reconciliation of omnibus accounts, subaccounts, error accounts, orders, and mutual fund accounts, a step which rarely completes. The normal situation is that at any given moment, there is no accurate figure for the number of shares in existence.

What Abuses can Occur Inside the Fund?

Neither is the cash position necessarily related to units of shares. Mutual funds can at their discretion, take late orders to buy up to a week after the trade date. If labelled as lost, or delayed, there is no difficulty for the fund itself, as the cash is good as long as it turns up into the cash account.

A lost order is originally an honest favour to an intermediary, but it may eventually be turned into an abuse. A lost order may once have been lost, or it may be a winning trade for an insider's accomplice. As the mutual fund's NAV is never recalculated, nor are is its correspondence closely audited, this practice of lost orders is essentially never re-examined for fraudulent motives.

What is perhaps more poignant is that it points to the flexibility of the book keeping system within the mutual fund - something that to date has not received much attention.

What Abuses can Occur Outside the Fund?

A mundane abuse is for the broker to place two orders, one to buy, and one to sell, shortly before the 4pm close. Then, as the market timing information comes in, the broker cancels the "bad" order. According to Fundserv trading rules that require error correction to be accepted, the mutual fund has no choice but to accept the cancellation up until 11.30am or so the next day.

This gives the broker a *late trade* - the perfect arbitrage. As long as the trades can be hidden amongst customer orders, there is no way the mutual fund can defend against this practice, as it cannot see through the orders to detect the pattern. Indeed, as the fund has effectively *outsourced compliance* of customer actions to the brokerage, it may not even see the need.

A further abuse is created by the lack of trails as to what constitutes a real order. Not only can the broker cancel an order up until the internal close time, a "lost order" can be sent in well past that time, as described above, to create a winning order.

More egregious still is *cherry picking*: take a customer's winning order, transfer it to the subaccount of the broker, and tell the customer that an error was made, and only the next day's price is available. The rules say that the brokerage has to make good on the deal, but the insider cares not whether the customer is made good under the rule, or not.

A more blatant abuse is to create differences between the subaccounts and the omnibus accounts, or between the omnibus accounts and the mutual funds accounts. This can lead to simply borrowing of created assets, or even to outright theft.

Why are there so many abuses? One reason is that mutual funds are not *tradeable* in the ordinary daily sense. As the NAV is fixed on a daily basis, the product is a simple pass-through from mutual fund to customer. Hence, there is no profit center charged with making money on the daily movements of these instruments, as there is with other instruments. And, therefore, there is no individual responsible for the profits and losses, and they get buried in the corporate balance sheet.

It is, perhaps, for all these reasons that industry insiders find the current attention on mutual funds somewhat mystifying. Given the difficulty in reconciling basic positions, and separating out errors from frauds, a little late trading is only the beginning of the issues.

Moving to Real Time Gross Settlement

During the entire time from customer order to completion, there is such latitude for abuses that it is difficult, and probably meaningless, to be comprehensive. What is more important is to point at the issue of delayed settlement as the root cause of abuse.

Only by eliminating delays in settlement will abuses disappear.

III. Conclusion

III.a Governance

We have above developed the case of how the mutual funds came to be so abused at the expense of their shareholders. In summary, the settlement system leaves open plenty of scope for abuse. And, the lack of effective governance allowed that abuse to develop in its own time.

We propose very strongly that one way to address this failure is to employ real time gross settlement in order to remove the temptation. The failure of governance is less easy to deal with.

The above descriptions do not fully address the complex interplay behind the failure, as they ignore the source of the governance decisions. In order to go further, we need to look at the regulatory environment.

Why did it Work at First?

Congress did not put in place a failed system in 1934, and the SEC did not approve measures that were fruitless from day one. Today's situation had its genesis in earlier, viable days of honest trading.

It is an article of faith in the securities industry that the clerks and managers doing the floor work and back office work are basically honest. The systems work when the people are trusted.

And, the people are trustworthy, and reliably so, when they are working together, as there exist informal systems in place -

reputation, loyalty, honour - to keep people working together for the benefit of the customers.

Where these systems break down is when the complexities force them apart. Several factors have arisen over the decades to change the makeup of the securities industry so as to reduce or break the assumption of trust in dealings. Some of these factors are:

- Size. The financial industry today is immense, far larger than the writers of rules considered in 1934. The acute difference is that it is no longer necessary to worry about one's own name being soiled, as the field is too big for word of any ordinary delitos to spread far afield.

- Litigation. It is practically impossible for a firm to deliver a poor reference to an employee, due to the potential for suits.

- Exposure. Firms' reputations are subject to much more scrutiny in these days of the Internet. It is no longer easy to suppress the news of a fraud, and, at the same time, punish the perpetrator.

- Prosecutions (I). Real frauds are prosecuted, but so many of the results end up as *Offers of Settlement*, agreed and drawn up before a judge. As these effectively ban the alleged perpetrator from the industry, with no finding of guilt, and as the money is rarely recovered, it is unclear whether these results are punishments or get out of jail free cards.

- Prosecutions (II). Those that do take a higher profile, such as those of Michael Milken, and today, Martha Stewart, are often perceived to be, rightly or wrongly, the actions of a jealous bureaucracy.

It is under these circumstances, that, regardless of the unquestionable honesty and integrity of the vast majority of clerks and managers in the securities industry, we must suggest that the field itself cannot rely on that trust, and that the securities industry as a whole should not be considered to be trustworthy.

How Regulation Misses the Target

Competition works to improve products. In contrast, regulations work to improve safety, by creating standards and lifting the game of poor players.

Unfortunately the approach of financial regulation often suffers from the *law of unforeseen circumstances*. This so-called truism often leads to the reverse of expectations arising. Here, we touch on some reversals that are particularly detrimental to the securities industry.

Regulations create standards to improve safety of poorer players, but they also inevitably work to lower the achievement of other, stronger players, as under a standardised and regulated environment, there is no reward for being better than the average. Thus, regulations work against competition to homogenise products to the lowest common denominator.

Further, each successive scandal results in a wave of new regulations. As each set of changes comes through, the business environment becomes ever more complex. Outsiders naively conclude that the regulations are so complex that no fraud is possible, but, generally, the reverse is true.

The more complex the regulations, the more space there is to hide fraud. More systems means more gaps, and more people means more departments, which leads to less scrutiny. Separation of roles can be employed happily to protect assets, or to protect secrets. It is no surprise that auditors are powerless to see frauds, as simply understanding the regulations that drive the structures is a full time job.

Even worse, as systems become more complex, the tendency to outsource increases. This means that what was once a simple local, internal governance issue suddenly becomes a contractual, commercial, and competitive issue. Mutual funds show how much potential for fraud derives from the tendency to outsource the subaccounting to intermediaries; what is not realised is that the pressure to outsource comes directly from increased regulations. Thus, the increased burden of regulation carries much of the blame for the increase in potential for fraud.

Finally, regulation tends to take a simplistic view towards scrutiny, that of adding more watchers. The current call for action to add more board members, and in some unexplained sense, to make them more responsible, is indicative of this trend. Yet, if there is one thing that has been learned from recent times, and recent events, it is that all watchers, however appointed and charged, in some way or another, can eventually be subverted.

An Example of Competitive Success

It is perhaps easy to dismiss efforts by unregulated and informal issuers of digital gold currencies. At the time of this writing, DGCs have less than a mere $50 million under management.

It is, however, far less easy to dismiss the effect of this as competition on the financial world. As the DGCs crossed over the periods of start-up uncertainty into stability and profitability, more conservative players took note. They copied the open governance model of the DGCs, and issued *exchange traded gold-denominated instruments* [ETF].

When these innovations entered the market, they built on the small successes of the DGC market by combining the security of strong, open governance with the depth of regulated markets. There is no doubt that gold-denominated ETFs are a big success, as, at the time of writing, total value placed under management after no more than 12 months is around $785 million.

Not only is this success a market endorsement of the DGCs' model of open governance, it is also an accusation by investors levelled at the financial industry and the banks, and the "trust us" level of governance that was previously offered.

An Example of Regulatory Failure

Since the early 1990s, FundServ has been offering a late morning close time for order entry, as approved by the Securities and Exchange Commission. Clearly, the question arises of why the window is so late, thus permitting so much late trading opportunity.

The industry draws attention to the the plight of the third party administrators ("TPAs") of qualified plans such as ERISA. Mutual funds wish to market their products directly to these TPAs, without being forced to have their product channelled through the competitive intermediaries.

Yet, the TPAs are also encumbered by much of the regulations that apply to brokers, without the size and automation to deal with the needs of submitting orders in a timely manner. To compensate for the slowness of the TPAs, FundServ offers a late closing time, up to 11.30am the following day.

Once offered to one, the standard must be offered to all, which allows other adroit and well-capitalised intermediaries to manipulate the system.

In this way, regulations designed to suit the lowest common denominator, for entirely fair and benign reasons, create the loophole that has led to so much fraud within the mutual fund industry.

III.b Solutions

We offer the following proposals.

Real Time Gross Settlement

An essential component of any solution is to move the mutual funds sector over to real time gross settlement of all transactions. Once it is possible to convert and trade incoming payments into shares in funds on an immediate basis, there is no longer any sense in market timing and late trading. If every share holder gets access to their shares instantly their payment is acceptable, then the time delays that represent opportunities for abuse disappear.

Real time gross settled payments, share transfers and trades are demonstrable and effective. They could be employed by mutual funds advisory firms in short order.

Yet, the securities industry is unlikely to move to RTGS except under massive pressure from outside the industry. For this reason, competition is likely the only enabler of change. As outside influences create the pressure for change, slowly, the innovations available outside the securities industry will trickle in.

Regulatory Strategy

Regulators should no longer rely on an assumption of cultural honesty. The world of finance has become too anonymous - the US trading system is too big and complex to permit honesty to play a reliable part.

As the financial systems get more and more complex, there is only one watcher that can keep up and make an intelligent decision as to the integrity and safety of an investment offering.

That watcher is the public.

For this reason, we propose that the SEC and other regulators shift gears. Instead of promoting their mission of *protecting the investor* by means of litigation after the event, regulators should promote a cult of *caveat emptor*.

Rules that seek to place insiders in closed and confidential control of assets should be eschewed in favour of rules that permit but not mandate the opening up of balance sheets and structures.

Transparency

The SEC should promote transparency. Not in the popular industry sense of lip service, but by permitting firms to experiment and work with shareholders to expose the internal governance information.

The SEC, in line with its mission of protecting the investor, already does this. It was not the SEC that blew the whistle on Enron, it was a member of the public. But, it was the SEC that mandated all the filings that the individual used to reverse-engineer the frauds.

We simply propose that the SEC take the wraps of this secret reality. It's time for investors to understand that they, and only they, can protect themselves.

Litigation

The cases launched by the Attorney General of New York State, in the pursuit of wrongdoing in the mutual fund industry, have had a curious, if predictable side-effect. Civil litigation has now embroiled many firms in complaints by classes of wronged investors. In comparison, the efforts of the SEC and of the State Attorneys General, may become mere footnotes in financial history.

It is sometimes unclear whether the efforts to prosecute by the SEC or the Attorneys General have resulted in punishment or not. However, it may well be that their time is better spent in establishing the evidentiary strength of any case, for the parties better able to pursue their claims, being the classes of wronged investors.

Internet

In closing, it is clear that the securities industry needs systems that can operate in an environment of no trust. The Internet thrives in this environment. We recommend that investors be assisted wherever possible to access their assets, directly and conveniently, over the Internet.

On the net, all traders are equal. Open governance lets traders defend and celebrate their equality, and the way should be opened for more of it.

References

[FC7] Financial Cryptography in 7 Layers, Ian Grigg, Proceedings of the 4th Conference in Financial Cryptography.

[Firms] Because of the sensitivity of the present scandal, we have omitted references to firms.

[5PM] This arrangement is known as the five parties model ("5PM"). It consists of dividing activity between five separate parties, being Issuer, Manager, Co-signatory/Mint, Repository/Operator, and Public.

[Float] For example, the operator of the digital subaccounting system can theoretically create new value, but that task is taken from him. Instead, the independent external Mint role is tasked with all new float, leaving the Operator with a limited Internet server role.

[Bars] For example, one company publishes the bars list provided by the repository on a quarterly basis. Another publishes a dynamic list of bar numbers, which it updates with every new bar movement.

[Rejects] Of course, a small percentage might be rejected, but we ignore that here.

[Adjust] At some unrelated point, the portfolio is adjusted over time to meet the investment goals, thus taking into account changes share purchases and sales.

[Int] Intermediaries include brokerages, hedge funds, third party administrators, and banks. In the text, when we refer to brokerages, we include all types of intermediaries.

[Sub] The reason for using own-subaccounting is two-fold. Firstly, the systems employed by the brokerages cannot deal with automatically coordinating the mutual funds' subaccounts with their own subaccounts (such would necessitate a capital expenditure). Secondly, mutual fund subaccounts would include the details of the customers, exposing the brokerage to theft of client base by the mutual fund. This effect is significant - several very large mutual fund families have grown by using the customer base of brokerages.

[SIPC] If mutual funds were traded under SIPC rules, each share would need to be perfected by some means. For example, the mutual funds could maintain a single accounting system at a centralised party, which permit each brokerage to foot off that account.

[ETF] Exchange traded funds denominated in units of gold now exist on the London Stock Exchange, the Australian Stock Exchange, the Toronto Stock Exchange, and the American Stock Exchange.

LIPPER
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"Leading Fund Intelligence"

Testimony of

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Lipper Inc.

Before the Subcommittee on
Financial Management, the Budget, and International Security

Committee on Governmental Affairs
United States Senate

January 27, 2004

Washington, DC

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Introduction

On behalf of Lipper Inc. (Lipper), I appreciate the opportunity to testify before the Financial Management, Budget, and International Security Senate Subcommittee with regard to our recent study on **12b-1 fees,** and generally on **management fees, fund expenses, "hidden costs," and governance structure** issues. All three topics are of vital importance to the $7 trillion mutual fund business. Careful handling will undoubtedly ensure investor trust in the business is elevated, distribution mechanisms are not crippled, free market forces are appropriately left to their own devices, and directors/trustees are supported and empowered properly as 'watchdogs' on behalf of underlying investors.

As background, Global Fiduciary Review is a unit inside Lipper that provides analytics and reports to directors/trustees to enable them to fulfill their fiduciary obligations. Advisory contract renewal – required by Section 15(c) of the Investment Company Act of 1940 – and quarterly performance reporting are the most prominent examples of the services we provide.

About Lipper: Lipper, a wholly owned subsidiary of Reuters, is a leading global provider of mutual fund information and analysis to fund companies, financial intermediaries, and media organizations. Lipper clients manage more than 95% of U.S. fund assets. The firm, founded in 1973 and headquartered in New York, tracks 115,000 funds worldwide through its offices in major financial capitals in North America, Europe, and Asia.

Rule 12b-1 Background

Introduction

Rule 12b-1 is a section of the Investment Company Act of 1940 that allows fund sponsors to spend fund (shareholder) assets to promote distribution. Yet, a wide variety of unforeseen distribution activities that are "intended to result in the sale of fund shares" have burgeoned since the Rule debuted. Sales and distribution practices have become necessarily intertwined with complicated issues such as brokerage, advisor profitability, and general business competition. As such, Lipper's primary intent of our lengthy research effort was to bring together all aspects surrounding Rule 12b-1, cull the information to uncover core issues, level the educational playing field, spur rigorous discussions, and set the stage for removing the Rule's antiquities.

[Full copies of the study are available to subcommittee members upon request.]

History

Debuting in 1980, Rule 12b-1 was originally conceived as a way to provide direct-marketed fund groups (*which sell shares directly to investors without a sales person*) with a way to compete with dealer-distributed complexes (*which use various "financial intermediaries" such as brokers, planners, and insurance agents to sell shares*). At the Rule's inception, the business was struggling, no-load funds had precious little market share, and the overall equity securities market was depressed. The Rule allowed a modest amount of fund assets to be used to provide groups such as Vanguard the financial wherewithal to 'spread the word' of no-load funds and achieve (size) economies of scale through asset growth. Expenditures were expected not to exceed around 0.25% of assets (25 basis points) per annum and be used for direct marketing and advertising campaigns as well as printing of fund documents for prospective investors. Plans were viewed as **temporary** to rectify distribution issues, i.e., low sales rates, and board involvement for review, analysis, and eventual approval was expected to be high. For the Rule to reach fruition, the SEC came to terms with the inherent conflict that advisors received as much or more benefit in advisory fee revenues as investors presumably would in incurring lower expense ratios. Yet, in enacting the Rule, the SEC did not specify what particular expenditures were to be considered lawful, presumably to not squelch creative distribution strategies and add a timeless quality to the rulemaking. With no formal qualms from the SEC, 'distribution freedom' implicitly provided by the Rule enabled it to quickly burgeon far beyond direct marketing.

Today, **12b-1 fees predominantly pay for sales commission and personalized service-fee payments to financial intermediaries.** Perhaps most pertinent, the argument that 12b-1 plan payments should directly correlate to fund asset growth (economies-of-sale) only partially applies due to the small proportion of 12b-1 plan expenditures for advertising and marketing.

1988 Revision Proposal

The enactment of Rule 12b-1 was accompanied by an SEC statement committing to close observance of the legitimacy of fund assets used for distribution. Modifications to the Rule were promised if and when the SEC felt changes were required. In 1988, based on those observations, they floated a revision proposal that outlined the following significant changes for consideration and comment:

- Limit the use of excess distribution expense recoupment (expenditures beyond a 12b-1 plan's maximum may be 'recouped' in subsequent years)
- Update NASD limits on maximum sales charges to include 12b-1 fees (put in place)
- Restrict the ability of funds to define themselves as "no-loads" when they carry – and charge – 12b-1 plans (put in place)
- Require more methodical analysis between 12b-1 plan expenditures and shareholder benefits realized
- Formally validate that 12b-1 payments are within a range that would have been recognized at arms-length
- Require annual shareholder approval of 12b-1 plans

The revision proposal was intensely debated and, aside from a new "no-load fund" definition and the NASD sales charge cap rules incorporating 12b-1 fees, none of the proposals reached fruition. Since 1988, the SEC has entertained revisions several times, but has not revisited Rule 12b-1 presumably due to more pressing matters and limited resources.

Rule 12b-1 Today

Direct-marketed vs.Intermediary-sold funds

Distribution plans implemented pursuant to Rule 12b-1 for most **direct-marketed** funds serve some of the same purposes today as were originally envisioned: advertising, direct marketing, and new investor documents. Due to the success of fund supermarkets, a not insignificant portion of plan fees also flow to supermarket proprietors to aid in building distribution muscle. Institutional funds focused on the qualified pension plan market may use 12b-1 fees to pay for plan administration and recordkeeping. A large proportion of 12b-1 plans currently in place are 'attached' to **intermediary-sold** mutual funds for three (3) primary purposes: 1) pay financial intermediaries for ongoing personalized investor service; 2) act as a method by which fund sponsors may recoup up-front commission payments to intermediaries who have already sold back-end loaded fund shares; and 3) pay out annual trailing commissions to intermediaries for products that possess a perpetual compensation structure ("level-load funds"). According to a recent Investment Company Institute (ICI) study covering 95 large fund complexes, approximately **63%** of 12b-1 plan expenditures went for intermediary compensation (commission), **32%** for administrative services (third-party recordkeeping and personal service), and **5%** for advertising and other promotional activities. Clearly, **the current role of Rule 12b-1 is primarily to facilitate fund share sales through financial intermediaries and supermarkets, while only a very modest proportion serves the original intent.** Classes of fund shares serve to provide investors with different ways to compensate their financial intermediary and service fees incentivize those sale personnel to "keep the assets on the books." Expenditures made pursuant to the Rule now total just shy of $10 billion encompassing 67% of the funds, are entrenched in the business, and hardly may be classified as temporary.

Board Review of 12b-1 Fees

While board involvement was originally viewed as a necessary ingredient of keeping 12b-1 plan expenditures in check and applicable to current sales woes, the evolution of fee uses rendered active oversight virtually fruitless in many instances. Due to commissions paid out to financial intermediaries for B-sale shares which then required 'reimbursement' (recoupment), securitization of 12b-1 fee cash flows, service fees for existing shareholders using intermediaries, and various other distribution commitments such as supermarkets, boards simply did not realistically have the option to terminate 12b-1 plans. While expenditures such as advertising and direct marketing could be considered discretionary and under board control, existing distribution arrangements could <u>not</u> truly be dismantled. Shareholder interests were better served by boards that supported existing sales channel arrangements through plan continuation.

Lipper Assessment

Recommendations

Given new market realities such as classes of fund shares, fronted commission payments (back-end loaded B shares), personalized shareholder servicing fees, securitized 12b-1 plan cash flows, supermarket sales commitments and the like, the Rule is undoubtedly due for an overhaul. Many of its provisions simply no longer apply. Lipper has formulated the following suggestions to be reviewed and considered by regulators and legislators alike in an attempt to point a Rule update in the right direction:

- Alter the Rule's language to account for the necessary continuation of some 12b-1 plans, e.g., remove temporary focus of plans, etc. – provide boards with the freedom to continue plans viewed as vital without reviewing antiquated considerations
- Embrace the 1988 SEC revision proposal that sought to eliminate a fund sponsor's ability to recoup distribution expenses in subsequent years when outlays in the current year

exceeded the maximum allowed – outlays beyond plan maximums should be at the discretion of, and borne by, the advisor

- Require more concrete analysis (at the board level) of the correlation between 12b-1 expenses and benefits to shareholders – more thinking beyond "…we need to do what everyone else is doing to be competitive…" should occur
- Issue guidelines to provide more specific ideas of what types of expenditures may, or may not, be considered valid for distribution purposes under the Rule – a list of acceptable uses, or unacceptable expenditures, may serve to curb abuse
- Eliminate the circumstances under which a shareholder may incur more sales charges than allowed under the NASD limits – a predictable cap which is not exceeded will serve investors more effectively
- Launch an education initiative to ensure investors possess detailed knowledge of the purpose of class-specific 12b-1 plans – investors do not understand the potentially many purposes of 12b-1 plans
- Provide shareholders with greater transparency on the specific uses of distribution expenses in offering documents and/or annual reports – currently, disclosure requirements do not provide investors with a basis for comparison and benefits of a plan; guard against abuses
- Provide boards the authority to pre-approve certain types of distribution expenditures – board members need to get back in the driver's seat and in control of many, but not necessarily all, provisions of a 12b-1 plan; guard against abuses
- Provide boards with legal constructs and/or standardized 'tools' to effectively assess a plan's cost versus shareholder benefit – cost/benefit analysis arguably diverges amongst boards currently and guidance is desired
- Undertake a study which <u>considers</u> whether the portion of 12b-1 plans used as "asset-based sales charges" should be removed from the auspices of fund companies and left to

distributors and market forces (investors negotiate with intermediaries) – more comparability of expense ratios, price competition, and better matching of supply, demand, and price

Also worthy of note is the general sense by Lipper and other observers that fund sponsors' distribution arms do not routinely generate substantial profit margins. Lipper's investment advisory profitability analysis – which displays pre- and post-distribution margins – indicates that a large portion of distribution-related 'revenues' are quickly remitted to sales channels. Leverage is typically possessed by the large retail distribution networks and sales forces which demand large payouts, a market reality referred to as "pay to play."

Intertwined Issues

We believe that the above actions serve to provide appropriate regulatory control, promote competition in the fund business, account for appropriate board involvement, and better inform shareholders. Yet, critical questions remain that must be factored into any forthcoming regulation or legislation. While beyond the scope of Lipper's research, the following questions must be considered for the correct 'spirit' to be built into a Rule 12b-1 overhaul. For instance, how is competition fostered when the financial wherewithal of fund sponsors is highly divergent? Is SEC and NASD (proposed) regulation to disclose compensation at point-of-sale sufficient to promote free market forces? What limits, if any, should be placed on distribution-related activities such as directed brokerage? Should advisory profit margins be a consideration in the regulation of sales practices when revenue sharing is extremely prevalent, and necessary, in the world of fund supermarkets? Should Rule 12b-1 be repealed, what other business structure or forms of regulation may be implemented without undue harm to the business, maintain reasonable asset thresholds, and protect shareholders? Should the issue of fund pricing, i.e., load structures, be left to distributors of funds (rather than sponsors), whereby the fund themselves would all be sold at net asset value and investors would negotiate the commission rate and service levels with which they are comfortable and/or willing to pay? Would this not then simplify the concept of operating expense ratios and comparability?

Misperceptions

Lipper also believes many of the criticisms of Rule 12b-1 result from a lack of awareness of the Rule's effective operation. It is often noted that shareholders do not benefit from (size) economies of scale to the extent that asset growth makes up for expenses incurred under a 12b-1 plan. Realizing that (typically) the greatest portion of 12b-1 expenditures go towards intermediary compensation and are essentially an alternative to traditional front-end loads, **the economies-of-scale argument is effectively outdated.** A similarly hot topic surrounding the Rule is the continuation of a 12b-1 plan on funds closed to new investors. In our view, one must consider that all but a small fraction of current average 12b-1 expenditures is allocated to marketing and advertising efforts to attract new shareholders. Therefore, it is reasonable to assume that **a fund using 12b-1 fees primarily to cover fronted sales commissions and ongoing service to current shareholders would incur most of the same 12b-1 expenses whether the fund is open to new investors or not.**

Conclusion

We urge legislators and regulators to consider the aforementioned suggestions and evaluate the perhaps not fully answerable dilemmas outlined. We maintain that Rule 12b-1 was, and remains, a valid concept that should be reshaped and not abandoned.

Fund Management Fees

Definition

Lipper defines management fees as all activities surrounding the management of fund portfolios and supporting administrative functions. Therefore, a management fee includes services such as security analysis, security selection, trade placement, office space, administrative support personnel, portfolio recordkeeping, and preparation of regulatory filings. Industry participants who refer to "advisory fees" may or may not be referring to what Lipper classifies as management fees and be excluding all services with the exception of those directly related to portfolio management.

Historical Ratio Data

Many industry observers have claimed that management fees have steadily climbed through a period when assets have risen precipitously. That statement is only partially true if you dissect and analyze the ratios. The ten-year historical data are as follows:

Management Fee Ratios – All Actively-Managed Open-End Funds

	1992	2002/3 (Current)
Medians	0.504%	0.597%
Asset-Weighted Averages	0.461%	0.462%

Source: Lipper Inc.

The rising median ratio shows the effects of more specialized asset classes such as international small cap, emerging market, and sector (priced higher) in addition to many small (new) funds being created while **the asset-weighted management fee average is clearly flat**. [Note: an asset-weighted average gives more mathematical weight to larger funds when computing the average. Since assets typically correlate to number of shareholder accounts, the asset-weighted average may be viewed as more indicative of what "most shareholders tend to pay."] When one disaggregates the ratios, the trends are unique by asset class, i.e., type of fund, but **the net result for a diversified portfolio over time has been very minimal**. In general, the underlying costs for portfolio management have increased over the last decade and thus given rise to smaller funds' elevated management fee ratios as fund groups matched revenues with current costs.

Management Fee Breakpoints

A fee "breakpoint" is triggered when a higher asset threshold within a management fee schedule is reached and typically lowers the incremental percentage fee charged an investor. For instance, a shareholder may pay 0.50% on the first $500 Million of fund assets, 0.45% on assets between $500 Million and $1 Billion, and only 0.40% on assets above $1 Billion. The theory behind breakpoints is that economies of scale are realized in the portfolio management process that should, in many instances, be passed along to shareholders. Lipper data show that 75%, 70%, 91%, and 71% of domestic diversified equity, taxable bond, sector equity, and world equity funds with assets in excess of $1 Billion, respectively, possess breakpoints in their management fee schedules. Given that the business is highly skewed towards smaller portfolios that do not achieve economies of scale, it is fair to conclude that most of the larger funds utilize breakpoints. The vast majority of funds utilize either a flat percentage of assets (no breakpoints) or standard breakpoint management fee schedule.

Management Fee Benchmarking

Management fee benchmarking occurs inside fund companies in three basic instances: 1) the advisory contract renewal (15(c)) process conducted by boards; 2) new fund pricing; and 3) where warranted, the management fee change process. While older, more established funds have shown little fee elasticity when faced with rising investment management costs, newer funds have tended to emerge with higher costs to align themselves with inflated entry costs. Therefore, if simple management fee averages are used to benchmark all funds, "leapfrogging" or "fee creep" phenomena occur. As newer funds drive up the benchmark (average), all funds have some level of justification – if they seek to mimic the average – to raise their fee to a higher level. Using size- (dollar-) weighted averages curbs the propensity for funds to continually reach for a presumably rising benchmark. **Fund boards must be instrumental in ensuring that proper management fee benchmarks are used.**

The Alliance Settlement

One may easily view a portion of the highly publicized $600 Mil Alliance Capital Management settlement with the New York Attorney General's office as punitive or as effective management fee setting. To most industry observers and participants, the 25% reduction in management fees 'inflicted' upon Alliance over time was arbitrary and not based on traditional fee benchmarking methodology. Lipper's view mimics the SEC in that we feel **market forces should determine fee levels and more structured analysis should determine whether a fund's fees are in line with funds of a similar nature and are "fair" and "reasonable."** If regulators feel that the current legal constructs utilized to set fees are ineffective, then new regulations should be enacted to clarify what new methodologies should be considered and/or employed to maintain equity amongst fund complexes.

Management Fees – Funds vs. Pension Plans

Academics, observers, and the media have claimed that "investment advisory fees" should be set identically for similarly focused pooled investment vehicles regardless of the investor audience. While one may rightfully argue that core investment (portfolio) management fees should be very similar for retail funds and pension plans, there are two primary dissimilarities that warrant consideration. First, portfolio managers of retail funds must deal with constant investor purchases and redemptions whereas pension plans' cash flows tend to be more stable and investment mandate 'tamer' and less 'fluid.' Second, there are extensive administrative duties associated with retail funds that do not apply to pension plans, primarily those that are required as a registered investment company. To truly derive a valid "investment advisory" comparison, all related administrative charges must be removed from retails funds' "management fees." A full-scale analysis across the fund business is simply not feasible as in only certain instances are administrative fees contractually separated from advisory fees. One could also use sub-advisory fee levels as a proxy for an advisory fee comparison, but (again) the industry would not be fully represented since the majority of funds do not use sub-advisors.

[Note: An ICI study entitled "The Expenses of Defined Benefit Pension Plans and Mutual Funds" released on January 6, 2004 used such a methodology and concluded that fund advisory fees are only slightly higher than pension funds'.] Arguably, the only comparative approach, given available information, is to use administrative fee benchmarks (using only those funds with separate administrative contracts) to remove from funds utilizing only management fee contracts a similar (proxy) fee to presumably uncover pure advisory fees. While not empirically perfect, the results will at least give critics a rough idea of pension fund/retail fund spreads in management fees. To Lipper's knowledge, a study of this nature has not been undertaken to date.

Total Expense Ratios

Definition

A total expense ratio of a mutual fund is defined as all expenses required to support on-going operations. The items included are: management, shareholder servicing (transfer agency), 12b-1 fees, non-12b-1 service fees, custodial services, legal, audit, printing and postage, trustee/directors' fees, registration, taxes, fund accounting, credit line fees (if applicable), interest expense (where applicable), and other expenses. Shareholder costs that are excluded from total expense ratios: front-end sales charges, general account-level charges, wrap fees, and fund-generated brokerage costs.

Historical Ratio Data

As with management fees, many industry observers have remarked that "...total expense ratios have risen at an enormous clip during a time when assets enjoyed unprecedented growth." Again, depending on which statistic is cited, i.e., average, median, or asset-weighted, the story is different. The ten-year historical data are as follows:

Total Expense Ratios – All Actively-Managed Open-End Funds

	1992	2002/3 (Current)
Medians	0.897%	1.297%
Asset-Weighted Averages	0.773%	0.786%

Source: Lipper Inc.

Similar to management fees, the median total expense ratio (TER) shows the affects of many small (new) funds being created while **the asset-weighted TER average rose a mere 0.013%** (1.3 basis points). [As noted earlier, since assets typically correlate to number of shareholder accounts, the asset-weighted average may be viewed as more indicative of what "most shareholders tend to pay."] The often-quoted average ratio, which is subject to biases by more expensive and smaller funds, exceeds the 1.297% cited above and is the catalyst for many cries of "...where are the economies of scale?" When one disaggregates the overall ratios, the total expense trends are again unique by asset class, i.e., type of fund. The large divergence amongst the median and asset-weighted average total expense ratio deserves some analytical explanation as follows:

- The pronounced rise in the median TER was driven by the proliferation of additional class of shares carrying relatively high 12b-1 fees
- The median TER was pushed higher by the asset mix in the business pushing towards more specialized – and rightfully higher priced – products such as international small cap, sector, and emerging markets funds
- The median TER rise was also supported by higher shareholder servicing (transfer agency) costs
- The modest level and flat asset-weighted TER indicates that the largest funds either do not carry 12b-1 fees or their fee is modest and has not changed

The core points of this analysis are: 1) **the majority of shareholders are not paying more in operating and distribution expenses than they were ten (10) years ago**; 2) rises in median expense levels have been due to many more back-end and level-loaded classes of shares which are modest in size; 3) **economies of scale are evident on the fund and sometime fund complex level, but do not logically translate to the business as a whole**; 4) a rise in shareholder servicing costs – which have bumped total expense ratios upwards and have been driven by a demand for more service options – has been borne at least partially by the investor, but most likely by both sponsor and investor. When one removes 12b-1 fees from the historical TER data altogether, the trend is either flat or decreasing, depending on asset class.

GAO Study on Total Expense Ratios

The General Accounting Office conducted a study on TERs released in March of 2003 focused on the 76 largest stock and bond funds using Lipper expense data. Their two core findings may be summarized as follows: 1) the asset-weighted stock fund TER average rose seven (7) basis points (0.07%) over the period from 1999 to 2001; and 2) the asset-weighted bond fund total expense ratio average dropped three (3) basis points (0.03%) over the same period. We do not dispute the results of their data analysis; however, we would maintain that an analytical flaw and therefore bias is inherent in the conclusion. Several very large Fidelity funds with performance incentive fees skew the ratios. In comparison to prior periods, all three funds earned an unusually large incentive fee reward (in the form of an increased management fee) realized during the three (3) years ended 2001 due to index-exceeding performance over the trailing 36 months. Given the size of the funds and the incentive fee adjustment, the funds weighed on the results heavily. Over other 'less favorable' periods and with incentive fee penalties, the same Fidelity funds would have drug the asset-weighted TER down significantly. **When one subtracts the incentive fee adjustments, the asset-weighted average total expense ratio of the largest equity funds remains virtually unchanged.**

Recommendations

- Support the initiatives to report total expense levels in shareholder reports based on a hypothetical account size, standard holding period, and in dollars
- Simplify shareholder reports so expenses are much more easily understood and impact crystal clear
- Similar to index returns in a fund prospectus, **provide investors with expense benchmarks** from which comparisons may be made (while the peer fund selection process is problematic, some level of macro comparison is desirable to spur competition and investor education)
- Launch an investor education initiative – coupled with disclosure – that seeks to ensure investors fully appreciate the return erosion that occurs with much more expensive funds

Costs Opaque to Investors

Overview

The issue of "hidden costs" has recently surfaced, primarily the result of New York Attorney General Eliot Spitzer's investigation into fund trading practices and fiduciary obligations. His probe has led him down several paths unrelated to timing and late trading, primarily related to less-obvious costs borne by investors. Aside from the potential for trading abuses and related expense, the three costs cited by critics of current practice and disclosure may be characterized as **general brokerage, directed brokerage, and soft dollar use**. All three costs involve the use of shareholder assets in the form of fund securities transaction-generated brokerage commissions and are charged directly to fund net asset values (prices per share), not included in the total expense ratio, and therefore not transparent to investors.

General Brokerage

Total brokerage commission expense incurred by a fund is required disclosure in Part B of the prospectus (Statement of Additional Information (SAI)). However, two issues perpetuate some level of opacity. First, the brokerage expense reported in the SAI is simply an aggregate dollar amount and must be manually converted to a percentage by time-rich, resourceful investors. The reported brokerage commission figure only encompasses standard 'agency trades' (trades on an exchange floor and typically transacted on a cents/share basis). Electronic trades transacted through electronic communication networks (ECNs) and those done on a principal basis (bid-asked spread) are not included. Furthermore, an imputed cost referred to simply as "implementation shortfall" (difference between a share price at time of a trade decision and the actual price at which the transaction took place) is not included because of the inability to adequately and consistently quantify the actual expense. The obvious concern of investors, beyond and sometimes in spite of cost, is "quality of execution." Academics cannot agree on one 'correct' algorithm that accurately measures implementation shortfall and comprehensive data are scarce. We would argue that **trying to fully quantify brokerage costs in total and given every trading scenario is similar to attempting to nail Jell-O™ to a wall.** Yet, we would also argue that an elevated level of brokerage cost transparency – to the extent it may be computed in good faith – is more desirable than what exists today.

Directed Brokerage

Directed brokerage refers to a practice that involves directing security trades – thus creating brokerage commission revenues – to a specific brokerage firm in exchange for "sales support." We understand this support typically takes the form of certain funds being included on "preferred lists" or prominently garnering financial intermediary recognition ("shelf space"). In some cases, directed brokerage results in expense credits (expense offsets) paid by the brokerage firm and is shown on a fund's Statement of Operations (part of an annual shareholders' report). Three critical shareholder issues arise regarding directed brokerage. First, is the quality of execution of the trades commensurate with the commission price tag? Second, in the event that a commitment for a certain level of trades is made, could trades be placed elsewhere for a lower cost and/or to realize better execution? Third, might portfolio managers be 'overtrading' to meet a trade level commitment? To the best of our knowledge, the exact level of directed brokerage across the fund business is not known, but we are aware that several very prominent fund complexes have recently decided to terminate the practice voluntarily. Obvious to most observers is the very evident conflict of interest with directing brokerage, creating preferential sales support and the resulting disservice it may provide investor investment options.

Soft Dollar Use

In the context of the fund business, "soft dollars" refers to the somewhat common practice of a fund manager directing security trades to a specific broker to obtain market or security research and trade execution. While the commission price per share incurred by shareholders may, in some instances, exceed the going or lowest market rate, fund sponsors are **not** ignoring their fiduciary obligations. Section 28(e) of the Securities Exchange Act of 1934 allows fund sponsors to pay more than the lowest or current market rate if it is determined that the portfolio management value of the research warrants such a decision and/or the quality of trade execution is deemed worth the premium paid. **Many of the same issues that apply to directed brokerage similarly apply to soft dollars such as cost concerns, quality of execution, conflicts of interest, and the potential for 'overtrading.'** Many critics have also expressed concerns over soft dollar use to pay for goods and services beyond research. Yet, **if clear shareholder benefits are reaped and advisor overhead is <u>not</u> simply being covered, then valid use should not necessarily be questioned.** Additionally, business observers such as Lipper ask whether an advisor should be paying for market and security research (in cash) out of the fee it receives for management services? As implied above, the answer depends on the extent to which the services paid for with soft dollars benefit investors rather than the advisor. Is shareholder benefit commensurate with the presumably higher price paid?

Suggestions, Recommendations

In our view, a number of required actions or topics for consideration emerge from the above discussion as such:

- Consider quantifying the aspects of brokerage costs that may reasonably be converted to an expense ratio (do not include in the current TER)
- Consider requiring disclosure of the "brokerage ratio" in the prospectus alongside a benchmark and allow investors to discern whether returns justify (relative) brokerage costs incurred; encourage more rigorous language about the origination of, and reasoning behind, costs
- Elevate disclosure requirements to make all brokerage arrangements, such as soft dollars, fully transparent to investors including "fallout advisor benefits" and conflicts of interest
- Through a Chief Compliance Officer, ensure that boards of trustees/directors are aware of all details surrounding brokerage arrangements and the value derived by shareholders
- Review the scope of services allowed under Section 28(e) to ensure shareholder benefits are truly realized
- Consider requiring more formal board review and justification of soft dollar use
- As supported by many other industry participants, regulators, and observers, elevate the general level of fee and expense disclosure(s) in terms ($) that may be easily understood by investors and may be compared across funds; prominently display in the annual and semi-annual reports to which investors pay the most attention

Of final note, investors and board members alike must understand that actual trading costs incurred (dollars/share or flat dollar amount/trade) may only account for a small fraction of true brokerage costs due to implementation shortfall. The skill required in placing trades and in shareholders' best interest should not be minimized as they may play significantly into investor returns as a direct cost to a fund's NAV.

Fund Governance

Current Atmosphere

Viewed as "watchdogs" by some and "lapdogs" by those more critical, mutual fund boards have arguably seen their responsibilities grow along side the complexity and demands of the business. Directors have recently come under fire as a result of Eliot Spitzer's probe into fund trading, as they were presumably unaware of the violations. Questions of board due diligence and the adequacy of the governance structure obviously emerge. Critics of the board structure point to a lack of independence and blame overtaxed directors, generous compensation, a high retirement age, a dearth of independents, lack of personal investment, the definition of independence, and affiliated chairpersons. While all possess some validity, **some core issues still remain unearthed. Equally valid are compliance policy adherence, board information sources, board financial expertise, contract renewal processes, sales practice transparency, and the opacity of board decisions**. A lack of compliance, detailed knowledge, effective tools, and an applicable legal framework all can detract from board effectiveness.

Level of Accountability?

Prior to Mr. Spitzer's realization that several fund groups were in direct violation of their own policies, directors could have potentially done more to prevent fraud. More hard-nosed questions could have been posed and a healthy level of skepticism could have been employed. Yet, what reason did they have to believe collusion or violations were occurring? Did they have sufficient information with which to exercise reasonable business judgment? We would argue that trust must be brought to bear on the advisor/board relationship and – in most instances – very little reason for distrust had arisen until just recently. Several dozen boards <u>now</u> have good reason to probe relentlessly and generally be skeptical.

Potential Solutions

- Appointment of a Chief Compliance Officer within each fund group who reports to the board and ensures sanctioned policies are adhered to
- Creation of an independent board administrative support group that would exist solely to serve each board's information desires and requirements
- Require board members to attain a mandated business knowledge level and achieve certification through an independent company
- Allow independent board members to elect the board chairperson, who then sets meeting agendas, surfaces issues, controls meeting flow and the like
- Elevate the level of fiduciary duty required of board members with regard to critical issues such as brokerage, cost structures, and affiliated payments
- Author more definitive rules and/or guidelines to assist boards in assessing advisory contract 'performance,' e.g., what possible actions to take under certain underperformance circumstances, etc.
- Require more board process and decision justification disclosure for critical items such as advisory contract renewal and business arrangements with related entities; relay clear, concise rationale to shareholders

Legislators and regulators are well advised to not dismantle the board concept, simply strengthen the structure through institutionalized compliance, education, administrative support, and more detailed guidelines to bolster oversight. When crafting reforms, regulators are further urged to consider cost of implementation – with smaller funds groups particularly in mind – that may be burdensome, out of reach for some sponsors, and harm shareholders over time. Fund governance was hardly ill-conceived. The complexity of the business now mandates further dimensions to governance to shore up its effectiveness.

Putting Management Contracts "Out for Bid"

Several legislators and industry observers have suggested that all management contracts be "put out for bid" each year to obtain the best manager and/or the most competitive cost structure, and generally allow market forces to operate freely. While such a suggestion appears to support the concept of a free, rather than captive, market system, observers arguably underestimate the cost and shareholder burden that may be incurred if and when a new manager takes over fund management for some – and perhaps all – of a competitive managers' funds. The total cost of 'uprooting' a fund would necessarily encompass transfer of all accounts to new shareholder servicing platform, portfolio management transition and likely security repositioning (increasing brokerage commissions), reassessment of other service provider contracts (that undoubtedly must mesh with internal systems effectively) and dealing with possible termination clauses, amongst other costs. Total cost versus benefit should obviously be considered before any board decides to take such drastic action. Opponents to freely moving advisory contracts amongst sponsors argue that raising underperformance issues and devising action plans is more desirable than effective "contract portability." In theory, **'very independent' boards should serve to keep costs in check and serve the same purpose as bidding with much less disruption to fund operations**. Nonetheless, in some instances such as fraud and negligence, putting an advisory contract out for bid may be the most desirable course of action. **A clearer picture of director/trustee fiduciary duty and resulting ramifications for <u>not</u> protecting shareholder interests with regard to the advisory contract renewal process would promote a stronger foundation and rigorous fee negotiations.**

Mutual Fund Oversight Board

More than a few legislators and observers have suggested that an "oversight board" responsible for controlling and monitoring the (consistent) duties of boards would cure many of the current governance ills. We tend to disagree. An oversight board simply creates yet another layer of bureaucracy, costs, and potential delays in action. A combination of a stronger governance structure and more definitive and stringent rulemaking by the SEC should serve to strengthen the board model. While on the surface centralized oversight appears desirable and may breed consistency, widely applicable policy design will be problematic, costs will be elevated, and board freedoms will be curtailed. Is there truly a regulatory hole that needs filling? We would argue that many of the mutual fund business ills recently raised are already covered by existing regulation(s) that need relentless enforcing or may be addressed through additional SEC rulemaking.

Concluding Remarks

Investor Costs

In Lipper's view, one of the core aspirations behind investor cost transparency is to promote competition. Competition creates price pressure, drives inefficient providers from the business, and serves investor interests long-term. Computation and disclosure of the true, total costs of owning a fund is the goal, but quite elusive. Items such as account-level and IRA maintenance fees could also be added to the prospectus fee table, but more investor assumptions would have to be made. However, there must be **focus by investors on costs** and the impact that they can have on account values over 10-, 20- and even 30-year periods. We are not convinced that most investors consider cost as a primary criterion in the fund selection process. Some commentators have cited large flows of investor money into three low-cost providers, e.g., Fidelity, Vanguard, and American Funds, as an indicator of cost sensitivity. One could surely take the viewpoint that investors are attracted to Vanguard, American, and Fidelity for reasons such as reputation, performance, desirable volatility profiles, very high visibility, service, and the virtually do-nothing and market-tracking appeal of index products. Expenses may not have entered into the decision. General fee levels may not deserve to seize the number one fund selection criterion spot, but **more investor education** of their impact would surely promote competition based on price. Furthermore, significant changes to costs that are anticipated or may occur, e.g., waivers disappearing, expense reimbursements ending etc., should be forewarned at the first sign of implementation.

Governance

In general and based on our experience, fund boards of larger fund complexes are extremely knowledgeable, savvy, have more resources at their disposal, and put much time and effort toward taking their stewardship duties seriously. However, questions remain whether more modest-sized groups can make these same claims. Decisions based on 'lesser' board models may result in governance that is less than optimal and counter to the spirit of board oversight. Furthermore, it is not clear what level of information is the basis for vital board decisions and the true 'strength' of compliance structures. Recent Heartland and Putnam board articles highlight the potential for misinformation flow and the general need for external administrative assistance for board members to obtain fully independent data and information on sponsor business practices. Finally, implementation of additional guidelines by boards with regard to the critical annual advisory contract renewal exercise would be helpful in framing what potential actions to take when certain unacceptable scenarios arise. **While an independent chairperson and 75% independent board members may appear to create a more external flavor, decision frameworks, information flow, and solid internal checks and balances must also be built into the governance model.**

General

Given the vast quantity of expert comments on the other pertinent industry issues on the table today, e.g., late trading, fund timing, selective holdings disclosure etc., Lipper has consciously chosen not to comment. We are not privy to the details of these more internal, operational issues and feel that the proposed solutions sufficiently cover what we perceive as the primary issues. We strongly contend that the end result of Mr. Spitzer's investigations will be very positive, yet temporarily very damaging to the image of the fund business. What will not kill it will make it stronger and shareholder interests will be better served long-term. Within an enhanced regulatory and/or legislative framework, funds will remain the best vehicle for most retail investors – the business will be vibrant for many years to come.

Yet, **we are currently in a period where "over-regulation" is quite feasible**. Overreaction to a dangerous situation is inherently human, but should be mitigated when applied to the current fund industry scandal. Perhaps most pertinent, the formulation of new rules or guidelines should unquestionably be left to those bodies whose constituents know the financial markets best. The SEC and NASD are arguably those bodies. While legislative action has been proposed by many well-intentioned, prominent individuals, unintended consequences that harm investors and impede markets may result. Many of the proposed solutions involve burdensome and costly infrastructure be built which may squelch competition and create a more oligopolistic model, thus reducing options. The SEC and NASD have overseen markets and governing bodies for decades and are best positioned to assess the efficacy of specific proposals that seek to eliminate malicious or self-serving activities, yet must not reduce fund investor freedoms and market forces. Above all, any **reforms that are designed to directly address shareholder-unfriendly practices should be crafted carefully and not rushed**.

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We trust that the subcommittee has found our statistics, comments, and insights useful and look forward – as investors and as a prominent service provider to the business – to a stronger mutual fund industry for many years to come.

Consumer Federation of America

Testimony of
Travis Plunkett, Legislative Director
Consumer Federation of America

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

Regarding Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors

January 27, 2004

Good morning. I am Travis Plunkett, Legislative Director of the Consumer Federation of America. CFA is a non-profit association of 300 organizations founded in 1968 to advance the consumer interest through advocacy, research and education. Ensuring adequate protections for the growing number of Americans who rely on financial markets to save for retirement and other life goals is one of our top priorities.

Introduction

I want to congratulate Chairman Fitzgerald, Ranking Member Akaka and the members of the Committee for holding hearings today on mutual fund practices that harm investors, including excessive costs and the convoluted and sometimes hidden incentives used to promote their sale. In doing so, you have opened a window into a mutual fund scandal that does far more harm to its victims than the recently revealed trading abuses – and that is the scandal of how mutual funds are sold to unsuspecting investors and the high costs that result.

This is not to excuse the trading abuses that were permitted to occur at all too many fund companies. They represent a gross violation of trust. However, investors who fall victim to abusive sales practices are likely to suffer far greater financial harm over the life of their investment than those who are victims of trading abuses.

I am referring here to the nearly 50 percent of mutual fund transactions that are conducted between broker-dealers and retail investors. What sets these transactions apart is the veneer of "impartial" advice that attaches to them. Recognizing that investors want and expect objective advice from their financial professionals, brokers have marketed themselves very aggressively in recent years as professional purveyors of just such advice. And they justify the commissions they receive in large part as compensation for the "advice" they offer. In fact, broker-dealers are not advisers, but salespeople. And the overwhelming evidence now suggests that they select the mutual funds (and other products) they recommend, not based on which offer the highest quality at the lowest price, as one would expect from an objective, professional adviser, but rather based on which offer lucrative financial incentives to the brokerage firm and the individual sales representative.

The incentives that are used to induce those sales are complex and often poorly disclosed, if they are disclosed at all. They include 12b-1 fees, directed brokerage, and payments for shelf space, in addition to the front and back loads that some funds charge. Furthermore, the competition among funds to be sold, in which compensation to the broker is often the most important determinant of fund sales, frees funds from having to compete by offering a high quality product at a reasonable price. As such, it allows funds to survive and even thrive that could not do so based on an objective assessment of their cost and quality.

This abusive approach to mutual fund sales harms some investors directly – by channeling them into funds with higher costs and poorer performance than they might otherwise have purchased. The long-term costs of a poor selection can be measured in the added thousands or tens of thousands of dollars that might have been earned from a lower cost, higher quality fund. Even investors who are not saddled with high sales loads, 12b-1 fees, and other distribution costs for poorly performing funds may be harmed indirectly by the sales model's weakening effect on mutual fund price competition. This lack of effective price competition permits and may even encourage escalation not just of distribution costs, but also of other shareholder expenses, such as portfolio transaction costs and management and administrative fees.

Abusive sales practices are not new. As a result of the negative light cast on the mutual fund industry by the recently revealed trading scandals, however, these old practices are getting new scrutiny – from Congress, the Securities and Exchange Commission, the National Association of Securities Dealers, and state securities regulators. This is a healthy, and long-overdue development.

So far, however, those who have examined these issues have tended to look at each practice – 12b-1 fees, payment for shelf space, soft dollar arrangements, unreasonably high management/administrative costs – in isolation. It is our strongly held view, however, that these practices – these problems – are closely related and need a unified, rather than piecemeal solution. Furthermore, while the mutual fund companies have certainly been accomplices in these practices, and thus bear a portion of the blame, many of these are problems that derive in large part from the broker-dealer sales model. Only a solution that addresses the gaping disparity between brokers' self-promoted images as objective advisers and their status as biased salespeople will be effective in driving down costs.

In my testimony today, I will discuss several abusive practices that help to drive up the cost of mutual funds to unreasonable levels. These include:

- 12b-1 fees that are used for entirely different purposes than those for which they were intended;
- revenue sharing arrangements that inflate current shareholders' portfolio transaction costs or management fees in return for agreements that promote the sale of the fund to new shareholders;
- soft-dollar agreements that similarly inflate shareholders' portfolio transaction costs in return for benefits that may or may not flow to those shareholders; and
- unreasonably high management/administrative costs at some fund companies that cannot be justified based on any additional level of performance or service offered by those funds.

I will then discuss how the mutual fund distribution system permits and even promotes these practices and review the regulatory response to date. Finally, I will propose additional reforms that can and should form the basis for comprehensive legislation to eliminate abuses and bring real price competition to the mutual fund marketplace.

12b-1 Fees

Rule 12b-1 was adopted by the SEC in 1980 after a lengthy period in the seventies in which funds had been losing assets. The rule permitted funds to use shareholder assets, rather than fund company assets, for certain marketing expenses. Under the rule, fees of up to 100 basis points, or one percent, can be charged as part of the fund's annual operating expenses.[1] Before the fees can be imposed, however, a 12b-1 plan must be approved by the fund's board of directors.

As the factors that directors are required to consider in approving such plans make clear, 12b-1 fees were intended to be used as "a short-term fix to a temporary problem" – the need to counter redemptions and build fund assets – not as a permanent means of paying for fund distribution.[2] Today, however, real world practice no longer reflects that intent. A study to be released today by mutual fund data research firm Lipper, Inc. has reportedly found that two-thirds of funds charge the fees, and 90 to 95 percent of them use the money to compensate brokers.[3] This allows funds to compensate brokers without having to charge an up-front sales load.[4] Similarly, fund companies that participate in fund supermarkets may use 12b-1 fees to cover the cost. Neither of these practices is consistent with the temporary nature of the fees envisioned by the SEC when it adopted the rule.

As a result of the transformation of 12b-1 fee from temporary to primarily permanent uses, these fees are no longer imposed exclusively by small, struggling funds as a way to build

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[1] NASD rules limit the amount of the fee that can be paid to broker-dealers to no more than 0.75 percent of the fund's average net assets for the year. An additional 0.25 percent service fee can go to the broker for providing on-going services to investors or for maintaining their accounts.

[2] "12b-1 Fees: Politics and Policy," *Fund Democracy Insights*, Vol. 1, Issue 4, September 2001. The article lists the relevant factors directors are required by the rule to consider in approving a 12b-1 plan, including "the nature of the problems or circumstances which purportedly make implementation or continuation of such a plan necessary or appropriate," "how it would be expected to resolve or alleviate them," and "the time it would take for those benefits to be achieved." The factors also require directors to "consider the interrelationship between the plan and the activities of any other person who finances or has financed distribution of the company's shares, including whether any payments by the company to such other person are made in such a manner as to constitute the indirect financing of distribution by the company."

[3] Brooke A. Masters, "Fund Fees Vital but Need Review, Lipper Says," *The Washington Post*, January 20, 2004.

[4] When brokers sell B shares of a fund, for example, the fund company typically pays the broker a commission up-front out of fund company revenues and then uses revenues generated by 12b-1 fees to reimburse itself for that cost.

assets and create economies of scale. As the Lipper research apparently shows, they have become all but ubiquitous, charged even by funds with billions of dollars in assets. The reason is hardly mysterious. As investors in the late 1980s and early 1990s became increasingly resistant to paying up-front sales loads when no-load options abound, the industry began looking for other ways of paying those distribution costs that would be less likely to attract investors' notice. 12b-1 fees filled the bill perfectly, because, although 12b-1 fees are disclosed as a line item in the fee table contained in fund prospectuses, many if not most investors appear to have a poor understanding of the fees and their long-term impact on shareholder returns.[5]

Brokers benefited from the increasing use of 12b-1 fees, because it gave the funds they were selling the appearance of lower costs, at least to unsophisticated investors, even when the opposite was true. Fund companies have benefited as well, because their management fees are paid as a percentage of assets under management and grow when fund assets grow. Use of 12b-1 fees allows them to boost their bottom line without risking fund company assets in the process. While fund companies often reduce management fees as fund assets hit certain benchmarks, they have clearly not fully passed along the economies of scale that have come with a rapidly growing asset base.[6] Thus, investors in funds that charge substantial 12b-1 fees may be stuck paying distribution costs whose benefits flow partially, or primarily, to the fund company, even when they themselves do use the services the fees are designed to provide.

Directed Brokerage

Another practice that grew out of the industry's desire to find less visible ways to pay distribution costs is the use of directed brokerage for this purpose. Under this form of "revenue sharing" payment, a fund agrees to conduct portfolio transactions through a particular broker in return for an agreement by that broker to sell the funds in that fund family. In practice, such agreements often mean the fund foregoes an opportunity to obtain lower transaction costs. Since transaction costs are paid directly from fund assets, any practice that drives up fund transaction costs will depress shareholder returns.

The conflict is virtually identical to that described above with regard to 12b-1 fees. The fund company uses the assets of current shareholders to promote the sale of the fund, or other funds in the same family, to potential investors. In the process, it boosts its own bottom line, which is based on a percentage of assets under management, without having to risk its own assets. As a result, shareholders are forced to pay higher costs for benefits that flow in part or in full to the fund company or, in some cases, to investors in other funds. Furthermore, some have

[5] For example, Paul Roye, Director of the Division of Investment Management of the Securities and Exchange Commission commented on the poor state of investor understanding of mutual fund costs and fees in his July testimony before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives.

[6] "Tricks of the Trade," by Craig D. Rose, *Union-Tribune* quotes New York Attorney General Eliot Spitzer as saying that mutual fund investment grew 60-fold between 1980 and 2000, while the industry's fees increased 90-fold, indicating that economies of scale are not being passed along to shareholders.

suggested that fund companies may be tempted by directed brokerage agreements to engage in unnecessary and excessive trading, which drives up shareholders' costs, in order to generate more commissions and boost the incentive for a broker to sell the family's funds.[7]

The practice appears to be quite widespread. A recent SEC enforcement sweep of 15 broker-dealers that sell mutual funds found that 10 of the 15 accepted revenue sharing payments in the form of brokerage commissions on fund transactions.[8] According to one estimate, $1.5 billion a year of the fund industry's $6 billion in trading commissions goes to pay for distribution through such arrangements, but others have suggested the percentage is much higher.[9]

Directed brokerage has one enormous advantage over 12b-1 fees as a means of paying distribution costs, at least if your goal is to keep those costs hidden. While 12b-1 fees enable funds to lower or eliminate the up-front load many investors object to, they still inflate the annual expense ratio and are clearly disclosed as a separate line item in mutual fund prospectuses.[10] Portfolio transaction costs, on the other hand, are only incompletely disclosed in the Statement of Additional Information, which is not automatically distributed to investors and is rarely requested.[11] Thus, distribution costs paid for through directed brokerage do not show up either in the form of a sales load or in the form of an inflated expense ratio.

Payments for Shelf Space

Payments for shelf space are another form of revenue sharing payment used to promote distribution. In this case, the fund's investment adviser makes cash payments to the broker-dealer in return for "increased access to their sales staff, or for 'shelf space.'"[12] The SEC, in its examination sweep, found that payments vary considerably, from 5 to 40 basis points on sales and from 0 to 25 basis points on assets that remain invested through the broker-dealer. Fourteen of 15 broker-dealers examined as part of the SEC sweep received such cash payments. Thirteen

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[7] "Misdirected Brokerage," by Rich Blake, *Institutional Investor Magazine*, June 17, 2003.

[8] "SEC Revenue Sharing Examination Findings" email provided to reporters by SEC Tuesday, January 13, 2004.

[9] "Misdirected Brokerage." The $1.5 billion figure – or 25 percent of funding industry generated trading commissions, is attributed to a "former fund marketing executive." The article quotes former SEC attorney Edward Siedle as suggesting the amount is closer to 75 percent.

[10] Since investors who purchase funds through brokers often do not receive the prospectus until after the sale, this "clear" disclosure does not necessarily equate with effective disclosure.

[11] Funds report the commissions they pay, but not other portfolio transaction costs, such as spreads, in the SAI. In addition, they may disclose the existence of revenue sharing payments generally in their prospectuses or the SAI, according to the SEC's email outlining its examination findings. The SEC also found that only about half of the broker-dealers disclosed their revenue sharing arrangements in any way, and that some of those disclosed only the existence of the payments without providing any other details.

[12] SEC email of examination findings.

"appear to have favored the sale of the revenue sharing funds by providing increased access and visibility in the broker-dealer's sales networks (e.g. listings on firms' websites, access to sales staff, promotional material sent to customers, inclusion on firms' recommended lists)."[13] About half of the brokers also paid their registered representatives more to sell the revenue sharing funds than they paid for the sale of other funds (except, in three cases, for proprietary funds).[14]

Unlike 12b-1 fees and directed brokerage, payments for shelf space do not come directly out of shareholders' pockets. Instead, the fund managers make the payments out of fund company revenues and must either absorb the cost or pass it along to shareholders indirectly as part of the management fee. At the very least, by eating into the manager's bottom line, the payments may reduce the likelihood that the management fee will be reduced in response to growth in fund assets. At worst, fund managers will pass those costs along to investors in a form that is even less transparent than directed brokerage payments.

Soft Dollar Arrangements

Soft dollar arrangements, like directed brokerage, involve an agreement by the fund company to pay higher trading commissions than might otherwise be available on its portfolio trades. In return, in this case, the fund receives not distribution, but research and other services. The practice is permitted as a result of a 1975 amendment to the Securities Exchange Act, which created a "safe harbor" for money managers who do not seek the lowest commission costs but instead use commissions to pay for certain types of non-overhead services.

The safe harbor was conceived primarily to allow funds to purchase research. A 1998 SEC study estimated that funds used soft dollar arrangements to purchase more than $1 billion in third-party research in a year.[15] A mutual fund executive testified before a House subcommittee in March that the research component of soft dollar commissions is worth six times the execution component.[16] Thus, the potential for these arrangements to significantly drive up shareholder costs is substantial. In recent years, soft dollars have also been used for a variety of services beyond research, including subscriptions, data feeds, pricing services, and other such services that closely resemble the type of overhead items for which use of soft dollars is prohibited.

Like directed brokerage, soft dollar arrangements allow mutual fund managers to shift costs onto to shareholders that they would otherwise be forced to pay themselves. As Paul Roye,

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[13] Ibid.

[14] Ibid.

[15] *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds*, Securities and Exchange Commission, September 22, 1998.

[16] Testimony of Harold Bradley, Senior Vice President, American Century Investment Management, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, March 12, 2003.

Director of the SEC's Division of Investment Management, testified in June before a House subcommittee:

> "Soft dollar arrangements involve the potential for conflicts of interest between a mutual fund and its investment adviser, since they involve incentives for fund advisers to (i) direct fund brokerage based on the research provided to the adviser rather than the quality of execution provided to the fund, (ii) forego opportunities to recapture brokerage costs for the benefit of the fund, and (iii) cause the fund to overtrade its portfolio to fulfill the adviser's soft dollar commitments to brokers."[17]

These conflicts of interest are exacerbated by the fact that no guarantees exist to ensure that shareholders who pay the soft-dollar costs reap the benefits of any research or other services paid for in this manner. In some cases, soft dollars may pay for services that primarily benefit the fund manager rather than fund shareholders. In other cases, the benefits paid for by shareholders in one fund may flow at least in part to shareholders in another fund. For example, investors in a fund family's bond funds might get benefits from soft dollar payments whose costs are borne by shareholders in a stock fund.

Soft dollar arrangements have another characteristic in common with directed brokerage. The potentially substantial costs they impose on shareholders are largely hidden from view. This is because the costs come in the form of portfolio transaction costs that are not included in the fund's expense ratio and are only partially disclosed in the fund's SAI. (See footnote 8 and text at footnote 8.)

Management/Administrative Fees

As the example of soft dollar arrangements make clear, not all high mutual fund costs are driven by distribution. Another type of non-distribution-related mutual fund cost that has come in for criticism is the exorbitant management/administrative fee[18] charged by some funds with no apparent justification in terms of improved performance or enhanced service quality.

In recent years, the debate over mutual fund management fees has focused primarily on questions of why – given the enormous growth in fund assets in the past two decades – mutual fund shareholders have not seen more benefit from resulting economies of scale. No one has made the argument that mutual fund expenses are excessive more eloquently, or more relentlessly, than my fellow panelist, John Bogle, Founder and former CEO of the Vanguard Group. The industry has attempted to answer this argument by showing that investors' total

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[17] Testimony of Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, June 18, 2003.

[18] Although these fees cover both portfolio management fees and fees for administrative services, for the purposes of simplicity I will from now on refer to these fees as management fees.

costs, including distribution costs, had declined in recent years.[19] However, about half the decline found by industry trade association Investment Company Institute (ICI) was the result of shareholder behavior – putting more money into no-load funds. Even the ICI research found that average expense ratios for stock funds had risen, from 0.77 percent in 1980 to 0.83 percent in 1998 and to 0.88 percent in 2001. That finding is compatible with the findings of recent studies by both the SEC and the Government Accounting Office, which also uncovered evidence of rising expenses.[20] It is incompatible only with the notion that growing assets would result in economies of scale that would be passed along to investors.

Since the emergence of the mutual fund trading scandals, the debate over management fees has tended to focus more on alleged differences in the fees that pension funds and mutual fund shareholders pay for advisory services. That case has been defined by another of my fellow panelists, University of South Carolina Professor John P. Freeman, whose definitive research paper on the topic found that pension funds paid roughly half as much in advisory fees as did mutual fund shareholders.[21]

That research has been hotly contested by the mutual fund industry, which argued that the management fees paid by pension funds and mutual funds are not comparable because of operational differences between the two types of accounts. To bolster its argument, ICI issued new research in November and expanded on that research in January claiming the advisory costs for mutual fund shareholders and pension funds are virtually identical once these operational differences are taken into account.[22] To get a "clean" number for advisory services, without attendant administrative costs included, ICI compared pension fund advisory costs to those of sub-advised funds. While we do not have the definitive answer with regard to the comparability of costs between pension and mutual funds, it seems clear that fees paid to sub-advisers should not be viewed as typical of the industry as a whole, since these, like pension fund advisory fees, are negotiated at arm's length, whereas most mutual fund advisory fees are not.

Regardless of the outcome of this debate, we believe there is compelling evidence that management costs at some funds are excessive. To approach this issue from the simplest, most straightforward angle, CFA recently examined costs at S&P 500 index funds, using a list of such funds compiled for us and Fund Democracy in July of 2003 by Morningstar. We chose this type

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[19] Investment Company Institute, *Total Shareholder Cost of Mutual Funds: An Update*, September 2002.

[20] Securities and Exchange Commission, *Report on Mutual Fund Fees and Expenses*, December 2000 found evidence that average expense rations of all stock and bond funds had risen from 0.73 percent in 1979 to 0.94 percent in 1999, primarily as a result of increasing use of 12b-1 fees to pay for fund distribution costs. General Accounting Office, *Mutual Funds: Information on Trends in Fees and their Related Disclosure*, March 2003 found that average expense ratios for large stock funds have risen since 1998, while fees for bond funds have declined.

[21] John P. Freeman and Stewart Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 Journal of Corporation Law 610 (2001).

[22] Investment Company Institute, *The Expenses of Defined Benefit Pension Plans and Mutual Funds*, January 2004.

of fund because no one can credibly argue that higher costs bring added benefits to shareholders in these passive investments, which seek only to match the returns of the underlying index. In reexamining the data last fall, we verified the information against fund profiles obtained through Yahoo! Finance, eliminated a handful of funds that had mistakenly been included in the data set, and identified the level of any 12b-1 fees imposed by the funds on the list.

Our search turned up 16 fund families that offer S&P 500 index funds with annual expenses of more than one percent. The highest cost fund charged annual expenses of 2.18 percent, according to the Morningstar data.[23] This compares with expenses of 0.18 percent and 0.19 percent respectively for the Vanguard and Fidelity funds. Most of the funds on the list consisted of B and C shares, with a significant portion of annual expenses coming from 12b-1 fees set at or near the maximum permissible level. However, two of the funds identified – AAL Large Company Index II A and Mainstay Equity Index A – charged front loads of 5.75 percent and 3 percent respectively for their high-cost funds.[24]

While distribution costs were a significant contributing factor to the high costs of many of the funds, virtually all of the funds on the list had underlying management costs (with 12b-1 fees subtracted) that were two, three, and even four times as high as those of the Vanguard and Fidelity funds. While we recognize that not every fund company can match the rock-bottom prices charged by Vanguard, for such large cost discrepancies to exist in a passive investment like an S&P 500 index fund, it seems reasonable to conclude that costs at the higher end of that scale are unreasonable. Furthermore, we have every reason to believe that a similar examination of other index funds would produce similar results, and no reason to believe that index funds are alone in charging these excessive fees.

Why High Costs Persist

Congress enacted legislation in 1970 authorizing the SEC to sue fund managers and fund directors when they impose fees that are excessive. Although the SEC requested this authority, it has never to our knowledge chosen to use it. Excessive is of course a subjective term and open to interpretation. It is possible the SEC has not yet encountered a fee it considers excessive. However, given the results of our quick review of S&P 500 index funds, and in light of the fact that a recent spot search turned up seven actively managed funds with annual expenses near or above 10 percent, there would seem to be ample candidates for SEC attention.[25]

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[23] This was the AAL Large Company Index II B fund.

[24] The AAL fund A shares had an expense ratio of 1.29 percent, including a 0.25 percent 12b-1 fee. The Mainstay fund had annual expenses of 1.02 percent, including a 0.25 percent 12b-1 fee.

[25] The search was conducted by Fund Democracy President Mercer Bullard in response to a request from Chairman Fitzgerald. The highest cost fund turned up in that search was the Frontier Equity Fund, which, according to its registration statement has annual expenses of 43.24 percent and a front load of 8 percent. Because the adviser waives certain fund expenses, however, the annual fee charged to investors is reduced to 42.26 percent.

Instead, current leaders at the SEC have said that they prefer to rely on improved governance and market competition to discipline costs. They have been highly critical of New York Attorney General Eliot Spitzer for taking a more interventionist approach. At first glance, the SEC's preference for market discipline of costs appears to be a perfectly reasonable approach. After all, where could one find a more robustly competitive market than the mutual fund market? Investors are free to choose from among hundreds of fund companies offering thousands of funds using several distribution and pricing models. In a market so rich in choice, how could excessive prices possibly persist?

A closer look, however, quickly reveals that the mutual fund market lacks three key characteristics needed to effectively discipline costs: transparent disclosure, meaningful price competition, and, absent those two characteristics, regulatory policing of the worst abuses.

<u>Lack of Transparent Disclosure</u>: Mutual funds provide more and sometimes better cost information than many other financial products. These disclosures nonetheless fail all three critical tests of for effective disclosure: does it provide 1) the information investors need, 2) in a form they can understand and use, 3) at a time when it is likely to affect their purchase decision?

1) Mutual fund cost disclosures fail to provide all the information investors need to assess costs and their likely effect on investment returns.

In the disclosure of mutual fund operating expenses, the most glaring short-coming is the omission of portfolio transaction costs from the annual expense ratio. These costs vary greatly from fund to fund and, in some cases, may exceed all other fund expenses combined.[26] Failure to include these costs in the expense calculation is an invitation to abuse. First and foremost, it creates a strong incentive for funds to pay for distribution and other services through directed brokerage and soft dollar arrangements, since these arrangements allow them to hide costs that they would otherwise have to disclose and, in the process, make the fund look like a better deal than it really is. It also reduces, though it does not eliminate, the incentive for funds to compete by keeping their brokerage costs as low as possible.[27]

We recognize that incorporating all transaction costs in the expense ratio is not necessarily an easy thing to do. While commissions are fairly easily quantifiable, spreads, market impact, and opportunity costs are more difficult. On the other hand, the fact that a

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[26] A memorandum from Paul Roye, Director, Division of Investment Management, to William Donaldson, Chairman, Securities and Exchange Commission, June 9, 2003 cited studies of mutual fund portfolio transaction costs that estimated brokerage commission costs at 0.30 percent of equity funds' net assets, market spread costs at about 0.50 percent of equity funds' net assets, and opportunity costs at 0.20 percent. Others have estimated the costs to be even higher. See, for example, Chalmers, Edelen & Kadlee, *Fund Returns and Trading Expenses: Evidence on the Value of Active Fund Management*, December 29, 2001.

[27] Since transaction costs are a drag on performance, funds still have an incentive to minimize costs, although for many funds the perceived benefits of directed brokerage and soft dollar arrangements clearly outweigh those incentives.

number of private companies already provide fund advisers with quantitative assessments of their transaction costs suggests that this is not an insurmountable task. Given the serious problems that result from not disclosing these costs, it is clearly a task that must be tackled.

Another shortcoming of operating cost disclosure is its lack of transparency regarding how management and administrative fees are spent. Although investors receive a general number for the operating costs, they have little if any ability to determine how much of that fee goes toward salaries, how much toward distribution payments, how much toward various administrative services, and, if transaction costs were to be included, how much toward portfolio transaction costs. Presenting this information in an easily understood pie chart would give investors a clearer understanding of how their money is being spent and whether it is being spent wisely.

Other disclosures are also lacking. Investors clearly do not receive adequate information about the financial incentives brokers receive to sell particular funds. Currently, because of an SEC rule interpretation, brokers do not have to disclose the source and amount of compensation they receive from fund sales on confirmations, as they must do for the other products they sell. This rule interpretation should be rescinded by the SEC. Brokers that receive payments for shelf space or participate in other revenue sharing arrangements should have to disclose that fact prominently before the sale. Information on sales incentives should include not just the existence of the incentives, but also the dollar amounts involved, how those compare to industry norms, and the nature of the conflicts of interest created. Investors would also benefit from better information about the availability of breakpoints as well as information that would allow them to compare the appropriateness of different share classes for different investment scenarios.

2) Mutual fund costs disclosures do not provide that information in a format that is likely to be read, understood, and used by investors.

One key short-coming of the current cost-disclosure system is that most disclosure requirements are satisfied if the information is included in the fund prospectus, where it may get lost in the huge mass of information provided. Other disclosures are relegated to the Statement of Additional Information (SAI), which is not automatically provided to investors and is rarely requested. As a result these disclosures may never be seen. Furthermore, neither document is designed to entice investors to read it, and many funds obscure the information they do provide by couching it in highly technical language.

Another shortcoming of the current system is that the key cost information, the annual expense ratio, is presented as a percentage of assets under management. Presented in this way, differences of a few basis points hardly seem significant, at least to unsophisticated investors, but they can have dramatic long-term effects on shareholder returns. In its on-line profiles of mutual funds, Yahoo! Finance computes three-, five-, and ten-year expense projections and presents them in a table next to projections based on the average cost for that fund category. While the system of categorization is imperfect, this approach offers a promising model for presenting cost information in a format that would really help investors to understand the long-term implications of those costs and to compare costs across funds.

The SEC should conduct a comprehensive evaluation of existing disclosures and proposed new disclosures to determine what does and doesn't work to effectively convey information to shareholders, particularly those who are not well served by existing disclosures. That evaluation should include issues related to format, placement, and readability, as well as content of disclosures.

3) Mutual fund cost disclosures do not provide key information at a time when it is most likely to influence purchase decisions.

Simple logic dictates that for cost disclosures to have an impact on the purchase decision, they must occur before the sale. Yet most cost disclosure requirements are satisfied by delivery of the prospectus, which may occur with the confirmation after the sale. We will never have effective cost competition in the mutual fund industry until this system is changed to require pre-sale disclosure.

Lack of Effective Cost Competition: Despite appearances, only a relatively small portion of the mutual fund marketplace could be said to be truly competitive. That is the 13 percent of mutual fund transactions that occur directly between the fund company and the retail investor and outside of any employer-sponsored retirement plan.[28] While performance-based advertising may distort this market somewhat, the prevalence of relatively low-cost funds in the direct-marketed segment of the industry strongly suggests that minimizing costs is viewed as critical to success for funds that rely on their ability to sell themselves to investors directly.

A growing percentage of mutual fund transactions occur through employer-sponsored retirement plans.[29] In these plans, investors generally have very limited options and therefore cannot effectively make cost-conscious purchase decisions. These investors must instead rely on their employers to consider cost when selecting the plan. But plans often compete for employers' business by shifting the administrative costs onto the employees in the form of higher 12b-1 fees. While the recent trading scandal may have made employers more sensitive to their fiduciary duties in selecting a plan, it is not certain that this is the case or, if it is, that this new sensitivity will extend to issues of cost.

That leaves the approximately 50 percent of mutual fund transactions that occur through broker-dealers and other salespeople and outside a company-sponsored retirement plan.[30] Funds that rely on this market compete to be sold, not bought. While funds that compete to be bought can be expected to do so by offering a high quality product and good service at a reasonable price, funds that compete to be sold do so by offering generous remuneration to the selling firm

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[28] Investment Company Institute, *2003 Mutual Fund Fact Book*, 43rd Edition.

[29] Ibid.

[30] "Misdirected Brokerage."

and to the individual salesperson. They do this through a variety of means discussed above – sales loads, 12b-1 fees, payments for shelf space, and directed brokerage – that drive costs to investors up, not down. As I previously noted, this sales-driven model frees funds from having to compete based on the quality or low costs of their product and allows high-cost, inferior funds to survive, and even thrive, that simply could not do so in a truly competitive market.

The Regulatory Response

The SEC was slow to acknowledge the need for fundamental reforms to bring down the costs of mutual funds. Last year, for example, when the House was considering mutual fund reform legislation, the agency opposed individualized cost disclosures on account statements as too costly, without ever conducting a cost-benefit analysis that considered cost savings to investors from making more cost-conscious decisions.[31] As an alternative, it proposed dollar amount cost disclosures for a hypothetical $10,000 account in the annual and semi-annual reports, a location where it is almost certain to have no effect on investor purchase decisions. The agency was lukewarm at best in its response to proposals to require funds to have an independent board chairman, a lack of support that helped keep this provision out of the House bill. And, more recently, when Attorney General Spitzer included cost reductions in his settlement with Alliance Capital Management, the Commission took the virtually unprecedented step of issuing a news release critical of the fee reduction agreement.

On the other hand, the Commission has conducted important investigations of both breakpoint practices and revenue-sharing arrangements. It reached a landmark settlement with Morgan Stanley over its mutual fund sales practices that should have put the brokerage industry on notice that it can no longer assume such practices will be ignored. And it has recently proposed several promising rules, though details on some of its proposals are not yet available. Specifically:

- The Commission recently proposed rules to strengthen the independence of mutual fund boards by requiring three-quarters of board members, including the chairman, to be independent, requiring independent members to meet at least quarterly without any interested parties present, and authorizing the board to hire staff to help it fulfill its responsibilities.

- This rule proposal would require boards to retain copies of the written materials they consider in conducting their annual review and approval of the advisory contract.

- The Commission issued a concept release seeking suggestions on how to improve disclosure of portfolio transaction costs.

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[31] New York Attorney General Eliot Spitzer noted in November 4, 2003 testimony before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives that a 25 basis point reduction in the annual expenses that shareholders pay would result in a savings of $10 billion annually.

- The Commission is developing proposed rules to improve disclosure of conflicts of interest related to mutual fund sales that, according to media reports, will include a point-of-sale document. That document would show investors in dollars what they would pay for any initial sales charges or loads, with estimates of next-year payments for funds with deferred loads or 12b-1 fees. The point-of-sale disclosure would also reportedly show whether the broker receives compensation from the mutual fund company in exchange for promoting the fund company's products and whether the brokerage firm or broker is paid more to sell that firm's funds rather than those from other fund families.[32]

- The same rule proposal will reportedly require increased disclosure on confirmation reports, including the price and any front-end sales charge in dollars and as a percentage of the purchase, dollar estimates of 12b-1 fees and of back-end loads, the levels at which discounts are available on sales charges, a dollar break-down of any payments brokers receive for selling particular funds or classes of fund shares over others, and, for the sale of proprietary or affiliated funds, whether the broker gets a higher percentage payout than he or she would for selling other funds.[33]

- In November testimony before the Senate Banking Committee, SEC Chairman Donaldson indicated that the Commission is considering additional reforms, including development of a solution to the problem of trading through omnibus accounts, and is examining the use of soft dollar arrangements.

Despite this important progress, there are serious gaps in the SEC's regulatory agenda. For example, the SEC does not have the authority to strengthen the definition of independent director. So, even if it adopts its independent governance requirements over the already announced objections of two Commissioners, non-immediate family members, individuals associated with significant service providers of the fund, and recently retired fund company employees would all be eligible to serve as "independent" directors. In addition, the SEC proposal does not require that a nominating committee of independent directors select new independent directors, nor does it require directors to periodically stand for election – proposals that have been included in mutual fund reform legislation. Congress must act to strengthen the definition of independent director and fill in these gaps in the SEC proposal.[34] The legislation introduced by Sen. Akaka and Chairman Fitzgerald contains an excellent definition of independence that would be an excellent supplement to the SEC's rule proposals.

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[32] This description is taken from a January 21, 2004 Dow Jones Newswires article by Judith Burns, "SEC Seeks Input on Fund Reports," which ran in the *Wall Street Journal.*

[33] Ibid.

[34] The SEC rules apply to funds that rely on one of its exemptive rules. The SEC has stated in its rule proposal that "almost all" funds either rely on or expect at some time to rely on one of these rules, so they believe the governance reforms would reach all funds. Legislation would eliminate this ambiguity.

It is impossible to judge at this point whether the SEC's concept release on portfolio transaction costs represents a genuine effort on the part of the Commission to come up with a workable solution or whether the Commission is merely going through the motions in order to affirm its long-held view that only very limited portfolio transaction information can be disclosed to investors.[35] Until these costs are incorporated in the expense ratio, funds will have a powerful incentive to shift operating and distribution costs into the one channel where they are invisible. Only time will tell whether the SEC is willing to embrace this approach. It would be far better for Congress to mandate this essential reform.

Even the Commission's promising disclosure proposals on conflicts of interest appear to have serious gaps. Although it is impossible to be sure until the rule proposal is published, it does not appear that the Commission intends to include information about the non-distribution related expenses of the fund – the annual expense ratio – in either the point-of-sale document or on the confirmation statement. Furthermore, if the Commission is going to take the unprecedented step of requiring point-of-sale disclosure, it should do more to ensure that it covers all the information investors should have prior to sale, including information on investment risks, for example, and comparative information on fund costs, not just sales incentives. Congress should build on what the Commission has begun and ensure that all the key information investors need pre-sale is included in these reports.

Chairman Donaldson has indicated the agency will study use of soft dollars, but the SEC does not have the authority to repeal the safe harbor. Soft dollars create unacceptable conflicts of interest. While some may have been content to trust mutual fund executives to handle these conflicts ethically before the trading scandals, that would be an irresponsible position to take in light of recent events. Congress should step in and do what the SEC cannot, repeal the soft dollar safe harbor, restoring funds' obligation to obtain best execution on their trades, and require funds to have explicit contracts outlining any services they receive from brokers and what they pay for them.

Suggestions for Additional Congressional Reforms

One shortcoming of the SEC approach is that it relies exclusively on better disclosure of broker-dealer conflicts of interest rather than on bans of conflict-inducing practices. We believe it would be a serious mistake to put too much faith in the ability of disclosure to influence purchase decisions made by investors who purchase their funds through brokers. Such an approach ignores the fundamental reality of how investors relate to brokers and the degree to which they rely on them for advice.

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[35] In the past, Commission staff members have suggested that inclusion of commission costs in the prospectus and more prominent disclosure of the fund turnover rate might satisfy this requirement. Turnover rate is a far from perfect proxy for transaction costs, however, and does nothing to distinguish between funds that obtain inexpensive execution for their trades and funds that do not. This is not a satisfactory approach.

Brokers are legally salespeople, without the adviser's obligation to place client interests ahead of their own. In fact, their exemption from the Investment Advisers Act is conditioned on their limiting themselves to giving advice that is "solely incidental" or "merely secondary" to product sales. However, this is *not* how they present themselves to clients. Instead, they adopt titles, such as financial adviser or investment consultant, that are designed to convey to their clients that advice is the primary service they have to offer. Their advertising campaigns relentlessly send the same message.

Even sophisticated personal finance writers often fail to make this distinction between brokers, whose role is to effect transactions in securities, and investment advisers, who role is to offer advice. If those who make their living covering personal finance issues make this mistake, it should not be surprising that unsophisticated investors tend to approach their relationship with their broker with an attitude of trust. Lacking confidence in their own financial acumen, they seek out the advice of a financial professional, and they expect to rely without question on that professional's recommendations.

Improved disclosure should help encourage investors to see their financial professionals in a more realistic light. We doubt, however, that even the best disclosures will be able to overcome multi-million-dollar advertising campaigns that send exactly the opposite message. Instead, we believe it is long past time to require brokers either to live up to the advisory image they project – and accept the attendant responsibility to make recommendations that are in their clients' best interests – or to cease misrepresenting themselves to clients as advisers. To the degree that the Commission has taken a position on this issue, however, it has been to propose to expand the loophole that allows brokers to portray themselves as advisers, earn fees they identify as fees for advice, and still rely on the "solely incidental" exclusion from the advisers act.[36]

Even where advisers have an obligation to put their clients' interests ahead of their own, the SEC has not to our knowledge ever enforced this obligation with respect to price or ever challenged advisers based on their recommendation of high-cost, inferior products. We believe it is time for the agency to start. However, we doubt the Commission will take this position without prodding from Congress. As a first step, Congress should conduct a thorough investigation of the role and operations of brokers and advisers as the basis for legislation to ensure that their conduct matches their representations about the services they offer.

Even before such a comprehensive review is undertaken, however, the current focus on mutual fund sales practices offers several opportunities to end some of the most abusive such practices. For example, an early news account of Lipper's research on 12b-1 fees included an interesting proposal in this regard. According to an article in *The Washington Post*, Lipper Vice President Jeffrey C. Keil suggested that investors might be better served if companies sold the

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[36] SEC Proposed Rule, "Certain Broker-Dealers Deemed Not To Be Investment Advisers," File No. S7-25-99. The rule was proposed in 1999, at which time the Commission adopted a "no action" position that assured brokers that they would not be subject to enforcement actions based on violation of the rule pending adoption of a final rule. No final rule has been adopted.

funds at a set price and left it to each broker to charge a specific commission and service fee.[37] This is an intriguing idea. There is, after all, no compelling reason why distribution costs should be paid through the mutual fund rather than directly by investors. The costs would be more transparent under such a system, and the change could transform the dynamics of competition. Specifically, if funds got out of the business of competing to be sold, and brokers' compensation came directly from the investor and did not depend on which fund they sold, then brokers might begin to compete on the basis of the quality of their recommendations, and funds might have to compete accordingly, by offering a quality product and good service at a reasonable price.

Finally, in his November testimony, SEC Chairman Donaldson also said the Commission was considering whether there were ways in which funds could "assume greater responsibilities for compliance with the federal securities laws, including whether funds and advisers should periodically undergo an independent third-party compliance audit. These compliance audits could be a useful supplement to our own examination program and could ensure more frequent examination of funds and advisers." Recent accounting scandals should have taught us all the risks of relying on audits that are paid for by the entity being audited. Even today, after passage of significant reform legislation, each new accounting scandal seems to be accompanied by a statement from the auditor expressing bewilderment at the idea that anyone would think they should have uncovered and prevented the fraud. We fear a new program of private audits in this area would produce the same, predictable response.

If the SEC needs a supplement to its own examination program, therefore, we believe a far better approach would be to create an independent board, subject to SEC oversight, to conduct such audits. The board could be modeled on the Public Company Accounting Oversight Board, with similar authority to set standards, conduct inspections, and bring enforcement actions and similar (or, better yet, stronger) requirements for board member independence. Several bills have been introduced that address this issue. S. 1822, Sen. Akaka and Chairman Fitzgerald's bill, would require the SEC to study the advisability of such a board. Legislation introduced by Senators Dodd and Corzine would instead entrust the study to the GAO. And legislation introduced by Senators Daschle, Kerry and Kennedy would create such a board. At the very least, we believe Congress needs to assess the adequacy of SEC resources for oversight of mutual funds and determine whether an independent board would provide the best supplement if those resources are determined to be inadequate.

Conclusion

Mutual funds have long offered the best way for investors who have only modest amounts of money to invest to obtain broad diversification and professional management. The trading scandals have sullied the fund industry's reputation, but they have also opened up an opportunity to reexamine some industry practices that had too long gone unchallenged. The SEC appears to be making genuine progress in addressing some of these issues related to fund

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[37] Brooke A. Masters, "Fund Fees Vital but Need Review, Lipper Says," *The Washington Post*, January 20, 2004.

governance and cost and conflict disclosure, but there are serious gaps in its efforts. Some result from the SEC's lack of authority to effect change, and others result from the SEC's lack of a vision for how the market could be transformed. In holding these and previous hearings, this Committee has helped to expand our understanding of what can and should be done to protect investors from abusive practices and to bring down unreasonable costs. We appreciate your efforts and look forward to working with you to make this vision of a more equitable marketplace a reality.

STATEMENT OF PAUL SCHOTT STEVENS

ON BEHALF OF THE

INVESTMENT COMPANY INSTITUTE

BEFORE THE

SUBCOMMITTEE ON FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY

COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

ON

"OVERSIGHT HEARING ON MUTUAL FUNDS: HIDDEN FEES, MISGOVERNANCE AND OTHER PRACTICES THAT HARM INVESTORS"

JANUARY 27, 2004

EXECUTIVE SUMMARY

- Like other investments, mutual funds have fees and expenses that investors pay to cover costs of services and benefits associated with fund investments. Mutual funds fees are subject to extensive disclosure requirements, including a requirement to provide a standardized fee table at the front of each fund prospectus.

- The SEC has proposed several further enhancements to existing disclosure requirements. The SEC's proposals would require: (1) disclosure of the dollar amount of fund expenses in shareholder reports; (2) improved prospectus disclosure concerning sales charge breakpoint discounts; and (3) additional disclosure about distribution-related costs (including 12b-1 fees and revenue sharing payments) prior to purchasing fund shares and on confirmation statements. The SEC is also seeking comment on how to improve disclosure of portfolio transaction costs. These far-reaching proposals should improve investor awareness and understanding of mutual fund fees and costs.

- Studies conducted by the Investment Company Institute, the SEC staff, the GAO, and industry analysts show that mutual fund fees have declined over time. In addition, in a recent study refuting the findings of an Iowa law journal article, the Institute found that mutual funds and pension plans likely pay similar fees for similar portfolio management services.

12b-1 Fees

- The SEC adopted Rule 12b-1 in 1980, authorizing funds to use their assets to pay distribution costs in an effort to help funds increase sales to offset net redemptions. The use of fund assets to pay for distribution has evolved over time and has allowed funds to give investors options in how and when they pay for professional advice or other services provided by financial intermediaries.

- 12b-1 fees are disclosed in fund prospectuses and are subject to substantive regulation, including numerical limits and fund director oversight. The SEC has proposed new requirements under which broker-dealers would have to make additional disclosures to investors about 12b-1 fees before they purchase mutual fund shares.

Revenue Sharing Arrangements

- Intermediaries such as broker-dealers often demand compensation for distributing fund shares and providing services to shareholders beyond the amounts they receive through sales charges and 12b-1 fees. Thus, it is common for fund investment advisers or principal underwriters to enter into "revenue sharing" arrangements under which the adviser or underwriter makes payments to compensate selling intermediaries out of its own resources.

- The principal investor protection concern raised by revenue sharing payments is whether they have the potential for influencing the recommendations of the financial intermediary that is receiving them. For this reason, the Institute has long advocated additional, point-of-sale disclosure to help investors assess and evaluate recommendations to purchase fund shares. The NASD and the SEC have recently proposed new point-of-sale disclosure requirements in this area.

Brokerage Allocation Practices

- In order to avoid the appearance of conflicts of interest as well as the potential for actual conflicts, the Institute recommends tightening existing regulations to curtail the use of soft dollars by all investment advisers, including mutual fund advisers, and to ban the practice of directing brokerage to reward broker-dealers for selling fund shares. The Institute is pleased that the SEC has announced plans to propose rulemaking in the near future to prohibit funds from using brokerage commissions to pay broker-dealers for selling fund shares.

- The Institute looks forward to working with the Subcommittee, regulators and others to achieve the important goal of promoting investor understanding of mutual fund fees and costs.

Table of Contents

I. INTRODUCTION

My name is Paul Schott Stevens. I am a partner in the Financial Services Group of Dechert LLP. From 1993 to 1997, I was Senior Vice President and General Counsel of the Investment Company Institute.[1] I currently serve as outside counsel to the Institute.

I am pleased to appear before the Subcommittee today on the Institute's behalf to discuss disclosure and substantive regulation of, as well as trends in, mutual fund fees and expenses, including Rule 12b-1 distribution fees, and to provide the Institute's views on regulation of revenue sharing and soft dollar arrangements.

Issues concerning mutual fund fees and expenses, and in particular investor understanding of those fees and expenses, are very important. These issues deserve, and receive, attention on a regular basis to determine whether improvements can be made. But I am compelled to note that these issues are completely unrelated to the late trading and market timing scandals. As the Institute has indicated in previous testimony before this Subcommittee, strong actions are required to address the late trading and market timing abuses that have been brought to light.[2] It would be a huge mistake, however, to point to those scandals as the basis for making wholesale changes to the basic structure and economics of the mutual fund business

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,601 open-end investment companies ("mutual funds"), 604 closed-end investment companies, 110 exchange-traded funds and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.240 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

[2] *See* Statement of Matthew P. Fink, President, Investment Company Institute, *Mutual Funds: Trading Practices and Abuses That Harm Investors*, Before the Subcommittee on Financial Management, the Budget, and International Security, Committee on Governmental Affairs, U.S. Senate, 108th Cong., 1st Sess. (Nov. 3, 2003).

that some have proposed. While the problems found at some fund firms are extremely serious and must be redressed, we should not lose sight of the fact that mutual funds still offer the best and least expensive way for millions of Americans to invest in the securities markets and achieve important financial goals.

My testimony will first discuss mutual fund fees generally, including the requirements governing disclosure of mutual fund fees and expenses, the continued decline of mutual fund fees and a comparison of mutual fund and pension fund fee levels. Next, I will outline current and proposed regulatory requirements relating to 12b-1 fees and revenue sharing. Finally, I will describe the Institute's recommendations for reform regarding brokerage allocation arrangements, including soft dollar arrangements and directed brokerage.

II. MUTUAL FUND FEES

Mutual funds, like all investments, have fees and expenses that investors pay to cover costs of services and benefits associated with fund investments. Mutual fund fees are subject to extensive disclosure requirements, as described below.

A. Clear and Prominent Fee Disclosure Is Provided to Investors

It is critical that investors receive complete and understandable disclosure before making investment decisions. The disclosures that mutual funds are required to provide to investors are unmatched by those of any other financial product. Each investor receives a prospectus at or before the time of buying fund shares. The prospectus provides detailed information about a fund's investment objectives and policies, risks, returns, fees and expenses, the fund manager, and how to purchase and redeem shares.

Reflecting their importance as part of the information that investors and their professional advisers should consider when deciding whether to invest in a fund, fund fees and expenses are disclosed in a straightforward, standardized fee table at the front of each prospectus. The fee table presents fund fees in two broad categories: shareholder fees (such as sales charges paid to compensate financial professionals who provide investment advice and other services) and annual fund operating expenses.

The fee table shows annual fund operating expenses broken down into three categories that are identified by specific, required captions. The first category of expense is the "management fee" that the fund pays its investment adviser for managing and administering the fund's portfolio. The second category is the "distribution (12b-1) fee," if any, that the fund pays to cover costs such as compensating broker-dealers, financial planners and other financial professionals for investment advice and other services they provide directly to investors. The third category is "other expenses," which includes expenses that the fund incurs for items such as shareholder services and recordkeeping, custody of the fund's assets, outside audits, legal counsel, and directors. Each type of annual operating expense is expressed as a percentage of the fund's average net assets. The fee table also shows total annual fund operating expenses as a percentage of average net assets (sometimes referred to as a fund's "expense ratio").[3]

[3] A variety of other readily available sources of information about mutual fund fees supplement the Securities and Exchange Commission's fee disclosure requirements described above. These sources include brokers and financial advisors, newsletters, newspapers and magazines. They also include the SEC itself, which in recent years has developed and made available on its website (www.sec.gov) both an interactive mutual fund cost calculator designed to assist investors in comparing the costs of different funds and other educational materials about investing in

In addition to listing a fund's fees and expenses, the prospectus fee table includes an example that illustrates the effect of fund expenses on a hypothetical investment over time. The example is designed to enable investors to readily compare the costs of two or more funds because the invested amount and time periods are standardized. The total is an "all-in" figure, expressed as a single dollar amount, that takes into account both sales charges and annual operating expenses.

The required disclosures of mutual fund fees are reinforced by SEC rules governing mutual fund performance advertising. Under SEC rules, funds that advertise performance information must provide standardized total return data for prescribed periods. Importantly, all standardized performance numbers must be presented net of fees. Thus, when investors review and compare fund performance data, the effect of all fees has already been taken into account. Moreover, the SEC recently amended its mutual fund advertising rules to require narrative disclosure that advises investors to consider fund charges and expenses before investing and explains that the prospectus contains this and other information.[4]

Taken together, the foregoing disclosure requirements provide investors and their professional advisors with the information needed to make informed decisions about investing in a particular fund.

mutual funds. The Institute and many individual fund groups also offer educational resources and tools for investors to help them better understand fees and expenses as well as other important aspects of mutual fund investing.

[4] *See Amendments to Investment Company Advertising Rules*, SEC Release Nos. 33-8294; 34-48558; IC-26195 (Sept. 29, 2003). This disclosure must be presented in a type size at least as large as and of a style different from, but at least as prominent as, that used in the major portion of the advertisement.

B. SEC Proposals Would Enhance Fee Disclosure

The SEC has proposed several new requirements to further enhance the disclosures provided to investors about mutual fund fees and the costs investors incur when purchasing fund shares. These various proposals, when taken together, represent a far-reaching package of enhancements to fund fee and distribution-related cost disclosures and, consequently, should improve investor awareness and understanding of mutual fund fees and costs. These proposals are described below.

1. Dollar Amount of Fund Expenses. The SEC has proposed to require new disclosure concerning fund expenses in shareholder reports, similar to the example in the fee table discussed above.[5] Specifically, the SEC has proposed that fund shareholder reports disclose the cost in dollars of a $10,000 investment in the fund, based on the fund's actual expenses and return for the reporting period.[6] The proposed disclosure is intended to improve investor understanding of ongoing fund expenses and allow investors to estimate the costs they bore over the reporting period. The Institute supports this proposal. It should enhance investors' awareness of the importance of fees by reminding them about the impact of expenses on their investment returns and will also assist them in comparing the expenses of different funds.[7]

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[5] *See Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*, SEC Release Nos. 33-8164, 34-47023, IC-25870 (Dec. 18, 2002) ("Shareholder Reports Release"). SEC Chairman Donaldson has indicated that the SEC will consider adopting this proposal at an open meeting on February 11th. *See* Speech by SEC Chairman: Opening Statement at the SEC Open Meeting by Chairman William H. Donaldson, U.S. Securities and Exchange Commission, Washington, D.C., Jan. 14, 2004 ("Donaldson Opening Statement"), available at http://www.sec.gov/news/speech/spch011404whd.htm.

[6] A similar requirement is included in H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act of 2003," which was approved by the U.S. House of Representatives on November 19, 2003.

[7] As an alternative to its proposal, the SEC considered an approach recommended by the U.S. General Accounting Office (GAO) in a June 2000 report. *See* U.S. General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could*

2. Breakpoint Discounts. The SEC has proposed new prospectus disclosure requirements relating to breakpoint discounts on front-end sales loads.[8] Many mutual funds that are sold with front-end sales charges (or "loads") 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 examinations revealed instances in which investors did not receive the benefit of sales charge reductions to which they were entitled. These examinations led to the formation of the Joint NASD/Industry Task Force on Breakpoints, which issued a report last summer making a series of recommendations for addressing this issue.[9] The SEC's proposal would implement the recommendations of the Task Force concerning prospectus disclosure. The Institute supports the SEC's proposal. It will benefit investors by helping ensure that they are aware of and knowledgeable about breakpoint opportunities.

3. Distribution-Related Costs. The SEC has proposed new rules to enhance the information that broker-dealers provide to their customers in connection with their transactions

Encourage Price Competition (June 2000) ("2000 GAO Report"). The GAO recommended that the SEC require funds to provide each investor with an exact dollar figure for fees paid by that investor in each quarterly account statement. (S. 1971, the "Mutual Fund Investor Confidence Restoration Act of 2003," which was introduced by Senators Jon Corzine (D-NJ) and Christopher Dodd (D-CT) late last year, similarly would call for individualized expense disclosure to investors.) In rejecting this approach, the SEC stated that its proposal was "intended to strike an appropriate balance between investors' need for [expense] information and the costs and burdens that would be associated with providing this information on an individualized basis." *See* Shareholder Reports Release.

[8] *See Disclosure of Breakpoint Discounts by Mutual Funds*, SEC Release Nos. 33-8347; 34-48939; IC-26298 (Dec. 17, 2003).

[9] *See Report of the Joint NASD/Industry Task Force on Breakpoints* (July 2003), available at http://www.nasdr.com/pdf-text/breakpoints_report.pdf.

in mutual fund shares.[10] The new rules would require broker-dealers to provide point of sale disclosure about distribution-related costs and conflicts to customers prior to effecting transactions in fund shares, and as part of transaction confirmations.[11] The SEC also has proposed new requirements to improve prospectus disclosure of sales loads and revenue sharing. While we are still analyzing the specific details of these proposals, we fully support their objectives.

4. Portfolio Transaction Costs. The SEC recently issued a concept release soliciting comments on how to improve disclosure of mutual fund portfolio transaction costs, including the feasibility of constructing a transaction cost measure.[12] In the release, the SEC acknowledges that quantitative disclosure of portfolio transaction costs presents many difficult issues.[13] The Institute supports the Commission's efforts to explore ways to improve disclosure

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[10] *See* SEC Proposes New Investment Company Governance Requirements, New Investment Adviser Codes of Ethics Requirements, and New Confirmation and Point of Sale Disclosure Requirements (Jan. 14, 2004), available at http://www.sec.gov/news/press/2004-5.htm.

[11] The proposed point of sale disclosure includes: the amount of sales loads that would be incurred at the time of purchase, and the amount of that load that would be paid to the broker-dealer; estimated 12b-1 fees that would be paid by the fund in the year following the purchase; and the maximum amount of any deferred sales load that would be charged if the shares purchased are sold within a year, along with a statement about how many years a deferred sales load may be effect. Disclosure also would be required about whether the broker-dealer receives revenue sharing or portfolio brokerage commissions from the fund complex. The proposed confirmation statement would require broker-dealers to provide more quantitative disclosure of the information included in the point of sale document.

[12] *See Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs*, SEC Release Nos. 33-8349; 34-48952; IC-26313 (Dec. 18, 2003). In view of the complexity of the issues relating to quantifying portfolio transaction costs, the SEC has requested comment from persons within and outside of the fund industry, including investors, mutual funds, academics, regulators, and the public generally.

[13] For example, only one type of trading cost (commissions) can be measured directly, but disclosing commissions alone would be misleading because some securities - notably, fixed income securities - are sold without explicit commissions. In addition, two types of transaction costs discussed in the concept release - spreads and market impact costs - while real, are not readily quantifiable. There are a variety of estimation techniques that can be used but, as the SEC has pointed out, there is no accepted standard and this could confuse investors seeking to make comparisons among funds using different methods of estimation.

of fund transaction costs and looks forward to commenting on the concept release in an effort to assist the Commission in crafting an appropriate proposal in this area.

5. Mutual Fund Advertising. Recent regulatory initiatives specifically seek to focus investors' attention on fund expenses when they view fund advertisements. For example, in addition to the recently adopted amendments to the SEC's mutual fund advertising rules discussed above, the NASD has issued a proposal that would require all mutual fund performance advertisements to include the fund's expense ratio.[14] The Institute supports this proposal.[15]

C. Mutual Fund Fee Levels

1. Mutual Fund Fees Continue to Decline. Mutual fund industry critics often target mutual fund fees and expenses as an area in need of reform, claiming that such fees and expenses have risen over time. Unfortunately, studies that claim that mutual fund fees are rising reach this conclusion by paying inadequate attention to the details of mutual fund fees and expenses or fail to track the expenses of particular funds over time. Studies of fund fees that are mindful of these factors invariably find that mutual fund fees and expenses have declined over time.[16]

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[14] *See* NASD Notice to Members 03-77 (December 2003), available at http://www.nasdr.com/pdf-text/0377ntm.txt.

[15] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Ms. Barbara Z. Sweeney, Office of the Corporate Secretary, NASD, dated Jan. 23, 2004.

[16] Studies conducted by the Institute, the SEC staff and the GAO are discussed below. Other fee studies reaching this conclusion include Lipper Analytical, "The Third White Paper: Are Mutual Fund Fees Reasonable," reprinted in The Mutual Fund Business, R. Pozen, ed., 1999 and LaPlante, M., "Influences and Trends in Mutual Fund Expense Ratios," Journal of Financial Research, Spring 2001.

According to Institute research, the average total cost that investors incurred when purchasing mutual funds[17] has declined steadily and significantly since 1980. From 1980 to 2001, the total cost of equity funds fell by 43 percent, the total cost of bond funds decreased by 41 percent and the total cost of money market funds decreased by 35 percent.[18]

The SEC's Division of Investment Management published its own study of mutual fund fees in 2000.[19] The SEC looked at both expense ratio trends and total ownership costs. According to the SEC study, the weighted average expense ratio for all fund classes declined in three out of the last four years that the SEC studied (from 0.99% in 1995 to 0.94% in 1999). While the SEC found an increase in the weighted average expense ratio from 0.73% in 1979 to 0.94% in 1999, it explained that this increase was due to the shift from use of front-end sales charges (which are not included in a fund's expense ratio) to finance distribution, to the use of 12b-1 fees (which are included in the fund's expense ratio). When examining the total ownership costs of "load classes,"[20] the SEC found a decline of 18% between 1979 and 1999.

[17] To properly measure the total cost of investing in mutual funds, it is important to consider both (1) the sales charges paid by investors directly to compensate financial professionals who provide investment advice and other services, and (2) the annual operating expenses that are paid out of the fund's assets to cover the costs of running a fund and other services. Unlike annual operating expenses, sales charges are one-time charges. Thus, to measure total shareholder cost accurately, it is necessary to "annualize" the sales charge, *i.e.*, convert it into the equivalent of an annual payment paid by the investor over the life of his or her investment.

[18] *See* Investment Company Institute, "Total Shareholder Cost of Mutual Funds: An Update," *Fundamentals*, Vol. 11, No. 4, September 2002, available at http://www.ici.org/pdf/fm-v11n4.pdf.

[19] *See* Division of Investment Management, U.S. Securities and Exchange Commission, "Report on Mutual Fund Fees and Expenses" (December 2000), available at http://www.sec.gov/news/studies/feestudy.htm.

[20] The SEC defined "load classes" as classes with 12b-1 fees higher than 25 basis points, classes with 12b-1 fees and contingent deferred sales charges, and classes with traditional front-end sales charges.

In 2000, the GAO also issued a report on mutual fund fees.[21] The GAO examined expense ratios for the 46 largest equity funds and 31 largest bond funds as of December 31, 1998 that had been in existence since January 1, 1990. The GAO report found that eighty-five percent of these equity funds reduced their expense ratios, with an average decline of 20 percent. The expense ratios of the bond funds declined by an average of three percent.

The GAO updated its findings in 2003. The GAO found that the average expense ratio of the 46 largest equity funds rose nearly 8 percent between 1998 and 2001.[22] The GAO's report, although technically correct, failed to explain that the increase in the average expense ratio of the 46 equity mutual funds studied by the GAO was due entirely to performance fees.[23]

More recently, the Institute undertook a study of mutual fund distribution channels and trends in distribution costs since 1980.[24] The study found that changes in fund distribution over the last 25 years have been accompanied by a significant decrease in the average cost of distribution services incurred by mutual fund buyers. The average distribution cost incurred by buyers of equity funds decreased from 1.49 percent (or 149 basis points) of their initial investment in 1980 to 40 basis points in 2001 - a 73 percent decrease. Similarly, distribution

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[21] *See* 2000 GAO Report, *supra* note 7.

[22] *See* U.S. General Accounting Office, *Mutual Funds: Information on Trends in Fees and Their Related Disclosure* (March 2003).

[23] *See* Investment Company Institute, "Performance Fees and Expense Ratios," *Fundamentals*, Vol. 12, No. 2, August 2003, available at http://www.ici.org/pdf/fm-v12n2.pdf.

[24] *See* Brian K. Reid and John D Rea, "Mutual Fund Distribution Channels and Distribution Costs," *Perspective*, Vol. 9, No. 3, July 2003, available at http //www.ici.org/stats/res/per09-03.pdf. For purposes of the study, distribution costs were defined as charges incurred by mutual fund investors directly through the payment of sales loads or indirectly through 12b-1 fees.

costs of bond funds fell 60 percent, from 82 basis points in 1980 to 33 basis points in 2001.

2. Mutual Funds and Pension Funds Have Comparable Fee Levels. In addition to claims that mutual funds fees have been rising, statements have been made to the effect that mutual funds pay substantially more than public pension funds for portfolio management services. Such statements are primarily based upon an Iowa law journal article that attempts to compare public pension plan and mutual fund fees.[25] The Institute recently published a study that refutes those statements. The Institute's study discovered serious deficiencies in the Iowa article's methodology. Most importantly, the Iowa article compared the "investment advisory fees" of public pension plans with the "management fees" of mutual funds, treating the two as if they were identical accounting concepts. They are not. The "investment advisory fees" paid by pension plans are primarily for portfolio management. The "management fees" of mutual funds encompass portfolio management costs, but also the costs of a range of business and administrative items that are necessary for fund operations, such as fund pricing, clerical staff, office space and equipment, the salaries of fund officers and interested directors, certain accounting and recordkeeping facilities, preparation of shareholder reports and prospectuses, supervising relationships with fund transfer agents and custodians, and Federal and state regulatory compliance. Not surprisingly, the authors of the Iowa article found that the "investment advisory fees" of public pension plans are lower than the "management fees" of mutual funds. However, that finding is not indicative of the relative costs that the two entities incur for portfolio management. The Institute's study also attempted to compare the "investment advisory fees" of pension plans with a like quantity for mutual funds. That

[25] *See* John P. Freeman and Stewart L. Brown, "Mutual Fund Advisory Fees: The Cost of Conflicts of Interest," *Journal of Corporation Law*, 26(3), Spring 2001, pp. 609-673.

comparison indicates that mutual funds and pension plans likely pay similar fees for similar portfolio management services.[26]

III. 12b-1 FEES

A. 12b-1 Fees Expand Investor Choice

Innovations in the mutual fund industry have given investors many choices about how and where they purchase mutual fund shares. Some investors prefer to buy mutual funds directly from the company sponsoring them. Others choose to purchase funds through brokers, financial planners, or other financial professionals who provide assistance and advice in selecting funds to help investors reach their long-term goals, such as retirement and education.

Investment professionals traditionally were compensated for their services by an upfront sales commission, or "load," paid by investors when they purchased mutual fund shares. In 1980, the SEC adopted Rule 12b-1 under the Investment Company Act of 1940. The rule authorizes funds to use their assets to pay distribution costs. Although the rule initially was conceived as a way to help funds increase sales to offset net redemptions, the use of fund assets to pay for distribution has evolved since Rule 12b-1 was adopted. Most significantly, it has allowed funds to give investors the option of paying distribution expenses over time

[26] *See* Sean Collins, "The Expenses of Defined Benefit Pension Plans and Mutual Funds," *Perspective*, Vol. 9, No. 6, December 2003, available at http://www.ici.org/stats/res/per09-06.pdf. The Institute found that fees for portfolio management services average 31 basis points (or 0.31%) for mutual funds and 28 basis points (0.28%) for pension plans. *Id.* at 7-8.

instead of in a single, upfront payment. Many funds now offer various classes of shares that invest in the same portfolio of securities but provide a variety of different payment options.[27]

These payment options can include a direct fee (*i.e.*, a sales charge), a payment made from the fund's assets over time (*i.e.*, a 12b-1 fee), or a combination of both.[28] Most investors use the services of a financial intermediary; thus, most funds have sales charges and/or ongoing fees to cover these costs. Indeed, Institute data show that among shareholders holding funds outside of defined contribution plans, more than 70 percent primarily purchase funds through financial advisors and other intermediaries.[29] In other words, in many cases, investors are receiving professional advice or other services from financial intermediaries when investing in mutual funds; Rule 12b-1 has made it possible for funds to provide investors with a choice of how and when to pay for these services.

B. 12b-1 Fees Are Fully Disclosed

Assertions that 12b-1 fees are "hidden costs" are completely without merit. As discussed above, all mutual fund fees and expenses are fully disclosed in a standardized fee table that is required to be at the front of a fund's prospectus. If a fund has a 12b-1 fee, it will be clearly identified as a separate line item in the fee table as part of the fund's annual operating

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[27] Different classes may be sold through different distribution arrangements (*e.g.*, retail broker-dealers, employer-sponsored retirement plans, etc.) and may have different expense levels that reflect their customization.

[28] Institute research indicates that each of these options can be optimal for particular investors, depending on the expected time horizon of their investment (including whether they are uncertain about the length of their holding period) and the amount invested. *See* Reid and Rea, *supra* note 24, at 11-13.

[29] *See* Investment Company Institute, 2001 Profile of Mutual Fund Shareholders, at 68.

expenses. In addition, it is reflected in the fund's total annual operating expenses shown in the fee table and in the hypothetical example of fund expenses that accompanies the fee table.

Investors also can determine whether a fund charges a 12b-1 distribution fee by reviewing the mutual fund listings published in most newspapers. A newspaper's listings offer information about a fund's fees by using a series of symbols next to the fund's name. A fund that has a 12b-1 fee will have the letter "p" next to its name in the newspaper.

In addition to disclosing the fact that a fund has a 12b-1 fee, such funds are required to include disclosure in the prospectus concerning the impact of this ongoing fee. Specifically, the prospectus must disclose that over time, 12b-1 fees will increase the cost of an investment in the fund and may cost the investor more than paying other types of sales charges.[30]

As noted above, the SEC has proposed new requirements under which broker-dealers would have to make additional disclosures to investors before they purchase mutual fund shares.[31] Such disclosures would include the estimated amount of 12b-1 fees to be paid in the year following purchase, if the fund's net asset value remained constant.

[30] Additional, more detailed disclosure about a fund's 12b-1 fee is required in the Statement of Additional Information, which is available to fund shareholders free of charge upon request. Such disclosure includes, among other things, a breakdown of the dollar amount of 12b-1 payments made for various activities, such as advertising and compensating broker-dealers.

[31] *See supra* note 10.

C. Substantive Regulation of 12b-1 Fees Further Protects Fund Investors

In addition to the wealth of information about fees and expenses that is available to mutual fund investors and their professional advisors, there are a number of substantive regulatory protections that apply to mutual fund fees, including in particular 12b-1 fees.

First, NASD rules place limits on all mutual fund sales charges, including "asset-based sales charges" (12b-1 fees).[32] In addition, a fund that has a front-end or deferred sales charge, or a 12b-1 fee higher than 25 basis points, cannot be referred to as a "no load" fund.[33]

Second, fund boards of directors oversee all expenses and have specific review, approval and oversight responsibilities with respect to any 12b-1 fee.

Pursuant to Rule 12b-1, any payments by a fund for distribution-related expenses must be in accordance with a written plan approved annually by the fund's board of directors,

[32] *See* NASD Conduct Rule 2830. NASD rules limit total front-end and/or deferred sales charges to no more than 8.5% of the offering price, although most funds charge far less than the maximum. The rules also limit 12b-1 fees. These fees are limited to a maximum of 1.00 percent of the fund's average net assets per year, which may include a service fee of up to 0.25 percent to compensate intermediaries for providing services or maintaining shareholder accounts. NASD rules also subject the aggregate amount of 12b-1 fees to a lifetime cap, based upon a percentage of fund sales. These limits appropriately treat 12b-1 fees, in effect, as an alternative form of sales charge.

In addition to these fee limits, NASD rules impose suitability requirements on broker-dealers with respect to securities that they recommend, including mutual funds. The NASD has provided guidance reminding its members that, in determining the suitability of a particular fund, a member should consider the fund's expense ratio and sales charges as well as its investment objectives. The NASD also has issued specific guidance concerning the application of suitability principles to sales of mutual funds that offer multiple classes. *See, e.g.*, NASD Regulation, Inc., "Suitability Issues for Multi-Class Mutual Funds," Regulatory & Compliance Alert, Summer 2000, available at http://www.nasdr.com/rca_summer00_reg.htm#suitability.

[33] NASD rules permit funds with a 12b-1 fee of no more than 25 basis points to be designated as "no load" funds in recognition that the expenses of funds with a low 12b-1 fee tend to more closely resemble those of funds with no sales charges or 12b-1 fees.

including a majority of the independent directors. The fund's directors must review, at least quarterly, the amounts spent under a 12b-1 plan and the reasons for the expenditures.[34]

In addition to the specific limits on fund fees and the board review, approval and oversight requirements described above, another level of investor protection is provided through requirements that shareholders must approve any material increase in a fund's 12b-1 fee. Thus, funds cannot unilaterally raise 12b-1 fees, nor may the board alone approve a fee increase.[35]

IV. REVENUE SHARING ARRANGEMENTS

As discussed above, mutual fund investors currently have choices in the manner and timing of payments to compensate investment professionals for the services they provide (*i.e.*, through sales charges, 12b-1 fees, or a combination). Competition among funds for the services of selling intermediaries (*e.g.*, broker-dealers) has led these intermediaries, however, to demand compensation, or expense sharing, for distributing fund shares and providing services to

[34] Some have questioned the propriety of funds that are closed to new investors continuing to pay 12b-1 fees. The continuing payment of 12b-1 fees in these circumstances is entirely consistent with the 12b-1 fee concept. Specifically, the fund underwriter "fronts" money to salespeople with the expectation that these expenditures will be recouped through the 12b-1 fee over time. It generally would not be appropriate, in this type of scenario, for funds to cease 12b-1 payments. The NASD's maximum sales charge rules (discussed above) operate in such a way that if a fund with a 12b-1 fee does not have new sales (*e.g.*, if the fund has closed), it will more rapidly approach the applicable rolling cap, at which point 12b-1 payments would have to cease.

[35] Similar substantive requirements apply to a fund's investment advisory fee. For example, under Section 15 of the Investment Company Act, both the board as a whole and a majority of the fund's independent directors are required to review and approve any investment advisory contract entered into by a fund on an annual basis, after an initial term of no more than two years. Fund directors must request, and the adviser is obligated to provide, information reasonably necessary to review the terms of the contract, including the advisory fee. A fund's adviser has a fiduciary duty with respect to the receipt of compensation from the fund. Section 36(b) of the Investment Company Act. The SEC and fund shareholders may bring suit against the adviser for breach of this duty. *See, e.g.*, Kalish v. Franklin Advisers, Inc., 928 F. 2d 590 (2d Cir. 1991); Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923 (2d Cir. 1982). Shareholders must approve any material changes to the advisory contract (including any proposed fee increase).

shareholders beyond the amounts they receive through sales charges and 12b-1 fees. Consequently, it is common practice in the fund industry for fund investment advisers or principal underwriters to enter into "revenue sharing" arrangements, under which the adviser or principal underwriter makes payments out of its own resources to compensate intermediaries who sell fund shares.

The principal investor protection concern raised by these payments is whether they have the potential for influencing the recommendations of the financial intermediary that is receiving them.[36] 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.[37]

The NASD recently proposed new point-of-sale disclosure requirements in this area.[38] The Institute supports the NASD proposal.[39] In addition, earlier this month, the SEC proposed

[36] Legislation currently pending before Congress contains a provision that would impose a fiduciary duty on fund directors to determine that any revenue sharing arrangements are in the best interests of fund shareholders. *See, e.g.*, H.R. 2420 and S. 1971. Such a requirement is misguided. The directors are responsible for overseeing uses of the fund's assets. Revenue sharing arrangements, by definition, do not involve the use of fund assets. Indeed, if revenue sharing payments are made directly or indirectly by a fund, they must comply with Rule 12b-1. H.R. 2420 and S. 1971 would address any possible concern that revenue sharing arrangements may involve an indirect use of fund assets by requiring fund directors to review revenue sharing arrangements to ensure that they comply with the Investment Company Act of 1940. Fund directors do not have control over, and should not be held responsible for, the investment adviser's or principal underwriter's use of their legitimate profits.

[37] *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 Oct. 15, 1997.

[38] *See* NASD Notice to Members 03-54 (September 2003), available at http://www.nasdr.com/pdf-text/0354ntm.txt. 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.

[39] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Barbara Z. Sweeney, NASD, Office of the Corporate Secretary, dated Oct. 17, 2003.

new point-of-sale and mutual fund confirmation statement disclosure that would address, among other things, revenue sharing arrangements and other inducements for brokers to sell particular funds.[40] Under the SEC's proposal, broker-dealers would be required to disclose to customers, prior to a purchase of mutual fund shares, whether they receive revenue sharing payments from the fund complex, and whether the broker-dealer pays differential compensation in connection with transactions in shares of the fund. In addition, confirmation statements would have to disclose quantified information about revenue sharing arrangements from persons within the fund complex and whether the broker-dealer pays its salespersons more compensation if they sell funds that carry a deferred sales charge and/or proprietary funds. Disclosure also would be required of any revenue sharing arrangement that would be applicable to the transaction. The Institute supports the objectives of the SEC's proposal and is studying it in detail in anticipation of filing a comment letter on it.

V. BROKERAGE ALLOCATION PRACTICES

The Institute believes that the time has come for a top to bottom reexamination of mutual fund brokerage allocation practices and the applicable regulatory requirements. Investment advisers, including advisers to mutual funds, may use the brokerage commissions from transactions for client accounts to obtain research products and services from broker-dealers and third parties ("soft dollar arrangements"). Advisers to funds also may take into account a broker-dealer's sales of fund shares in allocating brokerage ("directed brokerage"). While both of these practices are clearly permissible under existing applicable regulations, they

[40] *See supra* note 10.

can give rise to the appearance of a conflict of interest, as well as the potential for actual conflicts. The Institute therefore believes that it would be appropriate to tighten regulation in each of these areas.

A. Soft Dollar Arrangements Should Be Significantly Restricted

Section 28(e) of the Securities Exchange Act of 1934 provides a safe harbor that permits money managers, including advisers to mutual funds, to pay for brokerage and research services with client commissions, subject to various conditions. This section was enacted in response to concerns that, with the unfixing of commissions, money managers might be held liable if they paid more than the lowest possible commission rate and received these services.

As noted above, these arrangements can give rise to the appearance of a conflict of interest, as well as the potential for actual conflicts. Some assert that these arrangements may create incentives for advisers to (1) direct client brokerage to a broker-dealer based on the research services provided to the adviser rather than the quality of execution its clients' accounts will receive and/or (2) pay too much in commissions or engage in unnecessary trading to generate soft dollars credits to pay for products and services that the manager might otherwise have to pay for from its own assets. To reduce any such potential conflicts, the Institute recommends that the scope of the safe harbor under Section 28(e) be narrowed to exclude certain products and services.[41] These products and services would include:

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[41] *See* Letter from Matthew P. Fink, President, Investment Company Institute, to The Honorable William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, dated December 16, 2003 (recommending that the Commission adopt a revised interpretation under Section 28(e) of the Exchange Act to narrow the safe harbor in this manner). The Institute's recommendation could be accomplished by either Congress amending Section 28(e) or the Commission adopting a more restrictive definition of the scope of services and products covered by Section 28(e).

- Computer hardware and software, and other electronic communications facilities, used in connection with trading or investment decision-making;
- Publications, including books, periodicals, newspapers and electronic publications, that are generally available to the public; and
- Third-party research services, *i.e.*, research services that are not produced and provided by the broker-dealer effecting the securities transaction.[42]

This change would (1) ensure that the payment through commissions for products and services that have the attributes of traditional overhead and more routine expenditures of investment managers would fall outside of the safe harbor, and (2) limit the scope of the safe harbor to those research-related products and services that are produced by and provided directly by the broker-dealer receiving the commissions. Narrowing the safe harbor in this manner would be beneficial for investors because it would clarify application of the safe harbor in areas where guidance is needed; would make it easier for investors to understand the costs of various investment advisory products, including mutual funds; would reduce incentives for money managers to engage in unnecessary trading; and would interpret Section 28(e) in a manner that is more consistent with its original purpose - a narrowly tailored provision that allows a money manager to take into account the intellectual resources, as well as the execution capabilities, of a brokerage firm in determining how to allocate trades.[43]

Some have suggested that Section 28(e) be repealed altogether to prohibit soft dollar arrangements. The Institute agrees that this is an issue that may warrant further study and consideration.

[42] This recommendation does not represent a judgment that proprietary research is somehow "better" than third-party research. It is, rather, based on the Institute's conclusion that there is no inherent reason why research provided by one firm should be bundled with execution services provided by a different firm. In contrast, where both types of services are provided by the same entity, allocating costs between the two can be difficult, particularly since brokerage firms do not typically break out such costs.

[43] Because Section 28(e) is a safe harbor, failure to comply with its terms does not, in and of itself, violate any provision of law. For certain advisers, however, using commissions outside of the safe harbor raises serious issues under federal law. These include advisers to mutual funds and to pension plans under ERISA. In contrast, advisers to other types of accounts are not subject to similar substantive limitations. Instead, such advisers are only required

B. Directed Brokerage Arrangements Should Be Prohibited

The ability of fund advisers to take sales into account in allocating brokerage is strictly regulated under existing NASD rules.[44] The rules only permit funds to consider sales in allocating brokerage "after the fact;" conditioning fund sales on the payment of brokerage commissions is expressly prohibited. In addition, the rules provide that a fund can only take a broker's sale of fund shares into account in selecting a broker if it is otherwise receiving best execution. Notwithstanding the strict nature of these restrictions, this practice can give rise to the appearance of a conflict of interest, as well as the potential for actual conflicts, given the fact-specific nature of the best execution determination. For these reasons, the Institute believes that this practice should be prohibited.[45] The Institute is pleased, therefore, that SEC Chairman Donaldson announced recently that the Commission plans to consider amending Rule 12b-1 to prohibit funds from using brokerage commissions to pay broker-dealers for selling fund shares at an open meeting on February 11th.[46]

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to provide disclosure about their use of soft dollars in Form ADV. The Institute recommends that all investment advisers be prohibited from using brokerage commissions outside of the safe harbor to pay for any products or services used by the adviser. This change will extend the protections afforded to mutual funds and ERISA accounts to all investment advisory clients.

[44] *See* NASD Conduct Rule 2830(k).

[45] It should be recognized that such a prohibition could have the potential to improperly discourage funds from using brokers that sell fund shares for portfolio transactions, for fear of being second-guessed. This could result, in some cases, in funds not using the brokerage firm that would be best suited for executing a trade. In order to address this concern and ensure that such a prohibition does not inadvertently call into question legitimate brokerage allocations, the Institute recommends that a safe harbor be adopted for funds that use brokers that also sell shares of the fund in those cases where a fund has adopted policies and procedures reasonably designed to prevent sales from being considered in connection with brokerage allocation.

[46] *See* Donaldson Opening Statement, *supra* note 5.

VI. CONCLUSION

I appreciate the opportunity to provide testimony to the Subcommittee on these important issues on behalf of the Institute. The Institute supports initiatives to promote investor understanding of mutual fund fees and costs, and looks forward to working with the Subcommittee, regulators and others to achieve this goal.

Statement of

MARC E. LACKRITZ
PRESIDENT
SECURITIES INDUSTRY ASSOCIATION

before the

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

OVERSIGHT HEARING ON MUTUAL FUNDS: HIDDEN FEES, MISGOVERNANCE AND OTHER PRACTICES THAT HARM INVESTORS

January 27, 2004
Dirksen Senate Office Building
Room 342

I. Introduction

Chairman Fitzgerald, Ranking Member Akaka, and members of the Subcommittee, I am Marc E. Lackritz, President of the Securities Industry Association.[1] We commend you for holding this important hearing in furtherance of your Committee's long and proud tradition of effective oversight to protect the public. SIA's Board of Directors has made restoring the public's trust and confidence in the nation's securities markets and our industry our top priority this year. Today's hearing provides an excellent opportunity for all of us to work toward improving how we serve our customers.

A. What SIA Member Firms Do

SIA member-firms underwrite securities – stocks and bonds – to raise funds – capital – for private companies and public entities. These companies and public bodies use the funds we raise to expand and grow – hiring new workers, investing in new equipment, and building public works. Our industry has raised more than $21 trillion over the past 10 years to finance innovation and growth – new enterprises, new processes,

[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Bankers Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 800,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated $222 billion in domestic revenue and $304 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

new products, and new bridges, hospitals, roads, and schools. We also help individual investors achieve their financial goals, such as planning for a child's education or for a comfortable retirement. Thus, as intermediaries between those who have capital and those who need it, we have created capital markets to channel capital to its most productive uses.

Without public trust and confidence, our market mechanisms cannot function effectively or efficiently. The securities industry is based on two bedrock principles – disclosure and competition. The public's trust and confidence are the indispensable elements for the capital markets to work effectively. Our system has thrived because all market participants must adhere to the same rules, vigorously and fairly applied.

B. Role of Mutual Funds

Mutual funds are the vehicle by which an overwhelming majority of investors participate in our markets. They offer many small investors an inexpensive way to share in the benefits of owning stocks and bonds. Mutual fund portfolios give investors an avenue for diversifying a relatively small investment, thereby managing their risk exposures. For these reasons, mutual funds are extremely popular products for small investors, as well as for retirement plans such as 401(k) plans. As of January 2002, 89 percent of U.S. equity investors owned stock mutual funds, and 51.5 percent of equity investors held only stock mutual funds. Overall, 49.6 percent of all households in the United States owned mutual funds directly or through a retirement account.[2] Twenty-six percent of all household liquid financial assets were in mutual funds as of third-quarter 2003.[3]

Broker-dealers and other intermediaries play a critical role in the distribution of mutual funds. Third-party financial professionals such as full service broker-dealers, mutual fund supermarkets (discount brokers), financial planners, banks, retirement plans, and insurance companies distribute the vast majority of mutual fund assets.[4] Indeed, individual investors make only 12 percent of purchases of mutual fund assets directly from funds. Full-service and discount brokers benefit investors and promote competition among funds by offering investors a convenient and accessible way to compare and select from a range of different mutual-fund families.

The health of our markets depends to a great extent on the public's continued robust participation in mutual funds. As of November 2003, equity mutual funds had a market capitalization of $3.5 **trillion** dollars, roughly 23 percent of the total capitalization of our equity markets.[5] Retail investors, the backbone of both the mutual fund industry and our securities markets, put their trust in the integrity of mutual fund managers and

[2] http://www.sia.com/research/pdf/equity_owners02.pdf
[3] http://www.federalreserve.gov/releases/Z1/Current/
[4] Investment Company Institute, www.ici.org/stats/res/per09-03.pdf, at 5.
[5] For equity market capitalization (combined New York Stock Exchange and Nasdaq) see http://www.nyse.com/pdfs/mmv1203.pdf; http://www.marketdata.nasdaq.com/daily/daily2003.xls; For mutual fund data see http://www.ici.org/stats/latest/trends_11_03.html#TopOfPage

advisers, as well as in the financial advisers who assist their investment decisions and the brokers who implement their trade orders.

Yet all is far from well with mutual funds. Recent revelations of wrongdoing – including late trading and market timing contrary to fund prospectuses, as well as other practices – have shaken investors' confidence in many mutual fund organizations and in the intermediaries distributing mutual funds.

In order to restore public trust and confidence in mutual funds and their distributors, the interests of investors must come first. Investors must be assured that fraud, self-dealing, and dishonesty will not be tolerated. Investors should be treated fairly, and should be given complete, clear, and useful information about the funds they buy. All aspects of the mutual fund business – including fund fee structures, financial incentives offered to intermediaries, fund investment and redemption policies, and fund governance – must be as transparent as possible. And all investors should be assured of prompt execution and fair pricing of their mutual fund transactions.

A two-pronged approach is necessary to restore the public's trust in mutual funds. Swift, sure, and tough enforcement actions are the proper remedy to address clear violations of the law. Federal, self-regulatory organization ("SRO"), and state law enforcement authorities should stop the wrongdoers in their tracks. Vigorous enforcement protects investors' assets immediately and has an *in terrorem* effect against other would-be wrongdoers. SIA strongly supports tough, swift, and vigorous enforcement of the law.

In addition, the time has come to implement necessary reforms as well. We support efforts to improve disclosures and sales and trading practices to ensure that investors' interests come first. We offer our expertise and our full engagement in this effort so that the reforms will achieve our mutual goals of strengthening investor protection and avoiding future problems.

II. Need for Reform[6]

A. Background on Changes in Industry Practice

Mutual funds allow investors to enjoy the benefits of diversified portfolios and professional management. But there are expenses associated with operating any mutual fund. Funds pay an investment adviser for the professional management associated with the fund. There are also compliance and recordkeeping costs, trading commissions, and marketing expenses. Of course, different fund organizations take different approaches and costs vary. Inevitably, all of these services – which give investors important choices and benefits – have a cost.

[6] Our testimony is not intended to cover every aspect of mutual fund trading practices, but focuses instead on the questions contained in the Subcommittee's invitation to testify.

Investors also have many choices as to how they buy funds. Depending on the choices they make, investors may encounter several different arrangements for paying distribution and shareholder service expenses, (*e.g.* A shares (front-end load); B shares (12b-1 fee plus back-end load), C shares (level load), and no-load – see glossary for definitions).

As noted, many investors buy mutual funds, perhaps after consultation with a broker-dealer's registered representative ("RRs"). Broker-dealers literally can offer thousands of mutual funds to their customers. Firms and their RRs cannot hope to be informed about all of those funds, so often they will narrow the universe to several fund families. Fund organizations may provide broker-dealers with payments (so called "revenue sharing") with respect to those funds. Fund organizations may pay broker-dealers for "shelf space," *i.e.*, a preferred relationship with some funds as opposed to others. These practices, while not new, have become more complex in recent years.[7] As a result, we support improved disclosure of such revenue-sharing arrangements.

Revenue-sharing arrangements often encompass more than the provision of shelf space. In recent years, broker-dealers have been handling functions that mutual fund organizations previously might have performed exclusively. This shift in function has provided many operating efficiencies and benefits to investors, including consolidation of investments within a single financial services organization, and easier access to investment services. Revenue-sharing payments often help reimburse broker-dealers for some of the following expenses associated with processing fund transactions and maintaining customer accounts:

- Customer Sub-accounting
- Mailing confirms, prospectuses and other disclosure documents.
- Maintaining information websites.
- Implementing changes initiated by funds, including revising systems and procedures and communicating changes to registered representatives and customers.
- Overseeing and coordinating fund wholesaler activities at the firm.

In the absence of such third-party payments, many of these administrative and other expenses incurred in processing mutual fund transactions and servicing mutual fund accounts would be borne by fund shareholders through higher fund operating expenses. In addition, broker-dealers use revenue-sharing payments to fund other activities, such as education seminars for their RRs about the different funds they sell. These activities make the RRs more knowledgeable about the funds and can help them tailor their recommendations more effectively.

As a general matter, we do not believe that payments for these administrative services present the same type of potential conflict as payments for "shelf space" or inclusion on a preferred list. Revenue-sharing payments have aided the development of

[7] If an RR recommends a specific fund to a customer, NYSE and NASD rules provide that the fund must be "suitable" for that investor.

mutual fund supermarkets and benefited fund investors who appreciate the convenience and broad access to different mutual fund offerings that these supermarkets provide. Moreover, across the industry (both within and outside fund supermarkets) it is common for revenue-sharing payments to be based upon the full range of services provided, rather than individual costs associated with specific services. As a practical matter, it is not always possible to attribute a specific percentage of a revenue-sharing payment to the offering of shelf space or inclusion on a preferred list, as opposed to other services. Accordingly, it is important to recognize that the term "revenue sharing" encompasses many different practices.

B. Improving Disclosure of Relationships between Broker-Dealers and Funds

Improved disclosure should:

- Provide investors with timely, clear information in a useful format so that they can make informed investment decisions;
- Foster fierce competition, which affords investors broader investment choices at the lowest cost.

It is important to make disclosure investor-accessible and investor-friendly rather than a "Where's Waldo?" search through fragments of disclosures for relevant information. Achieving this goal requires a coordinated effort among Congress, regulators and SROs, as well as the mutual fund and securities industries. Mutual fund investors need relevant information on many levels when evaluating a proposed mutual fund investment.

- First, they need useful information about the fund they are considering. They need to know what type of fund they are buying – debt or equity, blue chip, or small cap – and they need to know the risks and range of returns of such funds. They also need information on expenses, soft dollars, directed brokerage (refer to glossary for definitions) – anything material that will help them understand the pros and cons of the fund they are considering.

- They also need to know about commercial arrangements that a mutual fund organization may have with a broker-dealer or its RRs that might provide incentives to the intermediary.

- Most importantly, investors need information in a clear format that is comparable across funds and fund families and that promotes consumer choice and competition.

SIA strongly supports efforts to enhance transparency of revenue sharing and differential compensation to mutual fund investors. At a minimum such enhanced disclosure should embody the following elements:

- A clear, simple presentation of the nature of services received (including the inclusion of funds on preferred or select lists, or provision of shelf space) and expenses reimbursed pursuant to revenue-sharing arrangements;
- A listing of funds or fund families with which revenue-sharing arrangements exist;
- The aggregate amount of revenue-sharing payments received during a specified period;
- The funds or fund families with respect to which higher percentage rates of compensation are paid to associated persons, such as proprietary funds or on sales of class B shares;
- The extent, if any, to which RRs may only recommend the purchase of funds with respect to which the broker-dealer participates in revenue-sharing arrangements.

A number of legislative and regulatory initiatives directed at improving transparency – such as enhanced disclosure of the arrangements between fund organizations and broker-dealers – have emerged in recent months. We generally support efforts to give investors additional information about the arrangements between fund organizations and broker-dealers. We have previously indicated to the NASD[8] and SEC[9] that any rulemaking in this area should be designed to:

- Achieve a uniform approach across regulatory entities regarding disclosure mechanisms for information on revenue sharing and differential compensation arrangements;
- Focus disclosure on circumstances where such arrangements are likely to influence recommendations made to investors, or limit the scope of recommendations that may be offered;
- Use disclosure vehicles that will focus investors' attention toward the material information that should be considered when making a mutual fund investment.

We urge policymakers to write new "rules of the road" to ensure that investors receive clear disclosure of the material aspects of the relationship between their broker-dealer (including its RRs) and the fund. SIA stands ready to assist policymakers with this effort.

C. <u>Disclosure of Operating Expenses</u>

Investors should have full, clear, and useful information on mutual fund fees since they will have a significant effect on an investor's return. The most efficient means for

[8] Letter to Barbara Sweeney, NASD from Stuart R. Strachan, Chair, SIA Investment Company Committee Rule Proposal Regarding Compensation for the Sale of Investment Company Securities, (October 17, 2003).
[9] Letter to Paul F. Roye, Director, SEC Division of Investment Management from Stuart R. Strachan, Chair, SIA Investment Company Committee, Revenue Sharing and Differential Compensation (October 31, 2003).

providing this information to investors is for funds to calculate expenses based on a hypothetical $1,000 investment. House Report 108-351 accompanying H.R. 2420 (Nov. 4, 2003) notes at 11 that:

> The SEC recently proposed a new rule requiring disclosure in a fund's semi-annual and annual report to include (1) a dollar example of the fees an investor would have paid on a hypothetical $10,000 investment, using the actual expenses incurred by the fund and the actual return achieved by the fund; and (2) the same dollar example using the actual expenses incurred but assuming a 5 percent return over the period so funds could be compared against each other. *** H.R. 2420 generally codifies the pending SEC proposal, but includes two important changes: first the dollar example in the annual report must be based on a hypothetical $1,000 investment. The Committee believes that using $1,000 as the example will make it easier for investors to calculate the amount of fees paid. Second, the legislation includes a requirement that account statements include a legend prominently stating that (1) the investor has paid fees on the mutual fund investment, (2) those fees have been deducted from the amount shown on the statement, and (3) the investor can find more information by referring to documents disclosing the amounts of those fees.

SIA generally concurs with these provisions. Providing information on a $1,000 investment both with respect to that fund's return and with respect to a hypothetical five percent return will facilitate exactly the type of comparison-shopping that H.R. 2420 and the SEC contemplate. At the same time, the costs of these changes will be in proportion to the benefit that investors derive.

D. Soft Dollars, Directed Brokerage, and Related Issues

SIA supports efforts to improve disclosure of brokerage arrangements among funds, their advisers, and broker-dealers. When Congress enacted Section 28(e) of the Securities Exchange Act of 1934, it recognized the need for money managers to obtain research from a wide range of sources. Section 28(e) permits money managers to pay for research and related services through commission ("soft") dollars rather than paying for them in cash. Such research helps money managers, including fund managers, do a better job of serving their customers. Over the years, the Commission has issued interpretations on the scope of research services that may be provided and examined industry practices. An SEC staff report notes, "the vast majority of products and services received by advisers are within the safe harbor established by Section 28(e) of the Exchange Act."[10] In general, soft dollars are both pro-investor and pro-competitive, because they increase competition among money managers, encourage independent research[11], and give investors more choices.

[10] SEC, Office of Compliance, Inspections and Examinations Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers, and Mutual Funds, September 22, 1998 ("1998 Report").
[11] We note that one objective of last year's settlement regarding research analysts was to require investment banks to fund independent research.

At the same time, we recognize that there are risks of abuse with respect to soft dollars. SIA strongly supports SEC and SRO enforcement efforts to curb soft dollar abuses and to deter others from engaging in such abuses. We also believe that mutual funds should ensure effective disclosure of soft dollar practices both to investors and to fund trustees. We would welcome a study of soft-dollar arrangements to ensure that they continue to benefit investors.

"Directed brokerage" practices also have been a subject of concern. The term "directed brokerage" means different things to different people. In general, directed brokerage refers to an arrangement in which a fund directs the execution of a portion of the fund's trades through a particular broker-dealer. In exchange for those brokerage commissions, the broker-dealer agrees to pay certain fund expenses, provide services to the fund, or provide a cash rebate to the fund through a commission recapture program. Directed brokerage programs involve the use of brokerage commissions to pay expenses of an investment adviser's client (*i.e.*, the fund). Directed brokerage has become increasingly common in the mutual fund industry, in particular because the use of directed brokerage to reduce fund expenses provides a direct benefit to fund shareholders. The 1998 Report – in citing the 1986 Release – states that unlike soft dollars, directed brokerage does not present the same conflict of interest issues, since **"the fund's commission dollars [are used] to obtain services that directly and exclusively benefit the fund."**[12]

However, certain practices also referred to as "directed brokerage" can create a different potential conflict. A fund's adviser may "direct" brokerage transactions to reward securities firms that also sell the adviser's funds. Fund managers are permitted in some circumstances to consider sale of fund shares as one factor in the selection of broker-dealers as long as the selection is consistent with their duties of best execution[13]. Directing brokerage to a broker-dealer purely as a *quid pro quo* for selling the fund's shares raises serious concerns. Moreover, SEC officials have raised the question of whether these practices represent the use of fund assets to pay for distribution and thus should be permitted only under a Rule 12b-1 plan approved by the fund's board of trustees.[14]

[12] 1998 Report, citing Interpretive Release Concerning Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Exchange Act Release No. 23170 (Apr. 23, 1986) (the "1986 Release")(emphasis added).
[13] NASD Rule 2830(k).
[14] That, in turn, might raise questions about exceeding limits on 12b-1 fees. Rule 12b-1 itself does not restrict the amount of expenses that may be paid pursuant to a 12b-1 plan. The NASD, however, has determined that a fund's 12b-1 plan fees should not exceed 100 basis points annually, 75 basis points of which could be for distribution expenses and 25 basis points for service fees. Rule 2830(d)(2)(E)(i) and (d)(5). After funds with asset based and contingent deferred sales load became popular, NASD, with the SEC's approval, determined that 12b-1 plan fees should be governed by the rules that apply to sales loads. NASD took this action so that shareholders paying for distribution indirectly through 12b-1 plan fees would pay no more than shareholders paying for distribution directly through front-end loads. *See* U.S. Securities and Exchange Commission, *Division of Investment Management: Report on Mutual Fund Fees and Expenses* (Dec. 2000) at n. 28.

With respect to both soft dollars and directed brokerage, the key investor protection issue to maintain is "best execution." The SEC has characterized best execution as the ability "to execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances."[15] The SEC has also stated that the "determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the [fund]."[16] This entails considering the full range and quality of a broker's services, including execution capability, commission rate, financial responsibility, and responsiveness to the adviser. If fund investors received mediocre executions because of soft dollar or directed brokerage arrangements, the relationships are indefensible. Poor executions in the absence of soft dollar or directed brokerage arrangements are also indefensible. With respect to research and execution services, advisers, fund trustees, and broker-dealers must put investors first.

Arrangements between funds and broker-dealers should be disclosed fairly and in context to investors and fund trustees. Clear, simple disclosure of material information is essential if investors and their intermediates are going to make intelligent and informed decisions. We support efforts to improve disclosure of information with respect to soft dollars and directed brokerage.

E. Late Trading

SIA is appalled by reports of late trading of mutual fund shares. As Attorney General Spitzer has noted, such activity is the equivalent of betting on a horse race after it is over. Reforms should make late trading virtually impossible to achieve. At the same time, SIA believes that these reforms should not penalize innocent investors, particularly those in 401(k) or 529 plans, and we have concerns that the recent SEC proposal to require a hard close solely at the fund or registered clearing agency level might have such an effect.

In an October 31, 2003 letter to the SEC[17] SIA suggested an alternative approach that would permit same-day pricing for orders received by the broker-dealer or other intermediary by 4:00 p.m., as well as orders received by the mutual fund or its processing

[15] *See* SEC Release No 34-9598 (May 9, 1972); Kidder, Peabody & Co., IA-Release No. 232 (Oct. 16, 1968). The SEC staff has noted:

> Although a mutual fund's investment adviser has an obligation to seek the best execution of securities transactions arranged for or on behalf of the fund, the adviser is not necessarily obligated to obtain the lowest possible commission cost. The adviser's obligation is to seek to obtain the most favorable terms for a transaction reasonably available under the circumstances.

Memorandum from Paul F. Roye, Director, Division of Investment Management, SEC, to the Honorable William H. Donaldson, SEC Chairman, Regarding Correspondence from Chairman Richard H. Baker, House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (June 19, 2003) at 26 ("Roye Memorandum"). *See also* Rules 11Ac1-5 and 11Ac1-6 under the Exchange Act.

[16] *Id.*

[17] Letter from Marc E. Lackritz, President, Securities Industry Association, to Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission (Oct. 31, 2003).

agent by 4:00 p.m. This requirement would be subject to the qualification that the recipient of the order must have an electronic order capture system with verifiable order entry time aligned with an atomic clock to document receipt. The proposal would eliminate a salesperson's ability to either withdraw a fund order after 4:00 p.m. or receive current day pricing for an order entering the system after 4:00 p.m.

We welcome further debate on eliminating late trading and hope that policymakers will adopt a solution that protects all investors and does not create competitive disadvantages for some. Late trading has had a terribly corrosive effect on investor confidence; we must find and implement an effective remedy *now*.

F. Regulation of Hedge Funds and Mutual Funds

Mutual funds and the broker-dealers that sell them intend those products as investment vehicles for the average investor, not the financial sophisticate. SIA also appreciates that investment advisers and portfolio managers should not discriminate against mutual funds and inappropriately favor hedge funds that they manage. However, provisions in legislation that would make it difficult for an investment adviser and its portfolio manager to manage both mutual funds and hedge funds under any circumstances may go too far.

Side-by-side management of mutual funds and hedge funds raises potential conflicts of interest that have been highlighted throughout the investigation leading up to the SEC staff's recent Hedge Fund Report.[18] These conflicts are not unique to situations involving hedge funds. Rather, they are endemic to the management of multiple accounts regardless of the nature of the client.[19] Recent legislative proposals purport to address these conflicts of interest by banning the joint management of registered and unregistered funds.

Specifically, the proposals would prohibit an individual from serving as portfolio manager to a registered fund while simultaneously serving as portfolio manager to an unregistered fund (or such other categories of funds as the SEC may prescribe by rule). The proposals would permit the SEC, by rule, regulation or order, to allow joint management by a portfolio manger in "exceptional circumstances when necessary to protect the interest of investors." However, any such rule, regulation or order would require: (i) enhanced disclosure by the fund of any conflicts of interest raised by the joint management; (ii) fair and equitable policies and procedures for the allocation of securities among the jointly managed accounts; and (iii) certification by the fund's independent directors in the periodic reports to shareholders or in some other appropriate document that those policies and procedures are fair and equitable.

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[18] SECURITIES AND EXCHANGE COMMISSION, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS (September 2003) ("Hedge Fund Report"). *See also SEC Chairman Donaldson Releases Staff Report on Hedge Funds*, (pub. avail. Sept. 29, 2003) at http://www.sec.gov/news/press/2003-125.htm.

[19] Of course, the presence of incentive compensation in the typical hedge fund does tend to heighten the potential for conflicts, although incentive compensation is not unique to hedge fund accounts.

We oppose language that limits such management to "exceptional circumstances." Permitting side-by-side management of mutual and hedge funds only where enhanced disclosure of conflicts has been made and policies are in place to assure fair allocation of investment opportunities between funds provides sufficient safeguards to investors. Limiting side-by-side management to "exceptional circumstances" would effectively operate as a ban. Such a ban would deprive small mutual fund investors of the same benefits and expertise available to wealthy investors. It seems unfair to deny to small mutual fund investors the most talented fund managers, while ensuring that they would be available only to the most privileged, wealthy few who qualify for hedge fund investing.

III. Conclusion

SIA abhors abusive activities involving mutual funds. We urge the SEC, the NASD, and state authorities to bring wrongdoers to justice swiftly and surely. We are proud of our work on mutual fund breakpoints to ensure that all investors get the discounts to which they are entitled, and we remain committed to working with policymakers to develop effective new disclosures and to prevent abuses going forward.

We are also proud of the capital our industry has raised, the jobs we helped create, the innovation and growth we helped foster, the new products and services we've made available, and the dreams we have helped our customers achieve. We are eager to work with you, and other Congressional committees and regulators, to improve mutual funds so they can continue to be an effective investment vehicle for all Americans.

Thank you very much.

Glossary

Many mutual fund terms do not have hard and fast definitions, but below are commonly understood definitions of important terms.

Classes of Funds -- There are many different types of mutual funds designed to meet the needs of different investors. As disclosed in the fundamental policy of the fund, the fund manager will only purchase portfolio securities of certain types. For example:

Equity or Stock Funds -- common stocks. Some examples include[20]:

Growth funds -- focus on stocks that may not pay a regular dividend but have the potential for large capital gains.

Index funds -- aim to achieve the same return as a particular market index, such as the S&P 500 Composite Stock Price Index, by investing in all — or perhaps a representative sample — of the companies included in an index.

Sector funds -- may specialize in a particular industry segment, such as technology or consumer products stocks.

Debt Funds -- bonds other debt instruments. Quality of the bonds may vary from U.S. Treasury securities or highly rated corporate bonds, to more risky "junk" bonds. Some funds invest in only tax-exempt securities.

Specific examples might include:

Blue Chip -- securities of well-established companies with seasoned management or large market share. A fund might be a blue chip growth fund, which focuses on companies with long term growth prospects, but does not pay dividends.

Small Cap -- securities of smaller, typically newer companies. A fund might be a small cap (for "capitalization") value fund, in which fund will buy stocks of companies whose current stock prices do not appear adequately to reflect their underlying value as measured by assets, earnings, cash flow, or business franchises.

Differential Compensation -- Broker-dealers and/or their registered representatives receive higher incentive payments for promoting certain funds (*e.g.*, in-house funds or funds with which the broker-dealer has a revenue sharing arrangement).

[20] Some of this information is from the SEC's website, noted below.

Directed Brokerage -- many people use this term to describe different things.

Under one definition, directed brokerage is an arrangement under which an account manager directs trades to a specific broker-dealer. In return, the broker-dealer agrees to pay certain fund expenses. Fund prospectuses disclose these arrangements, often as a fee table footnote. These arrangements do not raise conflict of interest issues because the fund directly benefits from the arrangement. For example, Fund A directs trades to Broker-Dealer X and that broker-dealer pays custody expenses for Fund A.

Under another definition, sometimes called "brokerage for sales," a fund manager or distributor directs fund brokerage to broker-dealers that sell shares of the fund. There are limitations on a broker-dealer's ability to seek brokerage commissions in exchange for a selling shares of a mutual fund. For example, NASD Rule 2830(k) provides, in part:

> (1) No member [*i.e.,* broker-dealer] shall, directly or indirectly, favor or disfavor the sale or distribution of shares of any particular investment company or group of investment companies on the basis of brokerage commissions received or expected by such member from any source, including such investment company, or any covered account.

But there are exceptions to these and other prohibitions. NASD Rule 2830(k) further states:

> (7) Provided that the member does not violate any of the specific provisions of this paragraph (k), nothing herein shall be deemed to prohibit:
>
> (B) a member from selling shares of, or acting as underwriter for, an investment company which follows a policy, disclosed in its prospectus, of considering sales of shares of the investment company as a factor in the selection of broker/dealers to execute portfolio transactions, subject to the requirements of best execution;

Fee Arrangements for Mutual Funds -- There are many different types of fee arrangement for funds

Front-End Sales Charge (or Front-End Load) - a sales charge deducted at the time of purchase from the purchase price for fund shares. It is expressed as a percentage of the total purchase or offering price of the fund's shares. The individual investor pays this charge directly.

Breakpoints -- Fund front-end sales charges may contain breakpoints that provide reduced sales charges for larger purchases. Funds disclose breakpoints in their prospectuses. They also disclose conditions for waivers of sales charges and for aggregating purchases or signing letters of intent that would result in lower sales charges.

Contingent Deferred Sales Charge ("CDSC") -- a sales charge deducted upon redemption of fund shares. This charge is assessed against the individual investor. The CDSC generally declines over a period of five or six years, so that a redemption within one year of purchase is subject to the maximum CDSC while the CDSC is reduced for redemptions in later years and disappears for redemptions more than five or six years from the date of purchase.

No-Load Funds -- The fund does not charge any type of sales load. But, not every type of shareholder fee is a "sales load." A no-load fund may charge fees that are not sales loads, such as purchase fees, redemption fees, exchange fees, and account fees. No-load funds also have operating expenses.

Rule 12b-1 Fees -- The SEC adopted Investment Company Act Rule 12b-1 in 1980, which permits fund assets to be used for distribution and shareholder services. NASD Rule 2830 establishes a general limit of 0.75% for distribution, 0.25% for service fees. The fund distributor pays fees from fund assets to broker-dealers and others who sell fund shares and/or provide ongoing services to fund shareholders.

Class A Shares -- are typically subject to a front-end sales charge. The front-end sales charge often has "breakpoints" for larger size investments. Funds often establish waiver categories, disclosed in their prospectuses, so that particular categories of investors are permitted to purchase shares with a reduced or waived front-end sales charge. Class A shares also may have a Rule 12b-1 fee of 0.25-0.50% of average annual net Class A assets.

Class B Shares -- typically have no front-end sales charge, a relatively high Rule 12b-1 fee of up to 1.00%, and a contingent deferred sales charge. Because the fund underwriter pays brokers a commission up-front for sales of Class B shares, the Rule 12b-1 fee is designed to pay the underwriter back for these advances. Class B shares typically convert to Class A shares within a year or two after the CDSC disappears.

Class C Shares -- Class C shares generally have no, or very low, front-end sales charges or CDSC. They may have a Rule 12b-1 fee of up to 1.00%. Class B shares typically do not convert to Class A shares.

4:00 P.M. Pricing -- Investment Company Act Rule 22c-1 requires that fund share orders must be received by the time specified in the fund's prospectus to receive that day's net asset value (NAV) per share price. In other words, if you buy mutual fund shares on Monday, the order must reach the fund by 4:00 p.m. to get Monday's NAV. If you send in your order at 5:00 p.m. on Monday, you should get Tuesday's NAV. Past SEC staff interpretations have permitted orders to be received by intermediaries, such as a broker-dealer, by 4:00 p.m. for same day NAV. The fund prospectus typically discloses the 4:00 p.m. deadline and who must receive the order by that time. "Late trading" refers to the illegal practice of helping an investor get today's price after 4:00 p.m. For example an investor enters an order to buy a fund's shares on Monday at 5:00 p.m. and gets Monday's NAV.

Revenue Sharing -- A fund adviser or distributor pays additional compensation to a broker-dealer or other financial intermediary. The payments may be for several different purposes. One purpose is to encourage the broker-dealer to provide "shelf space." Shelf space arrangements range from simply making the fund available to investors or more prominently featuring the fund. Payments may also be for administrative or recordkeeping functions, such as keeping track of the fund's shareholder records at the broker-dealer. Disclosure is generally required in the fund prospectus and Statement of Additional Information ("SAI"). Delivery of the prospectus containing this disclosure satisfies requirements of Exchange Act Rule 10b-10 (*i.e.*, the confirmation rule).

"Soft dollars" or "paying up" for research -- Section 28(e) of the Securities Exchange Act of 1934 makes it lawful for an investment manager (who has discretion to trade an account) to pay higher than the minimum commission when the manager also receives research services from that broker-dealer.[21] Congress enacted this provision at the time that it unfixed brokerage commissions. Congress wanted to ensure that, in appropriate circumstances, investment managers would be able to pay more than the absolute lowest available commission without breaching their fiduciary duty.

Under Section 28(e), the commissions must be reasonable in light of services received by the investment manager. The broker-dealer that provides brokerage may provide the research services or the broker-dealer may arrange that a third-party provide the research to the investment manager. If the product/service is also used for non-research purpose

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[21] Section 28(e) of the Securities Exchange Act of 1934 provides

> no person ... in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law unless expressly provided to the contrary by a law enacted by the Congress or any State subsequent to the date of enactment of the Securities Acts Amendments of 1975 solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion.

("mixed use"), the investment manager must develop and document a reasonable cost allocation. Mutual funds must disclose soft dollar arrangements in a general way in their Statements of Additional Information ("SAI"). Investment advisers must disclose soft dollar practices in their Form ADV Part II. SEC interpretations establish requirements for reliance on 28(e) (*e.g.*, any research obtained must provide "lawful and appropriate assistance" to the account manager in carrying out his responsibilities).

For more information, see http://www.siainvestor.com/index_flash.htm or http://www.sec.gov/investor/pubs/inwsmf.htm

Statement of John P. Freeman
Professor of Law, University of South Carolina Law School

Before the Senate Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security
January 27, 2004

"No issuer of securities is subject to more detailed regulation than a mutual fund."[1]

A LAW PROFESSOR COMMENTS ON THE MUTUAL FUND FEE MESS

The Fund Industry's Moral Compass is Broken; Conflicts of Interest are Rampant. The fund industry's hallmark is its external management set-up by which an outside company manages the fund while populating a number of seats on the fund's board, including the Chairman's seat. The external manager typically controls all facets of fund life, from the fund's incorporation through the selection of the initial board. Historically, this control has tended not to be relinquished over time.[2] This curious and dysfunctional

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[1] Letter of SEC Chairman Ray Garrett, Jr., to Honorable John Sparkman, August 1974, at v, transmitting REPORT OF DIVISION OF INVESTMENT MANAGEMENT, SEC, MUTUAL FUND DISTRIBUTION AND SECTION 22(d) OF THE INVESTMENT COMPANY ACT OF 1940 (1974).

[2] In the words of one of the industry's earliest and most vociferous critics:

> Now, this is about the birds and the bees of the American corporate scene. . . . The fund is conceived by a bunch of people whom we call advisors or managers. . . . This group gives birth to the fund. The fund is manned by the advisors. If I may carry this figure of speech, the umbilical cord is never cut after birth, as would be true in ordinary biological life.

Statement of Abraham Pomerantz, *University of Pennsylvania Law School Conference on Mutual Funds*, 115 U. PA. L. REV. 659, 739 (1967). As former SEC Commissioner Manuel Cohen once remarked when referring to testimony by fund investment advisors:

> They also made the point that the investment advisor creates the fund, and operates it in effect as a business. Many of them stated that "It is our fund, we run it, we manage it, we control it," and I don't think there is anything wrong with them saying it. They were just admitting what is a fact of life. The investment advisor does control the fund.

Investment Company Act Amendments of 1976: Hearings on H.R. 9510, H.R. 9511 Before the Subcomm. on Commerce and Fin. of the Comm. on Interstate and Foreign Commerce, 90th Cong. 674 (1967) (statement of Manuel Cohen, Commissioner, SEC).

external management governance system prevails throughout most of the fund industry, with the Vanguard Group being a key exception.

The fund industry's structure thus features a built-in conflict of interest; it creates and perpetuates the risk, always, that the manager will treat fund shareholders unfairly. It was this inherently conflicted structure that gave us the Investment Company Act of 1940, an Act created specifically to address and protect against over-reaching by conflicted fund managers to shareholders' detriment. In 1940, after exhaustive study, Congress determined that

> [t]he national public interest and the interest of investors are adversely affected . . . when investment companies are organized, operated and managed in the interest of investment advisors, rather than in the interest of shareholders . . . or when investment companies are not subject to adequate independent scrutiny.[3]

These findings are still valid. As a result of the fund industry's conflicted governance structure, fee overcharging is pervasive, and commonly it is accompanied by cover-up.

A prime example of overcharging is funds' advisory or "management" fees. These are key, because the principal thing fund investors buy is "professional investment advice." In our 2001 article in the *Journal of Corporation Law*, Professor Brown of Florida State University and I found that fund advisors are overcharging fund shareholders for portfolio management. There was nothing new about this finding. Consider this quote from my article on mutual fund advisory fees: Fund shareholders "pay nearly twice as much as institutional investors for money management. And that calculation doesn't even include any front- or back-end sales charges you may also pony up." The quoted language was not written by me or my co-author, Professor Stewart Brown of Florida State University. The comment was written by financial writer Ruth Simon in 1995. *See* Ruth Simon, *How Funds Get Rich at Your Expense*, MONEY, Feb. 1995, at 130. The quote appears in footnote 10 of our 2001 article.

Professor Brown, Ruth Simon, and I were not the first to detect fee overcharges by mutual fund managers. Nearly forty years ago, a study conducted for the SEC by the Wharton School of Finance and Commerce determined that where fund advisors had outside advisory clients, there was a "tendency for systematically higher advisory fee rates to be charged open-end [mutual fund] clients." WHARTON SCHOOL OF FINANCE & COMMERCE, 87TH CONG., A STUDY OF MUTUAL FUNDS 493 (Comm. Print 1962). Why this price disparity?

Here is what the authors of the Wharton Report concluded:

> In the case of fees charged open-end companies [mutual funds], they are typically fixed by essentially the same persons who receive the fees, although in theory the fees are established by negotiation between independent representatives of separate legal entities, and approved by democratic vote of the shareholders. This

[3] Investment Company Act of 1940 § 1(b)(2), 15 U.S.C. § 80a-1(b)(2) (1994).

> suggests that competitive factors which tend to influence rates charged other clients have not been substantially operative in fixing the advisory fee rates paid by mutual funds.

Id. at 493-94. In a nutshell, the reason for the price-gouging harkens back to the industry's dysfunctional, conflicted governance system. The chief problem with most mutual funds lies in the inherent conflict of interest between the shareholders and the funds' management.

The Wharton Report's findings later were corroborated by a study authored by the SEC itself and submitted to Congress in 1966. That study, entitled *Public Policy Implications of Investment Company Growth*, H.R. REP. NO. 89-2337 (1966), revisited the Wharton School's fee disparity findings and determined that, "[t]he Wharton Report's conclusions correspond to those reached by the more intensive examination of selected mutual funds and mutual fund complexes made by the Commission's staff." *Id.* at 120.

Conflicts of interest are pervasive throughout the fund industry. They infect the way the industry is managed and the way it is regulated. The lobbying arm, the Investment Company Institute, epitomizes the industry's conflicted management structure. Drawing most of its money from fund shareholders, the ICI resolutely protects the status quo for fund sponsors, even when its positions ill-serve fund shareholders.

The SEC is MIA.

I referred to conflicts of interest infecting the way the industry is regulated. The SEC's Division of Investment Management ("DIM") presents a classic case of "regulatory capture." It is conflicted as well. Bluntly stated, over time, DIM has become far too deferential to the industry. The SEC's Division of Investment Management represents a Chihuahua watchdog, not the Doberman shareholders need.

And then there are the DIM alums. What we almost always find when SEC staffers move on are SEC-honed skills being put to work protecting the wealth of fund managers, not fund shareholders. My analysis of SEC personnel movements, using data I obtained from the SEC under FOIA, shows that most of the SEC's senior personnel who leave the DIM go to work for mutual funds as officers or directors, for the ICI, or for service suppliers (law firms or accounting firms) who advise fund sponsors. These professionals are dedicated to protecting the industry's managers, and the industry's managers have an agenda that does not place fund shareholders first.

When I was working with the SEC in DIM years ago, I was told by a fellow staff lawyer: "Let's face it, in five years we'll all be working for these guys." Then and now, that staff lawyer's observation holds true. I tell you bluntly the SEC has failed mutual fund investors.

The clouds have been gathering for many years. In the course of Senate hearings during consideration of fund reform in the late 1960s, Nobel Laureate Paul Samuelson's warned:

> Self-regulation by an industry tends usually to be self-serving and often inefficient. *There is a danger that government commissions, set up . . . originally to regulate an industry, will in fact end up as a tool of that industry, becoming more concerned to protect it from competition than to protect the customer from the absence of competition. . . .* The SEC must itself be under constant Congressional scrutiny lest it lessen rather than increase the protection the consumer receives from vigorous competition.[4]

As recently as last Thursday, the public was treated to the spectacle of the SEC being roasted in *The Wall Street Journal* for intervening as amicus in a fund case over fee disclosure. Had the SEC intervened on the side of shareholders, calling for greater disclosure? Of course not. As the *Journal* observed, the SEC took the position that "disclosure with precision is not necessary" about an industry practice recognized as being a problem by "just about everyone except the SEC."[5]

Epitomizing the agency's indolence is the behavior of former SEC Chairman Arthur Levitt. As Chairman, for years Levitt presided over the industry's marketing boondoggle, Rule 12b-1.[6] While at the SEC, Levitt did nothing about Rule 12b-1. Once he left, he wrote a book, *Take on the Street*, offering investors this advice about 12b-1 fees:

> You should avoid owning shares in a fund that charges these fees, which are no more than a levy on existing investors to help find new investors. Why should you pay to tell the rest of the world how good your fund is?[7]

This is good advice, but it raises this question: While he was SEC Chairman, why didn't Arthur Levitt do something about this demonstrably flawed, SEC-authored rule?

We now turn to other industry fee-related problem areas, each of which ties into to the industry's conflicted and dysfunctional governance system.

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[4] Mutual Fund Legislation of 1967: Hearing on S. 1659 Before the Senate Comm. on Banking and Currency, 90th Cong. 368-69 (1967) (statement of Professor Paul Samuelson) (emphasis added).
[5] Tom Lauricella & Deborah Solomon, SEC Defended Fund-Broker Compacts in Past, *The Wall Street Journal*, January 22, 2004, at C1.
[6] Rule 12b-1 allows fund managers to tap fund assets to pay for costs incurred in selling fund shares. It is controversial because there is no proof that new fund sales confer a net financial benefit on existing fund shareholders who, under Rule 12b-1, get stuck with huge marketing bills. The rule was adopted by the SEC in 1980 and was little-used initially. Since then, the growth of 12b-1 fee payments extracted from fund assets has been staggering. Today, Rule 12b-1 pumps around $9 billion annually into fund sellers' pockets, money paid at fund shareholders' expense.
[7] Arthur Levitt, *Take on the Street* 48 (2002).

SOME SPECIFIC CONFLICT/FUND FEE HOT SPOTS

The Advisory Fee Mess

Fund managers are smart. Like the wily innkeeper Thenardier in *Les Miserables*, they know that a little nick, or slice, or cut here or there can add up.[8] As the late Senator Everett Dirksen allegedly observed: "A billion here, a billion there, and pretty soon you're talking about real money." Well, we are talking about real money taken from America's investing public, and the fund industry's conflicted investment advisors have been working under the radar and collecting it.

Fund managers well know that most shareholders do not even understand what a basis point is. (For the uninitiated, a basis point is a hundredth of a percent.) Advisory fee overcharges of twenty-five basis points, .25 percent, do not seem like much, but when applied to an asset base running in the trillions, they are huge. Fund investors are being overcharged to the tune of many billions of dollars per year, and the SEC has been asleep at the switch.

Price gouging over advisory fees is rampant, and the industry is in denial. Over-charging for portfolio management has been the industry's dirty secret for years. Remember the Ruth Simon quote? Note also that our findings echo the prior findings found in the Wharton Report and the SEC's own Public Policy Implications Study. For our efforts, in calling attention to the waste, my co-author and I have been called "irresponsible" by ICI President Matthew Fink. Our sin is that we had the brass to suggest that advisory fees are excessively high.

According to the ICI's Fink, fund advisory fees are highly competitive, and the fund industry epitomizes disclosure transparency. He's wrong on both counts. Fund advisory fee gouging is a national disgrace.

Consider these facts. Recently, Alliance Capital was charging 93 basis points (.93 percent) for managing the $17.5 billion Alliance Premier Growth Fund. This is a fee paid by shareholders of $162.7 million per year. At the same time as it was charging 93 basis points to its *own shareholders*, Alliance was managing the Vanguard U.S. Growth Fund for 11 basis points (.11 percent) -- less than 1/8 of what it was charging Alliance

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[8] Charge 'em for the lice
Extra for the mice
Two percent for looking in the mirror twice
Here a little slice
There a little cut
Three percent for sleeping with the window shut
When it comes to fixing prices
There are a lot of tricks he knows
How it all increases
All those bits and pieces
Jesus! It's amazing how it grows!

Cameron Mackintosh, *Les Miserables*.

shareholders. Alliance was also managing a $672 million portfolio for the Kentucky Retirement System for 24 basis points, a $1.7 billion portfolio for the Minnesota State Board of Investment for 20 basis points, a $730 equities portfolio for the Missouri Retirement System for 18.5 basis points, and a $975 equity portfolio for the Wyoming Retirement System for 10 basis points.

These price discrepancies cannot be justified on the basis of differences in service. According to the prospectus for the Alliance Stock Fund, the management company's institutional accounts shared "substantially the same investment objectives and policies" and were managed with "essentially the same investment strategies and techniques" as the Alliance Premier Growth Fund. Moreover, the different clients "shared a nearly identical composition of investment holdings and related percentage weightings."[9]

Obviously, Alliance's shareholders, to whom Alliance owed fiduciary duties, were getting gouged; non-shareholder outsiders paid Alliance Capital far less in the free market for equivalent services. These sorts of price discrepancies are intolerable.

Other Fee-related Practices that Injure Fund Investors.
Less than a year ago, in February of 2003, the ICI's head, Matthew Fink, sent a letter to Congress extolling the industry's embrace of "transparency and accountability principles," and proclaiming that the "mutual fund industry's governance and investor protection standards 'read like a blueprint for the guidelines publicly traded companies are only now being urged to follow.'"[10] I beg to differ. I say that the only thing transparent about the mutual fund industry are the ICI's lame arguments made in sponsors' defense. Here are some questions bearing on "transparency and accountability" for Mr. Matthew Fink and the ICI:

- **What is the deal with "revenue sharing"?** The GAO found in June that fund advisers are shelling out around $2 billion per year in "revenue sharing" to brokers who bring new customers into the funds. GENERAL ACCOUNTING OFFICE, MUTUAL FUNDS-GREATER TRANSPARENCY NEEDED IN DISCLOSURE TO INVESTORS 38 (2003). This lush payout, which the GAO says is growing in size over time, *id.*, supposedly comes not from fund assets but from "advisory profits." The GAO found that this "major expense" is one that "most fund advisers are not willing to publicly discuss." *Id.* at 38-39. So much for transparency.

  If fund advisory fees are rock-bottom competitive, as the ICI insists, then how are advisors able and willing to throw away $2 billion in profits annually to generate sales? Revenue sharing is blatant and worrisome. According to last Thursday's *Wall Street Journal*: "just about everyone except the SEC recognized this was a problem . . . .'" The revenue sharing problem is a $2 billion dollar a year problem, and growing.

[9] Alliance Stock Funds Prospectus (Feb. 1, 2002), at 46.
[10] Letter from Matthew Fink, President Investment Company Institute to Michael G. Oxley and Richard H. Baker, Feb. 21, 2003.

- **<u>What is the deal with "directed brokerage"?</u>** Directed brokerage refers to the advisor doling out cash created by excessive brokerage expenses (a cost borne by fund shareholders). The dirty cash is laundered as brokerage fees for fund portfolio trading. It is used to pay brokers to encourage them to sell fund shares. Never mind that there is no proof that using fund assets to generate new sales confers any net benefit on the existing fund shareholders who pay the marketing charge. For funds that already are paying money up to their 12b-1 ceiling, this directed brokerage boondoggle payment is a clear-cut violation of 12b-1, which provides the exclusive means by which fund assets can be used to subsidize distribution.[11] I want to know why the directed brokerage slush payments by funds that have reached the 12b-1 payout ceiling aren't flatly illegal. The SEC has belatedly started to do something about directed brokerage.

  Directed brokerage is a mechanism used to milk fund shareholders and create income for the advisor (by bringing in more assets to manage via new sales) without running up the fund's expense ratio. Like Enron's use of SPEs, this ploy is off-the-books.

- **<u>What is the deal with soft dollars?</u>** The ICI says advisory fees are kept low by keen competition. How can you tell what they are when the advisor is running up brokerage commissions to generate soft dollar benefits kicked back to it by brokers in the form of supposed research services furnished to the advisor? These service costs are not included in the advisory fee; they are buried in fund commission costs which are not included in funds' expense ratios.

  Bloated portfolio trading commissions are a hidden problem and a serious one. *See* Statement for the Record by Richard J. Hillman, Director Financial Markets and Community Investment, General Accounting Office, Mutual Funds Information on Trends in Fees and Their Related Disclosure, March 12, 2003, at 17, *available at* www.gao.gov/cgi-bin/getrpt?GAO-03-551T:

  > One academic study estimated that mutual funds pay brokerage commissions about $0.06 per share traded. Because individual investors trading through discount broker-dealers can trade for as little as $0.02 per share, the study's author attributes the higher amount of commissions—about 66 percent of the total amount per share—paid by mutual funds to charges for soft dollar research.

<u>Summary On Transparency and Accountability.</u>
The fund industry features a bizarre landscape, replete with excessively high advisory fee costs, and featuring hidden, off-the-books payments, all designed to use fund assets to fuel sales growth for the advisor. The conflict is blatant. I say again, there is no proof

[11] According to the American Bar Association-authored, *Fund Director's Guidebook,* "a Rule 12b-1 plan is the *exclusive means* by which a fund may use its assets to bear the cost of selling, marketing or promotional expenses associated with the distribution of its shares. Fund Director's Guidebook, 59 Bus. Law., 201, 231 (2003) (emphasis added).

that new sales of fund shares benefit existing fund shareholders. The benefit to advisors, on the other hand, by bringing more assets under management, is clear. When assets under management increase, fees for the advisors increase.

To this point I have not mentioned the most damning pieces of evidence showing that the fund industry is out of control: the market timing and late trading frauds. I reference those disturbing occurrences now to drive home a simple point: Both of those scams, and the other depredations mentioned above, tie into the industry's dysfunctional, conflicted management system. In both the late trading and market timing scams, we observe the same thing that we have seen with the directed brokerage, etc., problems chronicled above: conflicted managers eager to reap profit for themselves, even at the expense of fund shareholders to whom fiduciary duties are owed.

The Problem: The Fund Industry Is Over-Regulated and Under-Policed
If regulatory attention were equivalent to investor protection, we would not be here today. Unfortunately, the SEC, the self-proclaimed "Investor's advocate," has failed mutual fund shareholders. Today we confront a fund industry that is under-policed.

The only effective sheriffs on the scene today are operating at the state level, William Galvin in Massachusetts and Eliot Spitzer in New York. Together, they have exposed more corruption and brought more sunlight and fresh air to the fund scene in 6 months than the SEC has in the last 60 years.

What is Needed?
The SEC needs to shape up. It calls itself the "Investor's advocate." It needs to start acting like one. The SEC has hundreds and hundreds of lawyers; comparatively, Messrs. Galvin and Spitzer have a handful. Those two state regulators have been running circles around the SEC and the fund industry. Spitzer and Galvin have shown what is possible if a regulator has the "want-to."

Contrast the direct, correct treatment given fund managers by Spitzer and Galvin with the way the SEC dealt with Putnam in the face of grave wrongdoing exposed by Galvin in Massachusetts. Early in the game, to Mr. Galvin's consternation, the SEC announced that it had settled with Putnam under the SEC's traditional milquetoast formulation, by which the wrongdoer admits no wrongdoing, while promising never to do it again. The SEC needs to start enforcing the laws on the books. Making fund managers honor their fiduciary duties to shareholders would be a good place to start. Moreover, directed brokerage and soft dollars need to go. Rule 12b-1 needs to be eliminated or drastically overhauled.

Shareholders Need Clear, Rigorous Disclosure of Big Ticket Expenses.
The 1940 Act could be vastly improved by requiring detailed, clear disclosure about things like advisory fees, advisors' profitability, and revenue sharing (assuming it is allowed to continue, which I do not favor).

Disclosure is not a panacea. It is true that most shareholders will not read and fully understand all the data and nuances. But what makes our capital markets especially efficient is careful review of data by financial analysts, academics and the financial press. Members of these groups can be counted on to give important fund fee information the thorough study it deserves.

To date, the fund management industry has been able to hide the facts behind a weak, ineffectual disclosure system that allows key information, like management fee costs and advisory profits, soft dollar data, and revenue sharing data, to be presented in confusing ways, if these items are disclosed at all. This needs to change.

Shareholders Need Most Favored Nation Treatment.

Likewise, adopting "most favored nation" treatment of advisory costs would confer a huge benefit. Our 2001 article demanded for fund shareholders "most favored nation" treatment when it comes to fund advisory fees. We concluded the SEC

> should use its rule-making authority to declare that a presumption exists that fund shareholders deserve "most favored nation" treatment over advisory fees charged by their advisors. The "most favored nation" concept is both simple and powerful. Fund shareholders should pay a price for investment advice that is no higher than that charged by the fund's advisor and its affiliated entities when billing for like services rendered to other customers, such as pension funds, endowment funds, "private counsel accounts," or other advisory service users.

Most favored nation treatment will squeeze a lot of fat out of fund fees. Neil Weinberg of *Forbes* has called the "most favored nation" treatment the fund industry's "worst nightmare." Without "most favored nation" treatment, we will continue to find fund sponsors like Alliance Capital, lunching off fat fees paid by fund shareholders for advisory services, while selling those same services in the free market to institutional investors for far, far less.

Why should advisors be able to charge fund shareholders, to whom fiduciary duties are owed, fees that are multiples of the fees charged by the advisor on the free market for equivalent service? Simple fiduciary concepts demand that fund shareholders be treated no worse than strangers. When confronted with unfairly high price quotes, fund directors need to learn how to say "No," or, perhaps, "You're fired." As Delaware's Supreme Court has observed:

> *The power to say no is a significant power. It is the duty of the directors* serving on [an independent committee] to approve only a transaction that is in the best interests of the public shareholders, *to say no to any transaction that is not fair to those shareholders and is not the best transaction available.*

Kahn v. Lynch Communications Sys. Inc., 638 A.2d 1110, 1119 (Del. 1994) (brackets in original) (emphasis added) (quoting *In re First Boston, Inc. Shareholder Litig.*, C.A. 10338, 1990 WL 78836, at *15-*16 (Del Ch. June 7, 1990)).

Where is All of This Headed?
Being a realist, I find it hard to be optimistic. The fund industry is a $7 trillion colossus. Like numerous Americans, the fund management industry is obese, and in denial. To fund industry leaders, there are no problems that getting Eliot Spitzer out of their hair won't cure. The industry is banking on Congress leaving matters to the SEC which, until recently has been in a "partnership" with the ICI. For fund shareholders, the agency has been missing in action.

Will the ICI and the fund sponsors prevail? I hope not, but they are clever, well-heeled, driven, and used to getting their way. With its pro-business orientation, the Congress tends to side with business managers, losing sight of the interests of the millions of Americans who made money, paid taxes on it, and entrusted their savings to mutual fund managers expecting a fair shake. Those investors are the lifeblood of our capitalistic system, and they deserve far better than the fund industry has given them.

To those who believe that the marketplace holds all the answers, I offer this observation: Markets don't work well where there is deception, weak disclosure, and conflicts of interests. This is why Congress gave us the Investment Company Act of 1940 in the first place. Over 60-plus years, the fund industry has figured out how to game the system. There is much repair work to be done.

Thank you for inviting me. I welcome the opportunity to answer your questions.

Statement of Peter J. Kugi
Grafton, Wisconsin

Presented to a Hearing of the:
Senate Committee on Governmental Affairs
Subcommittee on Financial Management, the Budget and International Security

Entitled "Mutual Funds: Hidden Fees, Misgovernance and Other Practices That Harm Investors"

January 27, 2004

Chairman Fitzgerald, Senators Akaka, Collins, Levin and members of the Subcommittee:

Thank you for your continued effort in considering the critical issues concerning the mutual fund industry.

I am 38 years old and have been saving for my retirement since I was 18. Over the last 20 years, through company mergers and retirement program changes, I have participated in a number of 401K programs. I am always certain to read my funds prospectus and get as much information as I can about my investment. This past year has also brought me into litigation over market timing and breach of fiduciary duty issues by fund managers of a mutual fund I invested in. Given my history and pro active nature concerning my investments, I believe I would be considered more informed than most mutual fund investors.

In order to put my comments in context I also feel it's important to quickly mention a few of my socio and economic philosophies. In my opinion, there is an exorbitant amount of laws written to protect the average citizen and in general I believe in less government intervention. As a middle income American I'm also of the opinion that I'd rather save for my own retirement than rely on social security. I feel confident that given the opportunity I can managed my own money and reach my retirement goals. I believe the same to be true of my fellow citizens if given the same opportunities.

Having said this however, there are issues relative to the mutual fund industry that I believe require legislation. We are all now aware of the obvious problems coming forth in the securities fraud cases of this past year. Most of these high profile fraud issues, I'm confident, will be addressed. For instance, many large fund companies had different rules for the average investor versus the large institutional investor. Now that this has been identified as a problem, I would think this is something that can be defined, measured and regulated. Senator Lieberman's press release concerning mutual fund conflicts of interest and payola clearly illustrated another issue to be considered. In addition to addressing these problems there are however several issues I believe to be as important to the average investor.

Over the last several years I've come to realize that there are many hidden fees and transparent issues relative to the mutual fund industry. I believe action needs to be taken to address this. As much as I've tried to become informed on all of my investments there are still some things that simply aren't clear. A perfect example of this comes from my recent experience of considering several different guaranteed interest funds. What I had thought would be a simple analysis of several funds ended up taking me two days and I'm still not clear on what the best option is. One fund advertises a 4% interest rate with a .15% contract fee showing up in the fine print. After several calls and much debate it ended up that what this company was offering was simply 3.85% guaranteed interest. Over the course of the last 12 months I've done a complete study of my portfolio and found that more often than not this is the case. Fees and charges simply aren't clear and defined in a consistent fashion to the extent an average investor can discern them.

As stated previously, I'm not of the belief that my government needs to protect my every move. However this is one issue I believe needs more regulation. If the expectation is that our citizens start saving for themselves, I think we're going to have to have more confidence in our investment information. As is true with everything, the more informed you are the more confident you are. In a free market society, fund companies can charge what they see fit for fees, but the fees need to be clearly identified. In my opinion there needs to be additional regulation of the mutual fund industry and consideration of how fund companies post their information on fees and charges.

In conclusion, I'd offer the following ideas from an average investor's point of view. I'd envision some type of a standardized system for posting fund information in a common format that all fund companies will be mandated to use. This standardized format would clearly spell out all fees and charges associated with the investment in a consistent fashion. This would make it very easy for the average investor to see exactly where fees are applied and do a comprehensive "apples to apples" comparison of funds. It may make sense to consider privatizing this effort. I believe there are certain successful and proven companies that track and rate mutual funds that would be a great source to manage these new government regulations. These companies already have the expertise to wade through the pools of information to get to the facts.

Chairman Fitzgerald, Senators Akaka, Collins, Levin and members of the Subcommittee, this concludes my written submission. Thank you for allowing me to present these views. I apologize for not being able to attend today. I'd be pleased to further discuss these issues and offer the view of the average investor during any future hearings or correspondence that may take place.

STATEMENT OF

NIELS C. HOLCH

EXECUTIVE DIRECTOR

COALITION OF MUTUAL FUND INVESTORS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL MANAGEMENT, THE BUDGET AND INTERNATIONAL SECURITY

COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

WASHINGTON, D.C.

JANUARY 27, 2004

Chairman Fitzgerald, Ranking Member Akaka, and the other members of the Subcommittee, my name is Niels Holch and I am the Executive Director of the Coalition of Mutual Fund Investors. Thank you for the opportunity to present the Coalition's views on the issue of mutual fund fees and expenses. This is a very important topic to the more than 95 million American who are mutual fund shareholders. The Coalition commends the Members of the Subcommittee for their continued leadership on mutual fund reform issues.

The Coalition of Mutual Fund Investors ("Coalition" or "CMFI") is an Internet-based shareholder advocacy organization representing the interests of individual mutual fund investors. The Coalition is based in Washington, D.C., with a Web site that can be accessed at www.investorscoalition.com.

The mission of the Coalition of Mutual Fund Investors is to:

(1) Advocate full disclosure of all mutual fund activities to investors;

(2) Improve regulatory protections and industry best practices for the benefit of long-term mutual fund investors;

(3) Facilitate education opportunities for mutual fund investors; and

(4) Communicate to mutual fund investors about public policy issues.

The Coalition supports H.R. 2420, the bill sponsored by Representatives Richard Baker (R-LA) and Michael Oxley (R-OH), which passed the U.S. House of Representatives in November of 2003. The Coalition believes that this legislation is a good first step towards improving the current mutual fund regulatory framework.

After reviewing the provisions of the Baker/Oxley bill, the Coalition believes that there are several areas in which this legislation can be improved. As the U.S. Senate considers similar mutual fund reform legislation, the Coalition requests consideration of the following five improvements to the House legislation:

I. More Disclosure of the Shareholder Portion of Fund Operating Expenses

Under current law, a mutual fund is required to provide investors with a mathematical calculation called the "expense ratio." This ratio is derived by dividing a mutual fund's annual operating expenses by the average net assets of the fund over the same time period. Since this ratio is calculated using the same methodology for all mutual funds, investors have in their possession a number which is comparable across funds.

To provide further information to those investors concerned about the costs of owning a mutual fund, current law also requires mutual funds to provide a dollar example illustrating the impact of all fund expenses on a hypothetical $10,000 investment, using a 5% assumed rate of return over time. Both the expense ratio and the hypothetical cost calculation are provided, at a minimum, in a fund Prospectus document.

To improve investor disclosure and education, H.R. 2420 would require a mutual fund to disclose the estimated amount--in dollars--of the operating expenses of a mutual fund that is borne by each shareholder. The legislative proposal assumes a $1,000 hypothetical investment. While disclosure of this information may be in a quarterly, semi-annual, or annual statement to shareholders, mutual funds will be permitted to choose not to disclose this information in a shareholder account statement. Instead, a fund may disclose this information in another type of shareholder disclosure document or report.

While this proposal is a step in the right direction, more needs to be done to provide investors with meaningful data to evaluate the costs of owning a particular mutual fund. Hypothetical disclosures with an assumed rate of return are not much help to shareholders when their account balance is different than a hypothetical $1,000 or $10,000 investment. Likewise, a 5% assumed rate of return is about one-half the annual historical return for the U.S. equities markets and so this assumption also has little relevance for an equity investor. Finally, this information should not be buried in a mutual fund report; it would be far more useful to disclose it in a shareholder account statement.

Mutual fund shareholders need more data about their portion of the fund's operating expenses and this information should be disclosed in dollar terms in shareholder statements. The disclosure also should not be a hypothetical figure, but it should relate directly to the shareholder's account balance.

There is no reason why each shareholder in a mutual fund should not receive an annual estimate of the dollar amount of mutual fund operating expenses incurred by such shareholder. This expense figure can be the product of multiplying the shareholder account balance by either: (1) the fund's most recent expense ratio; or (2) a reasonable estimate of the projected expense ratio for the upcoming year. A footnote in the shareholder's statement can be used to explain the methodology used to make this calculation and to note that a shareholder's costs will be different if his or her holding period is less than one (1) year.

If a shareholder has a $17,000 year-end account balance in a fund with a 1.6% expense ratio, the shareholder statement would disclose that this shareholder's portion of the fund's annual operating expenses was $272.

Dollar disclosure of this type will help educate investors about the true costs of owning a particular mutual fund, as long as the methodology used is common to all funds and it is implemented in a manner that will facilitate comparisons among funds.

Disclosure should be made, at a minimum, in the annual shareholder statement from the mutual fund, although this type of disclosure can be made quarterly or semi-annually by calculating a pro-rata portion of the expense ratio and multiplying it by the shareholder account balance.

<u>Individualized dollar disclosure on shareholder statements is an effective mechanism to educate investors about the true costs of owning a mutual fund</u>. Requiring a simple calculation using account balances and a fund's expense ratio would not be expensive to implement; however, this proposal will be somewhat more complicated to implement for shareholders in omnibus accounts, where such shareholders receive account balances from their broker/dealer or other fund intermediary.

II. <u>More Disclosure of Portfolio Transaction Costs</u>

Since brokerage commissions and other portfolio transaction costs are the <u>largest expense not reflected in the expense ratio of a mutual fund</u>, the Coalition of Mutual Fund Investors supports more transparent disclosure of these costs. Under current law, the actual brokerage commissions paid by a fund are not disclosed in the expense ratio provided to investors. Instead, the cash amount paid for brokerage commissions is disclosed annually in the mutual fund's Statement of Additional Information. Unfortunately, this number has little value to an investor unless it is compared to the average net assets of the mutual fund and converted into a percentage ratio.

This disclosure problem is further complicated by the fact that mutual funds do not always pay a cash commission to transact in portfolio securities. For example, stocks purchased on the NASDAQ exchange and many bonds are traded via a bid/ask spread, with brokers on both sides of the transaction being compensated by the difference between the price offered by the buyer (the "ask") and the price offered by the seller (the "bid"). This market spread "cost" is not considered a cash commission payment and so it is not included in the disclosure mentioned above in the Statement of Additional Information. Instead, the higher price paid by the buyer and the lower price received by the seller are reflected in a fund's capital returns over time.

A further problem is the evaluation of other indirect costs of portfolio trading. For example, a mutual fund which seeks to purchase a large block of an illiquid security may have a "market impact" cost if its own actions raise the price of that security as it accumulates its position. Similarly, a mutual fund which expects to have a certain level of redemptions in its shares may need to retain a larger cash balance, creating an "opportunity cost" for this uninvested amount. And this "opportunity cost" will be higher for those funds with excessive market timing activities, thereby reducing the returns of longer-term shareholders.

H.R. 2420 requires the U.S. Securities and Exchange Commission ("SEC") to issue a Concept Release exploring the feasibility of developing a transaction cost measure that is accurate, verifiable, comparable, and not overly burdensome for mutual funds.

Presumably, this Concept Release would address the problems outlined above regarding purchases of securities with a bid/ask spread, market impact costs, and opportunity costs.

The Coalition of Mutual Fund Investors supports the development of an SEC Concept Release on portfolio transaction costs. In its Concept Release, the SEC should strive to develop a standardized approach to quantifying and measuring transaction costs. The SEC also should endeavor to select a disclosure format that provides comparability among different mutual funds and helps to improve investor education and decision-making. The Coalition is pleased that the SEC has started this process with its Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, issued on December 18, 2003.

However, this process may take several years to complete and, in the interim, something should be done to improve the disclosures that investors now receive of portfolio transaction costs.

The Coalition advocates a proposal which will immediately enhance investor disclosure of the actual brokerage commissions paid in cash by each mutual fund, a dollar figure which is currently disclosed in a fund's Statement of Additional Information. For comparison with other funds, this figure should be converted into a percentage of average net assets of the fund and disclosed as a transaction cost ratio.

To calculate this transaction cost ratio, a fund would take the amount of aggregate brokerage commissions paid each year and divide this amount by the average net assets of the fund over the same time period. This ratio should be provided on an annual basis and it would be separate from the expense ratio for comparability purposes. A mutual fund should be able to explain in a footnote why this number could be higher or lower, because of the purchase of NASDAQ stocks, bonds, or any other unique cost issues. Once the SEC has completed its evaluation of market spreads, market impact costs, and opportunity costs, a fund can disclose these additional costs, along with brokerage commissions that are paid, to provide a more meaningful financial measure of portfolio transaction costs. As a goal, portfolio transaction costs need to be measured in a standardized and comparable manner.

However, investors should not have to wait until academics and regulators devise a perfect formulation of transaction costs. As legendary investor Warren Buffett is fond of saying: "It is better to be approximately right than precisely wrong". Mr. Buffet was referring to the inadequacies of "beta" as a financial measure in this quote, but the analogy is quite appropriate when applied to this issue of portfolio transaction costs.

<u>The information necessary to develop a transaction cost ratio is available today. This information should not be buried in the Statement of Additional Information, but disclosed in shareholder statements for investors to evaluate</u>.

III. <u>More Disclosure of Third Party Payments</u>

It is a common practice in the mutual fund business for fund underwriters and/or investment advisers to pay additional compensation out of their own resources to broker-dealers or other fund intermediaries which are selling their funds. It is also common practice for these fund intermediaries to make payments for a variety of activities relating to the sale or distribution of a fund's shares which are not disclosed, including record keeping and other administrative activities. H.R. 2420 would require a mutual fund to disclose information concerning payments by any person other than the fund itself that are intended to "facilitate" the sale or distribution of the mutual fund's shares.

The Coalition of Mutual Fund Investors supports this legislative proposal. However, the Coalition is concerned with the use of the term "facilitate" in the legislation. The use of this word may permit some intermediaries to decline to disclose certain payments that are not categorized as "facilitating" the sale or distribution of fund shares.

In the interest of ensuring the broadest possible disclosure of payments relating to the sale and distribution of fund shares, the Coalition suggests expanding this concept to include <u>all payments by (and to) all parties involved in the sale or distribution of mutual fund shares, regardless of the stated purpose of such payments and including activities that occur both before and after the sale or distribution transaction</u>. Such expansion would result in the inclusion of administrative payments and fees for record keeping, shareholder servicing, and other "back office" activities, all of which may secondarily facilitate the sale or distribution of a fund's shares.

<u>Only with full disclosure of all third party payments will investors be in a position to evaluate both the existence and the indirect costs of these arrangements</u>.

IV. <u>Improved Disclosure of Basic Shareholder Information in Omnibus Accounts</u>

As the Subcommittee is well aware, many mutual fund intermediaries, including broker/dealers, use omnibus accounting to transact mutual fund shares for their customers. Under this practice, a mutual fund records only one accountholder in its master shareholder file, usually the financial intermediary itself, instead of establishing separate accounts for each shareholder. These omnibus accounts may have hundreds of thousands of shareholders, all recorded as one shareholder in the accounts of the mutual fund.

Many of the recent sales load discount abuses, and at least some of the market timing and late trading abuses, that have been made public through state, federal, and industry investigations of the mutual fund industry, are alleged to have occurred in omnibus accounts managed by broker/dealers and other financial intermediaries. And there are other areas which may require additional review for possible transgressions hidden in omnibus accounts, including contingent deferred sales charges (CDSC), access to and knowledge of fund-offered shareholder privileges, the timing of automatic conversion rights, and the timing and pricing of corporate actions, such as dividend reinvestments.

While it is important to preserve the primary role that financial intermediaries have in facilitating the transactions of their respective customers, the fact that mutual funds do not receive basic information about individual trading activities in omnibus accounts creates an environment in which fund shareholders are not all treated equally and fairly.

It is a bedrock principle of the Investment Company Act that mutual funds shall implement their written policies and procedures in a uniform manner. Mutual fund boards have a fiduciary obligation to ensure the equal and fair application of fund policies and procedures across all classes of shareholders. And mutual fund reform legislation being considered in Congress will likely raise the current fiduciary standards for fund boards to an even higher level.

However, it is hard to imagine how a mutual fund board will be able to ensure the uniform application of its fund policies and procedures without knowing both the identity of its shareholders as well as what individual shareholders are doing in omnibus accounts.

By obscuring the identities of individual shareholders, the industry practice of relying on contractual relationships with financial intermediaries to implement fund policies and procedures in omnibus accounts clearly isn't protecting the interests of long-term fund shareholders. To the contrary, the current financial arrangements between mutual funds and its intermediaries create financial and structural disincentives toward achieving the goal of fair and equal treatment of the individual investor.

The use of omnibus accounts has created lucrative, revenue-generating activities for financial intermediaries. Mutual funds, on the other hand, have lost their ability to oversee shareholder record keeping and trading activities in a manner which protects investor interests through an adequate system of checks and balances.

A good example of this problem is the denial of breakpoint discounts. Many fund groups provide volume or "breakpoint" discounts to shareholders who are charged a sales load for their purchases of mutual fund shares. The National Association of Securities Dealers has estimated that more than $86 million in breakpoint discounts were not correctly applied by broker/dealers in 2001 and 2002, representing investor overcharges in one out of every five eligible transactions.

Omnibus accounting plays a major role in the lack of recognition of breakpoint discounts, and the problem is exacerbated by the fact that mutual funds have differing policies for the application of these volume discounts. Individual investors can qualify for these sales load discounts by agreeing to buy a specified number of shares over a defined period of time. Many funds also permit investors to aggregate purchases among related parties, such as certain family members, for the purpose of qualifying for discounts as a group. Each fund group establishes its own policies for the dollar breakpoint thresholds (e.g., $25,000), the qualifying time periods, and the aggregation (or accumulation) rules for the application of these load discounts. And it is generally viewed as important to individual funds to have differing breakpoint discount policies for competitive reasons.

When a financial intermediary uses an omnibus account structure, the mutual fund and the individual investor have to rely on the intermediary to calculate and apply the correct discount in a manner consistent with fund policies. However, the intermediary often will have insufficient information to calculate the appropriate discount. For example, individual shareholders may use different broker/dealers for transactions within the same mutual fund group and this is even more likely for related party investors who may qualify for breakpoint discounts as a group.

In contrast, when an investor purchases shares directly from a mutual fund, the fund and/or its transfer agent can (and does) calculate and apply the discount without relying on an intermediary.

Proper application of breakpoint discounts is the legal obligation of both the mutual fund and its intermediaries, although the parties differ in their respective economic interests. It is in a mutual fund's economic interest to correctly calculate breakpoint discounts in order to avoid losing unnecessary investment monies to third party brokerage commissions. On the other side of the transaction, a fund intermediary is the direct beneficiary of an overcharge of sales commissions because the broker/dealers and their account executives receive these amounts as additional commissions. And these intermediaries are not in the best position to administer a fund's breakpoint discount policy because of the potential for the use of multiple broker/dealers among shareholders who qualify for the discounts.

A mutual fund is the only entity with the ability to correctly calculate and apply breakpoint discounts in accordance with its stated policies. The fund's record keeping and transfer agent function is under the direct jurisdiction of the mutual fund board and does not have the conflict of interest possessed by a financial intermediary. Yet mutual funds do not currently have access to any shareholder identity or transaction information in omnibus accounts.

A second example of this problem involves the market timing of mutual fund shares. The SEC is considering new rules requiring enhanced disclosure in fund offering documents of market timing policies and procedures. It is also the Coalition's understanding that the Commission staff is considering a mandatory 2% fee for redemption transactions that occur within a specified time period. This mandatory fee would be used as a "tool" for those mutual funds seeking to discourage market timing activities by short-term investors.

In applying redemption fees to combat market timing activities, mutual funds are not able to identify redemptions occurring in an omnibus account, as the intermediary only provides the fund with a "net" position for the day. This "net" position is calculated in one of two ways: (1) by offsetting all purchases and redemptions against each other and providing the mutual fund with one net trade which may be either a purchase or a redemption; or (2) by totaling all purchases and redemptions and providing the mutual fund with two transactions, one a purchase and the other a redemption. In either event, the mutual fund has no idea how long an individual "omnibus account" shareholder maintained the position being redeemed and, therefore, is unable to ensure the proper assessment of the redemption fee.

While the Coalition is supportive of current SEC proposals to combat market timing, more will need to be done to solve the structural problem of uneven treatment of mutual fund investors. Today, many mutual funds already have written policies that discourage market timing and a significant number of funds already use redemption fees to create a disincentive for short-term trading. However, the use of omnibus accounts has made it impossible for any fund to implement its market timing policies and impose its redemption fees in a uniform manner. This problem is going to become more of a challenge when mutual funds develop more rigorous market timing rules, particularly if redemption fees are used on a more widespread basis and at higher levels.

<u>The Coalition believes that individual, long-term shareholders will not be guaranteed equal and fair application of fund policies, procedures, fees and charges, unless and until each mutual fund is provided information from its intermediaries about the identity of all shareholders in omnibus accounts and the individual transactions engaged in by those shareholders</u>. More disclosure to investors of fund policies and after-the-fact compliance audits are not going to be sufficient steps to rebuild investor trust and confidence.

<u>As a specific solution to this problem, the Coalition recommends that each fund intermediary, including broker/dealers, be required to disclose basic investor identity information to each mutual fund, including, at a minimum, the name, address, and</u>

Taxpayer Identification Number (TIN) for each shareholder in an omnibus account. The fund intermediary also should be required to disclose the amount and timing of all purchases, redemptions, transfers, and exchanges for each such shareholder.

Once this shareholder identity and transaction information from omnibus accounts is disclosed to a mutual fund, the fund will be in a stronger position to ensure uniform application of its policies, procedures, fees, and charges for all of its shareholders. The fund record keeping and transfer agent function will be directly accountable to the fund board of directors and conflicts of interest among fund intermediaries will be eliminated. This proposed framework is preferable to the current bifurcated structure in which a fund applies its rules to its "direct purchase" shareholders, while relying on fund intermediaries to apply certain of its rules to "omnibus account" shareholders.

Under the present system, shareholders in these omnibus accounts are not really shareholders of record in a mutual fund in that their ownership interests in the shares of such mutual fund are not set forth in the mutual fund's master shareholder file. Indeed, while the intermediary maintaining the omnibus account has a legal responsibility to provide, at the mutual fund's expense, the appropriate disclosure documents and fund notices to its omnibus accountholders, the mutual fund has no ability to verify whether this is being done.

For this proposed framework to work properly, mutual funds should be permitted to use shareholder information from omnibus accounts only for compliance purposes and not for any marketing or customer relationship activities. It may be necessary to develop specific protections to ensure that the fund intermediary retains its primary role in this area and to prevent any potential misuse of this information by mutual funds. It also may be necessary to address privacy issues in developing this proposal.

The widespread failure to favor shareholder interests over institutional interests regarding breakpoint discounts, market timing and late trading requires a fundamental change to the status quo in the use of omnibus accounts by fund intermediaries. In order to protect long-term shareholders, a mutual fund needs to be placed in a position where it can ensure the uniform and proper enforcement of its policies and procedures, especially those rules regulating market timing and the proper calculation of fees and charges.

Individual investors rely on the fact that the stated policies and procedures of a mutual fund will be applied evenly and fairly. The current structure of omnibus accounts will not permit this to occur unless, at a minimum, the identity and transactions of these "omnibus" shareholders are disclosed to funds.

The Coalition believes that long-term shareholders need to be guaranteed equal and fair application of fund policies, procedures, fees and charges. And this can only be ensured if a single record keeper is responsible for all shareholder accounts and activity in a given fund.

IV. More Disclosure of the Fund Statement of Additional Information

Certain detailed information about the operation and management of a mutual fund is disclosed in the Statement of Additional Information (SAI). This document can be several hundred pages long and is filed with the SEC on an annual basis, along with the fund Prospectus. Because of the SAI document's length, an individual investor does not receive this document unless he or she telephones a mutual fund and requests a copy. An investor can also obtain a copy of the SAI through the SEC's Web site.

With the expansion of the Internet and the fact that almost every mutual fund family has a Website, there is no reason why the Statement of Additional Information should not be more accessible to any mutual fund investor over the Internet. The Coalition advocates that mutual funds be required to provide investor access to the Statement of Additional Information on a fund's Web site, if such a Web site exists.

The Coalition of Mutual Fund Investors advances this proposal in order to provide additional access by mutual fund investors to the Statement of Additional Information. Since the SAI is so lengthy, the cost of mailing the SAI to each mutual fund investor would be prohibitive. The use of the Internet to provide additional investor access to this document will provide improved transparency of mutual fund operational and management issues.

In conclusion, thank you for the opportunity to present the views of the Coalition of Mutual Fund Investors on these important mutual fund reform issues. The Coalition looks forward to working with the Subcommittee in its oversight role as mutual fund reform legislation is considered in the U.S. Senate.

WRITTEN STATEMENT OF ROY WEITZ, PUBLISHER OF FUNDALARM.COM

SUBCOMMITTEE ON FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY UNITED STATES SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

Thank you for giving me the opportunity to submit this statement. I followed the subcommittee's earlier mutual fund hearings with great interest, and felt they were extraordinarily productive. I expect this round of hearings to be equally productive, so it is truly an honor to be a part of the process.

My name is Roy Weitz. Each month for the past seven years, I have published FundAlarm.com, a free, non-commercial Web site. FundAlarm is generally designed to help investors decide when it is time to sell a mutual fund and, to further that goal, FundAlarm presents fund performance data, as well as various items of interest about the fund industry. FundAlarm is not intended to be balanced or objective journalism. I try to write FundAlarm from the perspective of a well-informed individual investor who is skeptical of fund industry hype, wary of fund industry intentions, and on-guard against fund industry shenanigans. Over the years, FundAlarm has been fortunate to develop a following of about 120,000 readers, including many of the leading financial journalists in the U.S.

Even before the current fund scandals, there was much to criticize about the fund industry, and there were problems in many different areas. After reviewing seven years of recent fund history, I think it's possible to summarize almost all of the problems with the fund industry in four words: *They pushed the limits.* During the roaring bull market of the late 1990s, fund companies pushed the limits of investment sense by introducing dozens of doomed gimmick funds, which still managed to generate additional management fees. Fund companies regularly pushed the limits on management fees in existing funds, often justifying higher fees by pointing out that they were merely keeping up with their peer group of funds. (If everyone in a peer group raises fees to the average, the average will increase, and then everyone will need to raise fees again just to keep up with the average, in a never-ending cycle of fee increases. Needless to say, fund companies tend to ignore this simple fact of arithmetic when they ask shareholders to approve higher management fees.) Fund companies have also pushed, relentlessly, to extend the limits of SEC Rule 12b-1, an area that I will examine in more detail below.

Although I believe fund companies have a history of pushing the limits, it's important to note that such behavior is not necessarily undesirable. In fact, in our economic system, all profit-making entities (including fund companies) are entitled – even expected -- to push for every financial advantage they can obtain within the system. The real problem with fund companies pushing the limits is that *no one has been pushing back.* Fund directors, who theoretically represent a strong opposing force, have generally capitulated to the fund companies. The SEC, also a potentially strong counterforce against the fund industry, hasn't pushed back hard enough, or consistently enough, to prevent the current (and perhaps future) scandals. Finally, individual fund investors have generally failed to push back against the fund industry, in large part because they haven't been provided with sufficient information in a number of critical areas.

The current fund scandals will soon be old news, and we will all move on to other things. And that is when the fund companies, inevitably, will start pushing the limits again. To successfully resolve the current fund crisis – and to prevent future crises – I believe we need directors, regulators, and individual investors who have the tools to effectively *push back*, and continue to push back, against fund companies. The 12b-1 plan is one key battleground in that struggle.

Pushing the limits on 12b-1 fees

At the time SEC Rule 12b-1 was enacted (1980), 12b-1 plans were clearly intended as temporary arrangements. Today, 12b-1 plans are essentially a permanent fixture of the mutual fund landscape. Initially, 12b-1 plans had one purpose, and one purpose only: To help mutual funds grow their asset base, so that funds could experience economies of scale, which would then be passed on to investors in the form of reduced fees and expenses. Today, that purpose of 12b-1 plans is all but forgotten, and there is credible research suggesting that mutual fund fees since 1980 have actually increased at a faster rate than fund assets – in effect, there have been *dis*economies of scale, which would probably mystify the economics profession if it occurred anywhere other than the fund industry.

Clearly, something has happened to Rule 12b-1 between 1980 and today, and it is not difficult to figure out what that is: Mutual fund companies have pushed Rule 12b-1 to its limits, and fund directors (who have ongoing responsibility to approve or disapprove a 12b-1 plan) have helped the fund companies do so. Specifically, companies that sell mutual funds through brokers have taken certain permissive language in Rule

12b-1, which permits them to charge shareholders for compensation paid to “sales personnel,” and these companies have turned Rule 12b-1 into a prop that permanently supports their distribution system of multiple share classes ("A-B-C"). In this context, it would be quaint -- even ludicrous -- to think of 12b-1 fees as a temporary charge designed to benefit shareholders. Other companies, which sell their funds through so-called mutual fund “supermarkets,” effectively use their 12b-1 plans to pay for permanent space on those supermarket shelves, a variation on the 12b-1 plan that clearly wasn’t contemplated in 1980, and also bears virtually no relation to the original intent of Rule 12b-1.

In every case, 12b-1 fees are paid out of fund assets, which ultimately means that the fees are paid out of investors' pockets. Yet fund investors typically have little or no idea how much they are paying in 12b-1 fees, because 12b-1 fees are generally presented as part of an overall expense ratio and, like all expenses, 12b-1 fees are expressed as difficult-to-interpret percentages. Even if fund investors do figure out how much they are paying in 12b-1 fees, their funds typically provide no relevant information about their 12b-1 plan -- in particular, how their 12b-1 fees were spent, and what tangible benefits they derived for their money.

Pushing back on 12b-1 fees

In the ideal world, activist fund directors would push back on fund company 12b-1 plans by demanding documentation of specific, tangible shareholder benefits. Directors would view permanent 12b-1 plans as the rare exception, rather than the rule, and directors would communicate the accomplishments of every 12b-1 plan, every year, to shareholders. The day of such activist directors may be coming. Meanwhile, at a minimum, I suggest that Congress, through the SEC, provide fund management and fund directors with renewed, clear guidance on the purpose of 12b-1 plans. Specifically, I believe that Congress should reaffirm the *temporary* nature of 12b-1 plans, and Congress should also reaffirm the essential -- indeed only -- legitimate purpose of 12b-1 plans, which is to lower investor fees and expenses within a relatively short period of time.

To help *investors* in mutual funds push back on 12b-1 plans, I suggest several changes to existing practice, which would significantly increase investor access to relevant information:

- Fund companies should be required to provide an annual statement to each investor estimating the pro-rata dollar amount of 12b-1 fees paid by that investor (this statement could be made part of the year-end account statement, and the estimate could easily be based on the year-end account balance);

- Fund companies should be required to describe, in detail, the services or value that shareholders have received from the 12b-1 fees expended by their fund, with a particular emphasis on how the 12b-1 plan is helping to lower fees and expenses (this could appear as part of the fund's annual report);

- Shareholders, rather than directors, should periodically vote on renewing or terminating their fund's 12b-1 plan (this shareholder vote might be conducted every three to five years).

A critical issue

Changing Rule 12b-1 won't be easy, because (as we have seen), 12b-1 fees support massive corporate structures. But I believe Rule 12b-1 must be changed because, in its current manifestation, Rule 12b-1 is a lie. Investors pour billions of dollars each year into 12b-1 plans, with results that are clearly not what the SEC intended, and with essentially no information about how their plans operate or what their money is used for. The 12b-1 plan has become a symbol of an industry pushed to its limits by fund companies, with virtually no resistance by Congress, regulators, fund directors, or individual investors. Congress has the opportunity to push back on 12b-1 plans, in an important way for investors, and I hope you will seize the moment.

Paul Schott Stevens
Direct Tel: 202.261.3348
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February 2, 2004

The Honorable Peter G. Fitzgerald
555 Dirksen Senate Office Building
Washington, DC 20510-1305

The Honorable Daniel K. Akaka
141 Hart Senate Office Building
Washington, DC 20510

Dear Chairman Fitzgerald and Senator Akaka:

Thank you again for the opportunity to testify on behalf of the Investment Company Institute at the Financial Management Subcommittee's January 27th hearing on mutual fund fee issues. In response to questions at the hearing, I explained that the interests of the mutual fund and investment adviser constituencies served by the ICI converge in many areas, including with respect to investment performance, shareholder service, and regulatory compliance. I also pointed out that the public record makes it clear that the ICI historically has advanced a policy agenda very much in the interests of fund shareholders. I promised to document, for the record, those examples cited in my testimony. These include the initiatives briefly described below and detailed in the enclosed documentation.

- ***Strong Support for Adequate SEC Funding.*** Recognizing that the protection of mutual fund investors relies heavily on a strong, well-funded SEC, the ICI has consistently expressed its support for sufficient SEC resources to oversee mutual funds. (Chronology of ICI Testimony, Speeches and Letters in Support of Adequate Funding for the SEC from 1993 to 2003 enclosed.)

- ***Development of Tough Standards for Personal Investing by Investment Company Personnel.*** In February 1994, the ICI formed an Advisory Group on Personal Investing to review practices and standards governing personal investing by investment company personnel and to make any recommendations deemed necessary or desirable in the interests of investors. The Advisory Group issued a report in May 1994 that recommended that investment companies adopt a series of measures that went beyond existing regulatory requirements to obviate conflicts of interest, prevent and detect abusive practices, and preserve the confidence of investors. In July 1994, SEC Chairman Arthur Levitt cited the recommendations, which were strongly endorsed by the ICI's Board of Governors, as evidence of the industry's "continuing commitment to high ethical standards." (Executive Summary of 1994 Report of the Advisory Group on Personal Investing enclosed.)

- ***Proposal to Require All Mutual Funds to Have Compliance Programs.*** The ICI submitted a proposed rule to the SEC in November 1994 that would have required all mutual funds to establish internal compliance systems meeting certain minimum standards. The ICI's proposal was intended to serve the interests of investors by promoting adoption throughout the industry of the best practices already followed by many firms to ensure regulatory compliance. The SEC acknowledged the ICI's 1994 proposal in its February 2003 release proposing to require mutual fund compliance programs, noting that it was "similar" to the SEC's proposal. The ICI believes that the SEC's final rule will benefit investors by, among other things, formalizing fund compliance programs and enhancing the flow of information to fund directors about significant compliance matters. (1994 ICI Proposal to Require Mutual Fund Compliance Programs enclosed.)

- ***Continued Calls for Enhanced Disclosure of Revenue Sharing Arrangements.*** As discussed on pp. 16-18 of the written statement I previously submitted for the hearing record, revenue sharing arrangements involve payments by a fund's investment adviser or principal underwriter out of its own resources to compensate financial intermediaries who sell fund shares. The principal investor protection concern raised by these payments is that they could have the potential for influencing the intermediary's investment recommendations. The ICI has long supported additional, point-of-sale disclosure of revenue sharing arrangements by broker-dealers because this would help investors assess and evaluate recommendations to purchase fund shares. (Chronology of ICI Actions Concerning Disclosure of Revenue Sharing Arrangements from 1994 to 2003 enclosed.)

- ***Recommended Best Practices for Mutual Fund Directors.*** Mutual funds have a unique governance system under which the board has numerous specific oversight responsibilities. Fund boards generally must have a majority of independent directors and those directors, in particular, are charged with overseeing the management of funds to police conflicts of interest and ensure that they are operated in the interests of shareholders. In February 1999, the ICI formed an advisory group to reexamine the continuing effectiveness of the director oversight system. The advisory group issued a report in June 1999 recommending that fund boards adopt 15 best practices to enhance their independence and effectiveness. The recommended best practices included, for example, that at least two-thirds of each fund board consist of independent directors, that persons formerly affiliated with the fund's investment adviser or certain other parties not serve as independent directors of the fund, that the independent directors select and nominate other independent directors, that the independent directors meet separately from management, that independent directors designate one or more "lead" directors, and that fund directors periodically evaluate the board's effectiveness. The Council of Institutional Investors described the 1999 best practices recommendations as "far reaching, extending beyond current legal requirements [and] industry practices," and termed some of the suggested practices "leading edge, surpassing practices currently endorsed by the Council and other groups." In October 2003, the ICI's Board of Governors adopted a resolution recommending the adoption of two additional best practices to (1) further strengthen director independence standards and (2) apply to mutual funds audit committee standards similar to those applicable to public operating companies under the Sarbanes-Oxley Act. (Executive Summary of 1999 Report of the Advisory Group on Best Practices for Fund Directors and 2003 ICI Board of Governors Resolution enclosed.)

- ***Proactive Response to Mutual Fund Scandals.*** The ICI has strongly denounced the abusive mutual fund trading practices uncovered by federal and state regulators over the past several months. Shortly following the New York Attorney General's announcement of an enforcement proceeding against Canary Capital Management alleging abusive mutual fund trading practices, the ICI urged that government authorities punish wrongdoers, and that fund shareholders who were wronged be made right. The ICI also responded with several affirmative regulatory recommendations. To address late trading, the ICI called for a "hard 4:00 p.m. close" that would shut the window on this practice. With respect to market timing, the ICI called for a mandatory 2% redemption fee (paid to the fund) on most short-term trades. In addition, to prevent abusive short-term trading by fund "insiders," the ICI urged mutual funds to amend or clarify their codes of ethics to cover transactions by fund personnel in shares of funds advised by the company. In addition to recommending regulatory changes to address late trading and market timing abuses, the ICI has been actively considering other ways to promote the interests of fund investors and enhance investor confidence. To this end, in December 2003, the ICI sent a letter to SEC Chairman Donaldson recommending significant tightening of regulation relating to the use of soft dollars and a ban on the practice of directing brokerage to reward broker-dealers for selling fund shares. The Institute's recommendations are discussed in greater detail at pp. 18-21 of my written statement. (ICI Press Release on Recommendations to Address Late Trading and Market Timing enclosed.)

These are just a few examples; there are many more. If you have any questions or need additional information, please do not hesitate to contact me at 202/261-3348.

Sincerely,

Paul Schott Stevens

Enclosures

Mr. Paul Stevens
Investment Company Institute

Question for the Record by Senator Akaka

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?

Answer

As a general matter, Section 2(a)(41) of the Investment Company Act of 1940 requires that the value of fund assets be determined in one of two ways: securities for which "market quotations are readily available" must be valued at their "market value"; all securities for which market quotations are not readily available must be valued "at fair value as determined in good faith by the board of directors" of the fund.

Thus, fair valuation comes into play only in those situations in which market prices are not available. Over time, mutual fund portfolios have come to include a widening array of asset classes and individual securities, and fund boards accordingly have had to develop procedures for fair valuing those securities for which market quotations are not readily available at all times. This has been an evolving process.

Of particular relevance here are securities that are principally traded on foreign exchanges, and the need for a fund to fair value such securities when an event occurs after the close of the foreign exchange that is likely to have changed the value of the securities as of the time (typically 4:00 p.m. Eastern time) that the fund is valuing its portfolio. In 1999 and 2001, the staff of the SEC provided detailed guidance to the fund industry concerning, among other matters, the obligations of funds to monitor for such circumstances, the ongoing need to determine when market quotations are not readily available, the duty to fair value those securities impacted by such events, and the factors that a board should consider for this purpose. In March 2002, the Investment Company Institute published a supplemental white paper entitled "Valuation and Liquidity Issues for Mutual Funds" that outlined appropriate valuation practices in light of the SEC's guidance. (A copy of the ICI paper is enclosed.)

Since at least 2001, funds in the industry have sought to implement the SEC staff guidance with respect to international as well as other securities. They have utilized increasingly sophisticated techniques, where necessary, to establish "fresh" prices as of the time they value their portfolios. Importantly, in light of the number of securities potentially impacted and the narrow time window within which funds must value their portfolios daily, a variety of service providers (including large commercial pricing services) are today assisting funds to apply appropriate factors and models for establishing fair value prices and to assess the accuracy of those prices after the fact. Typically, these activities are conducted pursuant to detailed procedures established and overseen by fund boards (including independent directors). In my judgment, all international funds and other funds the securities of which may not have market quotations readily available as of the time the fund values its portfolio should have procedures of this kind.

INVESTMENT COMPANY INSTITUTE®

VALUATION AND LIQUIDITY ISSUES FOR MUTUAL FUNDS

2002 SUPPLEMENT

This paper is designed to inform and assist Institute members generally with respect to mutual fund valuation issues. It is not intended, nor should it be relied upon, as a substitute for appropriate professional advice with respect to the applicability of laws and regulations in particular circumstances, nor is it intended to express any legal opinion or conclusion concerning any specific action, policy or procedure.

March 2002

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I. INTRODUCTION

In February 1997, the Institute published a paper to provide practical information to Institute members about the process of valuing portfolio securities and assessing their liquidity.[1] Since that time, the staff of the Securities and Exchange Commission's Division of Investment Management has issued two letters providing general guidance on the valuation of investment company portfolio securities.[2] This paper is intended to supplement the 1997 ICI Valuation Paper to take into account this recent guidance from the staff, particularly as it relates to the fair valuation of portfolio securities.

This supplement briefly reviews the statutory and regulatory framework for valuation described in greater detail in the 1997 ICI Valuation Paper and summarizes the 1999 and 2001 letters. The supplement then discusses the valuation of foreign and domestic portfolio securities in light of the recent guidance and the review of fair valuation methodologies used in that process. Finally, the supplement describes the responsibilities of fund boards in the valuation process.

The fair valuation process requires funds to make determinations as to the value of a particular security or group of securities depending on the particular facts and circumstances involved. As the SEC has recognized, there is no single standard for determining fair value in good faith.[3] Indeed, "different fund boards, or funds in the same complex with different boards, when fair value pricing identical securities, could reasonably arrive at prices that were not the same."[4] As a result, the SEC and the staff have refrained from prescribing standard valuation procedures and have focused instead on the need for funds to adopt and consistently

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[1] Investment Company Institute, "Valuation and Liquidity Issues for Mutual Funds" (Feb. 1997) (the "1997 ICI Valuation Paper").

[2] 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 (the "2001 letter") and 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 December 8, 1999 (the "1999 letter"). These letters are available on the SEC's web site, *www.sec.gov*.

[3] Accounting Series Release No. 118, Inv. Co. Act Rel. No. 6295, [1937-1982 Accounting Series Release Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶72,140 (December 23, 1970) ("ASR 118"), at 62,296. *See also* 1999 letter at 5.

[4] 2001 letter, at n.22 (quoting the 1999 letter).

apply valuation procedures reasonably designed to ensure appropriate valuations for portfolio securities.

Reflecting this approach, this paper describes circumstances under which a fund may be required to fair value portfolio securities, the information that may be available to detect those circumstances and the factors that should be considered in developing valuation procedures. The paper does not attempt to set forth standard approaches or model procedures, given that the determination of what is appropriate for each fund rests with each fund and its officers and directors. Individual fund complexes should establish valuation policies and procedures that conform to their own particular circumstances and needs.

II. BACKGROUND

A. The Statutory Framework for Valuation

The fundamental rules governing valuation of fund portfolio securities are set forth in Section 2(a)(41) of the Investment Company Act of 1940 (the "1940 Act"), which defines the "value"[5] of fund assets in terms of a simple dichotomy:

- securities "for which market quotations are readily available" are to be valued at "market value;"
- all other securities are to be valued at "fair value as determined in good faith by the board of directors."

This statutory dichotomy recognizes that market prices generally are objective and accurate reflections of a security's value. It is only when market prices are not available that fair valuation must be considered.[6]

[5] Section 2(a)(41) of the 1940 Act and Rule 2a-4 thereunder give meaning to the term "value" for these purposes.

[6] The 2001 letter notes that the 1940 Act's definition of "value" does not permit funds to ignore readily available market quotations where they exist. The staff believes funds must "exercise reasonable diligence to obtain market quotations for their portfolio securities before they may properly conclude that market quotations are not readily available." For example, if market quotations from one source are determined to be unreliable, the fund should

B. General SEC Guidance on Valuation

1. ASRs 113 and 118

In 1969 and 1970, the SEC issued two accounting series releases that offered guidance on proper valuation methodologies. ASR 113[7] principally addressed valuation practices with respect to restricted securities, but also offered guidance on certain other aspects of the valuation process. ASR 118 expanded upon ASR 113 and provided more general guidance. Notably, in addition to its other guidance, ASR 118 dealt with the use of fair value methodologies to price securities and set forth the general principle that the fair value of securities "would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale."[8] ASRs 113 and 118 remain the primary SEC authority on permissible valuation practices.

2. Putnam No-Action Letter

In 1981, the staff issued a no-action letter to two funds with respect to the valuation of portfolio securities that were principally traded on foreign exchanges.[9] As described in the no-action request, the funds calculated their NAVs at 4 p.m. Eastern time and used the closing market prices established earlier in the foreign markets to value their foreign portfolio securities. The request letter noted, however, that if "some extraordinary event were to occur after the close" and the funds' pricing personnel determined that the securities' closing prices were "no longer a reasonable estimate of such securities values as of 4:00 p.m.," the funds would determine the fair value of those securities as of 4:00 p.m. "using other appropriate indicia of value," which may include the next day's opening market prices.

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diligently seek to obtain market quotations from other sources before determining that market prices are not "readily available." 2001 letter at 9-10.

[7] Accounting Series Release No. 113, Inv. Co. Act Rel. No. 5847, [1937-1982 Accounting Series Release Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶72,135 (October 21, 1969) ("ASR 113").

[8] ASR 118 at 62,296.

[9] Putnam Growth Fund and Putnam International Equities Fund, Inc., 1981 SEC No-Act. LEXIS 3088 (pub. avail. February 23, 1981) ("Putnam Growth Fund").

In its response, while not using the term "extraordinary event," the staff stated that it would not recommend any enforcement action to the SEC under Rule 2a-4 if the funds value their foreign securities at 4:00 p.m. New York time using the earlier-established foreign closing market prices "except when an event has occurred since the time [those prices were] established that is likely to have resulted in a change in [their] value."[10] This no-action position, in effect, recognized that the 1940 Act's mandate to use market value as determined by readily available market quotations applies equally to securities traded principally on domestic and foreign exchanges.

The SEC has twice made reference in its releases to the staff's position in *Putnam Growth Fund*. First, in a footnote in a 1984 release proposing amendments to Rule 22c-1(b), the SEC stated:

> If the foreign exchange on which a portfolio security is principally traded is closed at the time a fund computes its current net asset value, then the fund may use the previous closing price on the foreign exchange to calculate the value of the security, except when an event has occurred since the time the value was established that is likely to have resulted in a change in such value. If 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.[11]

Second, in 1998, in discussing the need for appropriate disclosure of fair valuation practices, the SEC stated that in fair valuing certain securities in response to volatility in Asian markets:

> [F]unds appear to have relied on a long-standing position of the SEC's staff that a fund may (but is not required to) value portfolio securities traded on a foreign exchange using fair value, rather than the closing price of the securities on the exchange, when an event occurs after the close of the exchange that is likely to have changed the value of the securities.[12]

[10] *Id.* at *12.

[11] *Pricing of Redeemable Securities for Distribution, Redemption and Repurchase*, Inv. Co. Act Rel. No. 14244, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,711 (Nov. 21, 1984), at n.7 (the "Rule 22c-1 Release").

[12] *Registration Form Used by Open-End Management Investment Companies*, Inv. Co. Act Rel. No. 23064 [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶86,014 (Mar. 13, 1998), at 80,318, *citing* Putnam Growth Fund.

C. Recent SEC Staff Guidance

Recent staff guidance in 1999 and 2001 has focused on funds' obligations to monitor events and determine when market quotations are not "readily available," thereby triggering the obligation to employ fair value pricing procedures in determining the value of portfolio securities.

1. The 1999 Letter

The staff issued the 1999 letter to provide guidance relating to funds' pricing responsibilities during emergency or unusual situations. The letter included guidance on valuing fund portfolio securities, both foreign and domestic, in situations where the exchanges or markets on which the securities trade do not open for trading for an "entire trading day" and no other market prices are available.[13] The 1999 letter also provided guidance on the fair value pricing process, particularly with respect to factors that may be taken into consideration when fair valuing a security, and the obligations of the fund's board with respect to that process.

2. The 2001 Letter

The staff followed the 1999 letter with a second letter that discussed the obligations of funds and their directors to determine, in good faith, the fair value of portfolio securities when market quotations are not readily available because of "significant events" that occur after closing market prices are established, but before the time set for the calculation of the fund's NAV. The 2001 letter focused primarily on the valuation of securities traded on foreign exchanges, but also provided guidance on the valuation of domestic securities, the good faith obligations of the fund's board with regard to fair value pricing and the inappropriate use of fair value pricing for securities for which market quotations are available.

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[13] The staff noted that neither these types of situations nor situations involving market breaks, trading restrictions, internal fund failures, or natural disasters would allow a fund to suspend redemptions in the absence of certain determinations by the SEC. 1999 letter at n. 2 and accompanying text.

Although the SEC and staff previously had expressed the general concept that events that occur after the close of a foreign market but before the time set for the calculation of the fund's NAV may warrant fair valuation of fund portfolio securities,[14] the 2001 letter provided more detail on the staff's views in this area than had earlier been available. For example, the 2001 letter for the first time articulated in writing the staff's view that market volatility could constitute a "significant event" for valuation purposes.[15] As a result, funds should review their own valuation procedures in light of this most recent guidance, as described below.

III. VALUATION OF FOREIGN SECURITIES IN LIGHT OF RECENT GUIDANCE

A. In General

In issuing the 2001 letter, the staff sought to address, among other things, whether under certain circumstances the closing market prices for securities trading in overseas markets may no longer be "readily available" market quotations by the time a fund investing in those securities calculates its NAV. As noted in the 2001 letter, most funds calculate their NAVs once each day as of the close of the major U.S. securities exchanges, usually 4:00 p.m. Eastern time.[16] Many foreign markets close earlier than that, sometimes by as much as fifteen hours.[17] As stated in the 2001 letter, "the closing prices of foreign securities may not reflect their market values at a fund's NAV calculation if an event that will affect the value of those securities (a 'significant

[14] *See* the discussion of Putnam Growth Fund and the SEC's 1984 and 1998 releases *supra* Section II.B.2 (Putnam No-Action Letter), pp. 3-4.

[15] 2001 letter at p.5. *See infra* Section III.B.2.b (Events Relating to Multiple Issuers), pp. 14-18.

[16] In general, Rule 22c-1 under the 1940 Act requires funds to compute their NAVs at least once daily at a specific time or times as determined by their boards and to sell and redeem shares at a price based on the NAV that is next computed after receipt of a purchase order or redemption request. (The latter requirement is known as the "forward pricing" rule.)

[17] The Tokyo Stock Exchange, for example, closes at 3:00 p.m. local time (1:00 a.m. Eastern standard time). Selecting a time to price other than 4 p.m. Eastern time or the close of the major U.S. markets can reduce the period between the close of foreign markets and the time set for a fund's NAV calculation. However, there are a number of operational and practical issues that a fund should consider before making a decision to change the time for NAV calculation. For example, funds that offer exchange privileges would have to consider how exchange transactions will be handled if the fund group calculates the NAVs for different funds in the complex at different times. Funds, particularly those sold through intermediaries, also may face challenges with the implementation of multiple cut-off times for the receipt of purchase orders and redemption requests. As a result, most funds that have considered this option to date have not found it viable. Nevertheless, as back office and distribution systems evolve, this may become a more practical option for certain types of funds.

event') has occurred since the closing prices were established on the foreign exchange or market, but before the fund's NAV calculation."[18]

The 2001 letter also states that the use of closing prices that were established before a "significant event" occurred may cause dilution in the value of the interests of shareholders that remain in the fund.[19] It indicates that under these circumstances fair value pricing can protect long-term fund investors from short-term investors who seek to take advantage of funds as a result of significant events occurring after a foreign exchange or market closes, but before the funds' NAV calculation.

While this may be true, nothing in the 2001 letter warrants a conclusion that the elimination of arbitrage and the dilution that can result is an appropriate reason, in and of itself, to fair value fund portfolio securities.[20] Indeed, as noted above, the 1940 Act does not permit funds to use fair values unless market quotations are not "readily available." The existence of any particular market timing strategy involving a fund does not necessarily call into question the ready availability of market quotations for that fund's portfolio securities.

[18] 2001 letter at 2. For purposes of the 2001 letter, the term "NAV calculation" is defined as the specific time or times each day, as determined by a fund's board, at which the fund computes its NAV (usually 4:00 p.m. Eastern time). Significant events that occur after that specific time (*e.g.*, 4:00 p.m. Eastern time) but before the actual calculation of the fund's NAV (which typically occurs one to two hours later) should not be taken into account in that day's NAV. *See* "Paul Roye Speaks on Fund Valuation," THE INVESTMENT LAWYER, August 2001, at 11 (the "Roye Interview"). The same analysis would apply to trading that occurs after the time set for a fund's NAV calculation.

[19] The 2001 letter includes an exhibit with a hypothetical scenario designed to illustrate that fair value pricing can protect long-term shareholders from short-term investors who seek to take advantage of arbitrage opportunities when significant events occur after a foreign exchange or market closes but before the time set for a fund to calculate its NAV. While the hypothetical example is useful to demonstrate the dilution caused by a successful market timing transaction, the example makes a number of assumptions that are unlikely to apply in many instances. First, the example describes a major after-hours movement (more than 10%) in a foreign market that is evidenced by trading in financial instruments in the U.S. Those types of financial instruments may not exist or be traded in sufficient volume to be useful indicators for all markets. Second, the example describes an unusually large market timing transaction ($10 million) in a small fund ($45 million in total net assets at the time the purchase order is received). As a result, the example assumes that the fund receives a purchase order equal to 22.2% of its total net assets, and does not reject it as a market timing transaction or for some other reason. Funds often reject transactions of that magnitude for any of several reasons, including to prevent market timing abuses. Finally, the example assumes that the foreign market closes the next day in perfect correlation with the trading in the financial instruments in the U.S. This assumption led the staff to describe the market timing transaction as involving "no risk to [the market timer's] investments," but ignores any market activity that may have occurred during the next trading day in the foreign market. For example, U.S. markets on January 3, 2001 were significantly higher in response to a reduction in U.S. interest rates. The Japanese market opened higher the next day, but traded down throughout that day, ending slightly lower than its previous close. The possibility that the foreign market would reverse course during that next trading day introduces a significant degree of risk into this type of timing transaction.

[20] By the same token, a fund that is not the victim of arbitrage and the resulting dilution cannot, solely on that basis, avoid the need to fair value portfolio securities for which market prices are not readily available.

Moreover, while fair value pricing has the potential to reduce opportunities for short-term traders to take advantage of long-term fund investors, it cannot entirely eliminate the possibility that this will occur.[21] Arbitrageurs and other short-term traders attempt to predict whether a fund's NAV is likely to rise or fall the next day. For example, an arbitrageur may seek to take advantage of a perceived correlation between movements in different markets (*e.g.*, the theory that an increase in the U.S. market on Day 1 may suggest that a particular foreign market will rise on Day 2). Such a correlation does not necessarily indicate, however, that the value of fund portfolio securities trading on that foreign market has changed *as of the time the fund calculates its NAV* on Day 1, which is the critical factor in determining whether a "significant event" has occurred. Moreover, fair valuation is an inherently subjective process. By making clear that different funds could reasonably arrive at different prices for the same security, the staff has recognized that judgment is involved and that there is no one, "right" answer. This subjectivity makes it unlikely that fair valuation, in and of itself, can completely eliminate arbitrage opportunities.

Thus, while the use of fair valuation procedures can reduce a fund's exposure to arbitrage activities, a fund's decision to employ such procedures should be based upon the need to take reasonable steps to ensure that the prices of fund portfolio securities reflect their value as of the time set for NAV calculation. The resulting fund share prices, in turn, will be fair to purchasing, redeeming and existing shareholders, regardless of whether they have long-term or short-term investment horizons.[22]

B. "Significant Events"

The concept of a "significant event" is central to the 2001 letter. The letter provides that if a fund determines that the closing market prices of one or more of its portfolio securities no longer represent their current value at the time of the fund's NAV calculation because of an intervening "significant event," then that market quotation is no longer deemed to be "readily

[21] With this in mind, many funds have put in place other mechanisms designed to discourage or prevent abusive short-term trading practices, such as redemption fees and/or restrictions on exchange transactions.

[22] *See* 1997 ICI Valuation Paper at 1.

available" and the fund should value those securities using a fair value methodology. This section of the paper discusses various activities related to identifying significant events through the monitoring of external data, as well as a variety of fair valuation procedures that may be followed after a determination has been made that a significant event has occurred.

1. Definition of "Significant Event"

"Significant event" is defined in the 2001 letter as "an event that will affect the value" of a fund's portfolio securities. The 2001 letter does not elaborate on the precise meaning of the words "will affect." Consequently, funds will need to employ a degree of judgment in determining whether a significant event has occurred.

In some cases, it will be reasonably clear that an event has changed the value of fund portfolio securities from their closing market prices. For example, assume that a fund that holds stock in a Taiwanese company learns that, after the close of the Taiwanese market but before the time set for the calculation of the fund's NAV, the company unexpectedly announced that earnings had been substantially overstated in prior periods due to accounting irregularities. This likely would be a significant event with respect to that company, since this type of announcement, absent other news, generally will adversely affect a company's share price. By contrast, assume that (after the close of the foreign market but before the time set for calculation of the fund's NAV) the prime minister of a country in which a fund is invested resigns. Based on information reasonably available to it under its procedures to monitor for significant events,[23] the fund may not have an adequate basis to determine whether this event has affected the value of its portfolio securities as of the time of its NAV calculation. In such a circumstance, the resignation likely would not be a significant event in the sense contemplated by the 2001 letter.

Of course, events may occur that fall somewhere in between these two examples. In such cases, funds will need to make judgments regarding whether the events have affected the value of their portfolio securities. Funds should follow the parameters established under

[23] *See infra* Section III.B.2.a.2) (Monitoring), pp. 11-12.

authority of their boards in making these judgments,[24] and should consider documenting their determinations. Because of the degree of judgment involved, different fund groups may come to different conclusions about whether certain types of events require the use of fair valuation.

In addition, funds should periodically review these "significant event" determinations (for example, by examining next-day opening prices of the portfolio securities in question). Based on these reviews, funds may conclude that they should revise the criteria or standards they use for determining when an event would be considered a "significant event" for purposes of the 2001 letter.[25]

2. Types of Significant Events

As the staff notes in the 2001 letter:

> [Significant] events may relate to a single issuer or to an entire market sector. Moreover, significant fluctuations in domestic or foreign markets may constitute a significant event. Significant events also may stem from occurrences not tied directly to the securities markets, such as natural disasters, armed conflicts, or significant governmental actions.[26]

The following two sections of the paper discuss single issuer and multiple issuer events, respectively.

a. Events Relating to Single Issuers

1) Identification

The 2001 letter states that a significant event may relate to a single issuer. Depending on the facts and circumstances involved, any of the following single issuer events could be

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[24] *See infra* Section VI (Responsibilities of the Board in Light of Recent Guidance), pp. 23-26.

[25] *See infra* Section V (Reviewing Fair Methodologies), p. 22. As noted therein, next-day prices can be affected by events that occur in the period between the time for NAV calculation and the opening of the foreign market.

[26] 2001 letter at 5, n.11 and accompanying text.

significant in the sense contemplated by the 2001 letter: (i) corporate actions such as reorganizations, mergers, spin-offs, liquidations, acquisitions, and buyouts; (ii) corporate announcements on earnings; (iii) corporate announcements relating to products such as new product offerings, product recalls, or other product-related news; (iv) regulatory news such as government approvals (such as new patents or drug approvals); (v) news relating to natural disasters affecting the issuer's operations; or (vi) events relating to significant litigation involving the issuer. Of course, the need to assess the impact of events such as these on valuation arises only when the event occurs after the close of the relevant market or cessation of trading in the particular security but before time set for the calculation of a fund's NAV.

2) Monitoring

The 2001 letter states that "consistent with their obligations under the 1940 Act, funds should continuously monitor for events that might necessitate the use of fair value procedures."[27] The staff notes, however, that "monitoring should not be unduly burdensome because funds and their investment advisers typically monitor such data on a continuous basis in determining whether to buy, sell, or continue to hold portfolio securities."[28] This suggests that significant events often would be readily ascertainable by a fund in the course of the management of its portfolio, and that there is no duty to exhaust all possible sources of information in determining whether a significant event has occurred.[29] Nevertheless, monitoring in making investment decisions may differ in certain respects from monitoring for significant events. Consequently, funds should adopt procedures reasonably designed to monitor for significant events as part of the pricing process and employ reasonable diligence in monitoring sources of information.

In designing monitoring procedures, funds should consider using the general news and financial market information sources currently utilized in making investment decisions. To the extent practicable, funds also could consider using other sources of information, particularly with respect to foreign securities, such as trading and investment personnel located abroad,

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[27] *Id.* at 5.

[28] *Id.* at n.12.

[29] *See also* 1999 letter at 5 ("during emergency situations, fund boards should evaluate as many relevant factors as they are able to under the circumstances").

foreign regional brokers, and/or foreign custodians.[30] Funds also should review their monitoring procedures periodically to satisfy themselves that the information sources being utilized remain appropriate and consider whether any new or different sources should be used. Funds should recognize that it is unlikely that any set of monitoring procedures will alert a fund to every significant event.

Although they may or may not have primary responsibility for monitoring for pricing-related developments, portfolio managers, traders, and global custodians most directly involved with a fund's portfolio securities often may be the first to learn that a significant event with respect to a single issuer has occurred. As a result, funds should encourage these persons to report significant post-close developments that come to their attention to designated fund pricing personnel.[31]

Regardless of the sources used, funds should take appropriate steps to ensure that the information they are receiving is reliable and timely. Procedures should retain the flexibility to determine that particular sources of information may not be reliable under all circumstances and need not be monitored and/or used.

3) Fair Valuation

If a fund determines that a significant event has occurred after the close of the foreign exchange or market, but before the fund's NAV calculation, then the closing prices for any security or securities affected by that event would not be considered "readily available" market quotations, and the fund must value those securities pursuant to a fair value pricing methodology.[32] However, funds may wish to consider the need for their valuation procedures to preserve flexibility to use closing market prices in situations where the impact of any fair

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[30] There may be practical limitations on the use of trading and investment personnel located abroad, foreign regional brokers, and foreign custodians. These persons, for example, may be asleep or otherwise unable to be reached at or near the time set for a fund's NAV calculation. In addition, while foreign custodians may provide news alerts relating to market events, they may be less likely to do so with respect to events affecting individual issuers.

[31] Third-party service providers such as subadvisers and global custodians may have their own monitoring procedures in this regard to use as a basis for communication with their fund clients. Funds may wish to inquire whether their service providers have such procedures.

[32] 2001 letter, text accompanying n.9. As noted in the 2001 letter, this is consistent with the views expressed by the SEC in the Rule 22c-1 Release.

valuation determinations would not materially affect the fund's NAV. As the Director of the SEC's Division of Investment Management has confirmed, there is a materiality standard implicit in the 2001 letter.[33] If a fund determines that a significant event occurred but that the impact of that event on the affected portfolio securities would not materially affect the fund's NAV, as a practical matter, the fund could value those securities using their closing market prices.[34] If the cumulative impact of all fair valuation determinations made on a given day would materially affect the fund's NAV, however, then the fund would need to use those fair values.

The SEC consistently has recognized that no single standard exists for determining fair value in good faith. Instead, the SEC has adopted a more flexible standard, which requires fund directors to "satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered and to determine the method of arriving at the fair value of each such security."[35] ASR 118 further states that "directors should take into account all indications of value available to them in determining the 'fair value' assigned to a particular security."[36]

The "factors relevant to the value of securities" and "indications of value" when a significant event has occurred will depend upon the particular fund and the facts and circumstances of the situation. The SEC has suggested a number of methodologies that can be used, and a number of factors that can be considered in making fair value determinations.[37] However, other factors also could be relevant in valuing securities as the result of a significant

[33] Roye Interview, *supra* note 18, at 11.

[34] *Id.*

[35] ASR 118, *supra* note 3, at 62,295-96.

[36] *Id.* at 62,296.

[37] *Id.* ASR 118 indicates that methodologies could be based upon: (1) a multiple of earnings; (2) a discount from market of a similar freely traded security; (3) with respect to debt instruments, the yield to maturity; or (4) a combination of the foregoing. The factors that ASR 118 indicates are among those that should be considered in determining fair value methods include: (a) fundamental analytical data; (b) the nature and duration of restrictions on disposition; (c) an evaluation of the forces that influence the market in which the securities are purchased and sold; and (d) specific factors, including (among others) the type of security, financial statements, cost, size of holding, analysts' reports, transactional information or offers, and public trading in similar securities of the issuer or comparable companies.

See also infra note 43, which discusses other factors that funds may need to consider, if relevant, when fair value pricing portfolio securities.

event. Fair valuation procedures should describe factors to be considered but should not preclude consideration of additional or different factors where warranted.

b. Events Relating to Multiple Issuers

1) Identification

The 2001 letter states that a significant event may relate to more than one issuer. These events could include, for example: (i) governmental actions that affect securities in one sector, country or region in a particular way; (ii) natural disasters or armed conflicts that affect a country or region; or (iii) significant market fluctuations. As with events relating to single issuers, whether such an event will be "significant" in the sense contemplated by the 2001 letter depends on the facts and circumstances involved.

Governmental Actions. An example of a governmental action that affected securities in one country occurred in September 1999, when the Malaysian government banned the repatriation of the proceeds from the sale of Malaysian securities by foreign investors, effectively trapping foreign investments in Malaysia. This action had the same effect on the value of all Malaysian securities, and many funds fair valued Malaysian securities in a "top down" manner, reducing the Malaysian ringgit/U.S. dollar exchange rate used in their NAV calculation.[38]

Natural Disasters, Armed Conflicts and Similar Situations. Significant events may stem from occurrences not tied directly to the securities markets, such as natural disasters, armed conflicts, or other similar situations. These types of events could affect multiple issuers directly (*e.g.*, by disrupting business operations or causing damage to property) or indirectly (*e.g.*, by causing a stock market to close for an entire trading day or longer).[39]

[38] *See infra* Section III.B.2.b.3) (Fair Valuation), pp. 17-18.

[39] *See* 1999 letter at 3 (discussing a 1999 earthquake in Taiwan and other similar events that cause markets to be closed for an entire trading day).

Significant Market Fluctuations. The 2001 letter states that a significant fluctuation in domestic or foreign markets may constitute a significant event, and, thus, may require a fund to fair value some or all of its portfolio securities if the fluctuation occurs after the close of the markets on which those securities trade but before the time set for NAV calculation.[40] Although not specified in the letter, such fluctuations presumably could be evidenced by, among other things, changes in the value of:

- baskets of depository receipts relating to securities in the foreign market;
- futures contracts or other derivative securities based on indexes representative of the foreign market;
- baskets of securities from the foreign market or funds that are comprised of those securities, such as exchange-traded funds (ETFs) or closed-end country funds;[41] and/or
- the U.S. market, to the extent that the U.S. market may bear a correlation to the particular foreign market.

In light of the reference to market fluctuations in the 2001 letter, funds should consider whether their valuation procedures for foreign portfolio securities should treat movements in the values of one or more of these items as a significant event.

In making this determination, funds may wish to consider the extent to which, over a period of time, such movements on any given day are correlated with movements the following day in the foreign markets to which the item relates. Funds should take into account a number of factors regarding the use of historical correlations in this regard. First, while correlations between a change in either a financial instrument or the U.S. market and the next day's foreign market could indicate that the price of securities trading on that market has changed as of the time a fund calculates its NAV, this is not necessarily the case. Even if *future* prices in a foreign market tend to be correlated with either a particular financial instrument or the U.S. market, this

[40] For example, a significant fluctuation in the U.S. market that occurs prior to the close of the London market (typically 11:30 a.m. Eastern time) should not require fair valuation of securities principally traded in London, since it occurs *before* the time that the values of those securities were established.

[41] The staff noted in the 1999 letter that changes in the value of depository receipts, index futures contracts and other derivatives, and baskets of securities could possibly assist funds in valuing portfolio securities. *See infra* note 43. In the 2001 letter, the staff stated that it believes that the same factors it had described in the 1999 letter also can assist funds in determining whether a significant event has occurred. 2001 letter at n.13.

does not necessarily mean that prices in the foreign market as of the close of the U.S. market are similarly correlated. Second, correlations change over time. The fact that movements in a particular foreign market recently have followed the U.S. market or trading in certain financial instruments does not necessarily mean that they will do so in the future, or that they will do so on any given day.

Funds also should note other limitations in using movements in the value of a particular financial instrument or the U.S. market. For example, ADRs, index futures contracts, closed-end funds and ETFs each have their own ownership and trading characteristics, and may change in value for reasons unrelated to the value of securities in the foreign market (*e.g.*, differences in liquidity, ex-dividend dates, etc.). Nevertheless, movements in these instruments may be more probative of a change in the value of a fund's portfolio securities than broad market correlations. For example, changes in the price of a country-specific ETF may provide a better indication that the value of securities trading on the markets in that country has changed than movements in a broad market index, such as the S&P 500, even if the country's markets have tended to correlate to the S&P 500. Similarly, a fund may invest in specific securities whose prices are not necessarily correlated with those of other securities in the relevant foreign market, making correlations between the U.S. market and the foreign market less meaningful with respect to the value of the fund's portfolio securities.

To the extent that a fund decides to employ one or more of the items listed above to determine when a significant market fluctuation has occurred, it should consider the magnitude of a movement that will be deemed significant. The staff's guidance does not specifically define how large a market movement should be to be considered significant for these purposes.[42]

Given the many considerations and variables, different funds may reach different conclusions about whether and when to treat fluctuations in the value of a particular financial instrument or market as significant events, requiring the use of fair valuation procedures. Some funds may wish to treat these types of fluctuations as *indicators* that closing market prices for certain portfolio securities may no longer be reliable. Under this approach, designated pricing

[42] The 1999 and 2001 letters make reference to extreme market fluctuations, such as those experienced in Asia in 1997. However, neither letter suggests that these are the only types of market fluctuations that will affect the value of a fund's portfolio securities.

personnel would then be required to take additional steps to determine whether a significant event had occurred with respect to the affected securities and therefore whether fair valuation of those securities is warranted.

2) Monitoring

Procedures designed to monitor for significant events such as government actions, natural disasters, or armed conflicts should be similar to those designed for monitoring for significant events relating to single issuers discussed above.

Procedures to monitor for significant market fluctuations are likely to vary considerably from fund to fund. In general, such procedures should assign responsibility for monitoring for significant market fluctuations to appropriate personnel, which may include pricing personnel, portfolio managers or traders, depending on the fund's particular circumstances. If pricing personnel are not assigned this responsibility, the procedures should designate pricing personnel to be alerted when there is a market fluctuation that is considered significant under the fund's valuation procedures. The procedures also should specify the process to be followed in such an event.

3) Fair Valuation

Once a fund has determined that a significant event affecting multiple issuers has occurred, the fund may value each security pursuant to the methodologies described above with respect to significant events affecting single issuers[43] or, in appropriate circumstances, may make a uniform "top down" adjustment to the value of the affected securities (*i.e.*, apply a

[43] *See supra* Section III.B.2.a.3) (Fair Valuation), pp. 12-14. In addition to the factors in ASR 118, the staff listed a number of factors in the 1999 letter that funds may need to consider, if relevant, when fair value pricing portfolio securities including: the value of other financial instruments, including derivative securities, traded on other markets or among dealers; trading volumes on markets, exchanges, or among dealers; values of baskets of securities traded on other markets, exchanges, or among dealers; changes in interest rates; observations from financial institutions; government (domestic or foreign) actions or pronouncements; and other news events. With respect to securities traded on foreign markets, the staff noted that factors also might include the value of foreign securities traded on other foreign markets, ADR trading, closed-end fund trading, foreign currency exchange activity, and the trading prices of financial products that are tied to baskets of foreign securities, such as exchange-traded funds. The staff noted that these factors are merely illustrative and are not intended to preclude consideration of any other relevant factors. 1999 letter at text accompanying n.14.

percentage increase or decrease to every security). As noted above, however, if the impact of that event on the affected portfolio securities would not materially affect the fund's NAV, as a practical matter, the fund could value those securities using their closing market prices.[44]

A fund may wish to employ a "top down" approach if, having followed its procedures to monitor for significant events,[45] it has obtained no information leading it to conclude that individual portfolio securities have been affected differently by the event in question.[46] The "top down" approach could be applied to an entire portfolio or to any subset of portfolio securities, such as those from a particular region, country, exchange or market sector. The staff has stated, however, that at least with respect to certain types of significant events, such as natural disasters, funds should pay particular attention to whether all issuers are affected by these types of significant events similarly and should, to the extent possible, make efforts to determine whether a particular issuer has been affected by that event differently from the damage inflicted generally.[47] It should be noted that specific information often may be difficult to obtain in these situations, particularly in the first few days following the event, despite diligent efforts to do so.

C. Fair Valuation of Foreign Securities for Other Reasons

1. Low Trading Volume

The 2001 letter states that "low trading volume of securities in some foreign markets raises issues as to the reliability of the market quotations" (and, therefore, whether those market quotations are readily available) and "can trigger the requirement to fair value price those

[44] *See supra* text accompanying notes 33-34.

[45] *See supra* Section III.B.2.b.2) (Monitoring), p. 17.

[46] The Director of the SEC's Division of Investment Management recently noted that the staff takes the view that "it may be appropriate to employ a top down approach in certain instances, such as when there is a market event that indicates that stock prices in a foreign market generally would be significantly higher or lower at 4:00 p.m. as compared to the close of the foreign market because the event would widely impact securities held by the fund in that market. On the other hand, not all significant events will affect all portfolio securities equally, so a top down adjustment may not be appropriate." Roye Interview, *supra* note 18, at 10.

[47] 1999 letter at n.6.

securities."[48] This is the same principle that the SEC applies to thinly traded domestic securities.[49]

In light of this guidance, funds should consider adopting procedures to detect, where possible, instances where a foreign security is thinly traded, sales are infrequent, or other data exists that may call into question the reliability of market quotations. These procedures could include "stale price reports" or "stratification reports." Stale price reports identify securities whose last sale price has not changed from day to day, or over a period of several days. Stratification reports identify securities whose last sale price changed significantly from the prior day, or whose last sale price change from the prior day deviated significantly from the change in an appropriate benchmark index.

It should be noted, however, that neither low trading volume nor a report such as a stale price report or a stratification report, standing alone, implies that funds should disregard quotes that reflect actual transactions or pricing service evaluations.[50] In most cases, there should be other clear circumstances evidencing that prices are not reliable *in addition* to low volume or a significant fluctuation in a security's closing market prices before a fund employs fair valuation.[51] Moreover, the 2001 letter makes clear that a determination that market quotations are not "readily available" would not preclude a fund's board from concluding that the most recent closing market prices represent fair value; closing prices generally should be considered along with other appropriate factors when making fair value determinations.[52]

2. Trading Limits

The 2001 letter also addresses the valuation of securities that are subject to trading limits or "collars." If a security subject to a trading limit or "collar" on the exchange or market on

[48] 2001 letter at 4.

[49] ASR 118 at 62,295.

[50] *See* 2001 letter at 9-10 and *supra* note 6.

[51] *See* Roye Interview, *supra* note 18, at 11 (confirming that low volume, in and of itself, does not require funds to disregard quotes that reflect actual transactions and recommending that funds employ flagging mechanisms such as stale price reports to identify securities as to which further investigation may be warranted to determine the reliability of quotes).

[52] 2001 letter at n.9.

which it primarily trades reaches the "limit up" or "limit down" price and no trading has taken place at that price, the 2001 letter states that funds must determine the fair value of that security.[53] If trading has taken place at that price, funds must consider whether market quotations are "readily available" for that security. If a fund reaches the conclusion that, despite that trading, the "limit up" or "limit down" price does not represent a readily available market quotation for purposes of Section 2(a)(41) of the 1940 Act, then the fund must fair value price the security.[54]

With many foreign securities, information as to whether trading limits have been reached can be difficult or impossible to obtain. Nevertheless, funds should take reasonable steps to gain access to this information, which may include encouraging their portfolio managers and local traders to report instances where securities for which they are responsible have reached these types of trading limits.

IV. VALUATION OF DOMESTIC SECURITIES IN LIGHT OF RECENT GUIDANCE

The obligation to implement and maintain pricing procedures to identify whether a significant event has occurred, which would cause the closing market price of a security to no longer be a readily available market quotation, applies to domestic securities as well as foreign securities. In the 2001 letter, the staff indicated that this may occur with respect to scheduled market closings (*i.e.*, when domestic markets close earlier than the NAV calculation pursuant to advance notice, such as on or in advance of a holiday) and unscheduled market closings (*i.e.*, when market disruptions cause domestic markets to close early on a given day or when trading is halted in a domestic security).[55]

Many funds disclose in their prospectuses that their NAV is calculated as of the close of a major market, such as the NYSE, rather than stating a specific time for the NAV calculation. In such a case, the early close of that market (scheduled or unscheduled) automatically would cause the fund to calculate its NAV as of the earlier time. As a result, with respect to securities

[53] *Id.* at 9.

[54] *Id.*

[55] *Id.* at 4.

traded on that market, there would be no interim period between the market close and the NAV calculation and therefore no period of time during which a significant event could occur.

A. Scheduled Market Closings

The scheduled close of some domestic markets may be earlier than the time set for the calculation of a fund's NAV. Funds that are likely to hold portfolio securities that primarily trade on such markets should consider whether to implement procedures to monitor for significant events that occur with respect to those securities during the period between the close of those markets and the time specified for the calculation of the fund's NAV. The procedures also should address the fair valuation of those securities if a significant event occurs.

B. Unscheduled Market Closings

The unscheduled cessation of trading, either in the form of unscheduled market closings or trading halts in individual securities, can create a period between the closing (or last) market price and the calculation of a fund's NAV. Valuation procedures should address this possibility. Funds could consider, for example, implementing procedures that include mechanisms to alert the fund's pricing personnel that a market has closed early or that trading has been halted in a particular portfolio security.[56] Funds also should take steps to determine whether a significant event has occurred with respect to the security or securities whose trading is affected by the unscheduled closing or trading halt and, if so, to assess whether to value the security or securities using fair valuation methodologies.[57]

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[56] An early market close does not necessarily require funds to fair value portfolio securities traded on that market. For example, funds should consider whether those securities continue to trade on other markets. *See* 1997 ICI Valuation Paper at n.7 and accompanying text.

[57] For example, suppose that a fund owns securities of a company that is involved in major litigation, and trading in those securities is halted on the primary exchange on which the securities trade in advance of an important ruling in the case. The fund would need to consider whether the ruling was a "significant event" for purposes of valuing that company's securities, requiring the implementation of a fair value pricing methodology. Depending on the nature of the litigation and the court's decision, the fund might not be able to assess whether the decision has affected the value of the securities as of the time of pricing. In these circumstances, the fund may determine that the last sale price of the securities is still the best indication of their value at that time. *See supra* Section III.B.1 (Definition of "Significant Event"), pp. 9-10.

V. REVIEWING FAIR VALUATION METHODOLOGIES

The 2001 letter states that "funds should regularly evaluate whether their pricing methodologies continue to result in values that they might reasonably expect to receive upon a current sale."[58] In order to do this, the staff suggests that funds should compare their fair value prices with values that are available from other sources (if there are any).

The next actual sales price of a security (foreign or domestic) might be one such source. With respect to foreign securities, fair value prices also might be compared to the next-day opening prices of the securities on the foreign exchange or market.[59] However, the next-day opening prices or next actual sales prices for a security may differ from the fair value of that security as of the time for NAV calculation, given the subjectivity inherent in fair valuation and the fact that events could occur in the intervening period between the time for NAV calculation and the opening of the foreign market.[60] Thus, discrepancies between fair values and next-day opening prices or next actual sales prices may occur on a regular and recurring basis. These discrepancies do not necessarily indicate that the fund's fair value procedures are inappropriate.

Nonetheless, systematic comparisons of fair values to the next-day opening prices or next actual sales prices may be useful to assist fund personnel with ongoing monitoring and evaluation of the appropriateness of the fund's fair value methodologies. Fund personnel may want to document the comparison of fair value prices to next-day opening prices or next actual sales prices so that this information can be considered in assessing the reliability of the fund's fair value methodologies and whether any changes in the methodologies should be considered.

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[58] 2001 letter at 7.

[59] Indeed, the SEC has suggested that, in appropriate circumstances, funds may use the next day's opening price on the foreign exchange on which the security trades as an indicium of the fair value of the security. *See* Rule 22c-1 Release, *supra* note 11. Funds should note some of the practical consequences of using next day opening prices. For example, delaying the calculation and dissemination of an NAV to shareholders and third parties such as distributors, intermediaries and the media to wait for the open of a foreign market may cause processing and other systems problems and would cause the fund's NAV to appear as "not available" in newspapers the next day.

[60] For a fund that calculates its NAV at 4:00 p.m. Eastern time, the lag between the NAV calculation and the opening of the foreign markets ranges from three hours for securities traded on the Tokyo Stock Exchange, which opens at 9 a.m. local time (7 p.m. Eastern time) to twelve hours for securities traded on Euronext Paris, which opens at 10 a.m. local time (4 a.m. Eastern time). Fundamental economic developments or issuer specific developments during this gap in time may cause the value of securities traded on these markets to change.

VI. RESPONSIBILITIES OF THE BOARD IN LIGHT OF RECENT GUIDANCE

A. In General

Fund boards of directors or trustees have responsibilities under the 1940 Act with regard to the fair value pricing process. In setting forth the staff's views concerning the 1940 Act requirement that the board determine, "in good faith," the fair value of portfolio securities for which market quotations are not readily available, the 1999 and 2001 letters recognize three important, general points. First, there are practical limitations on the ability of fund boards to be involved in the day-to-day administration of pricing procedures. Second, fair value pricing necessarily involves making judgments. There is not one "right" way to fair value securities, and different funds (with different boards), consistent with the good faith standard, could arrive at different prices for the same security. Third, the letters underscore the importance of having well-considered, reasonable valuation procedures that have been approved by a fund's board, are consistently applied, and are reviewed on a regular basis.

Boards should examine whether valuation procedures for securities traded on foreign markets will reasonably ensure that that the prices of those securities will not be "stale" because they do not take into account significant events that occur subsequent to the time those foreign markets close. At the same time, boards should recognize that closing market prices generally provide an objective measure of the value of fund portfolio securities, whereas fair value prices necessarily involve some degree of subjectivity.[61] In the case of events whose effects upon the value of portfolio securities may be unclear, the objectivity provided by closing market prices may result in fairer and more accurate valuations. Conclusions regarding which valuation procedures appropriately balance these considerations, like other board determinations, ultimately are matters of business judgment.

The staff's specific guidance, as it relates to delegation and oversight by fund boards, is discussed below.

[61] Presumably, this is why funds are required to use market prices when they are readily available. *See supra* note 6 and accompanying text.

B. Board Delegation of Fair Value Pricing Responsibilities

In discussing the board's "good faith" responsibilities, the 1999 letter notes that fund boards typically are only indirectly involved in the day-to-day pricing of a fund's portfolio securities, and states that most boards fulfill their obligations by reviewing and approving pricing methodologies.[62] The letter indicates that while the board may formulate these methodologies, more typically they are recommended and applied by fund management.

The board practices described in the 1999 letter are used because of the practical reality that most fund directors (particularly independent directors) do not have the expertise to devise specific pricing methodologies themselves and cannot reasonably be expected to be available every time a valuation issue arises.[63] Likewise, although fund boards are generally apprised of the formulas or other methodologies that may be used by third party pricing sources, such as pricing services or dealers, they typically do not approve each specific formula or other methodology.[64]

The letter mentions that there are a number of techniques that funds may use to minimize the burdens of fair value pricing on directors, such as delegating certain responsibilities for fair value pricing decisions to a valuation committee.[65] As described in the 1997 ICI Valuation Paper, such committees may consist of designated fund management personnel.[66] Fund groups that have not already formed valuation committees may wish to consider whether the use of such a committee would facilitate or enhance their current pricing processes. Regardless of whether a committee is used, or whether that committee includes directors as members, the board retains oversight responsibilities with respect to fair valuation determinations.

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[62] 1999 letter at 7.

[63] *See* 1997 ICI Valuation Paper at 10-11.

[64] *See id.* at 12-13.

[65] 1999 letter at 7. Along the same lines, the 2001 letter states that "[c]onsistent with the good faith requirement, boards may appoint persons to assist them in determining fair values and to make actual fair value calculations." 2001 letter at 8, n.23.

[66] *See* 1997 ICI Valuation Paper at 28-29 for a discussion of the possible functions of fund management valuation committees.

According to the 1999 letter, the degree of fund board involvement in the fair value pricing process necessary to satisfy the "good faith" standard depends on the comprehensiveness of the pricing procedures adopted for the fund. If a fund's board has approved comprehensive procedures governing the process by which fund management should fair value price portfolio securities, it would need to have comparatively little involvement in the day-to-day valuation process in order to satisfy its good faith obligation.[67] On the other hand, the board's involvement may need to be "greater and more immediate" when pricing procedures are relatively less comprehensive.[68]

Based on the foregoing, funds and their boards may wish to adopt pricing procedures that are as comprehensive as is feasible,[69] and that are implemented by fund management or a qualified third party. However, because it is not possible to anticipate every valuation issue that might arise, procedures should remain flexible enough to allow pricing personnel to take appropriate action in a timely manner in fair value pricing situations not specifically covered by the fund's valuation procedures. Thus, the board-approved valuation procedures should set out procedures to be followed by pricing personnel in such situations, including when it may be appropriate to seek board ratification promptly following any fair value determination.

C. Board Oversight Responsibilities

Fund boards retain ongoing oversight responsibility for the valuation of fund assets, whether they delegate valuation functions or not. Accordingly, citing earlier SEC guidance, the 2001 letter reminds fund boards that they must "continuously review the appropriateness of the method used in valuing" portfolio securities.[70] In the context of this review, fund boards should receive periodic reports from fund management or a qualified third party that discuss the

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[67] Some fund boards follow a practice of reviewing periodically (*e.g.* quarterly) determinations made by fund management.

[68] 1999 letter at 8.

[69] In this regard, funds may wish to consider whether their procedures should specifically reference factors to be considered in fair value pricing situations. *See* 1999 letter at 5; 2001 letter at 8 (discussing the need for fund boards, in making fair value determinations consistent with the good faith standard, to consider all of the appropriate factors that are available to them). *See also supra* notes 35-37 and accompanying text.

[70] 2001 letter at 7 and 8.

functioning of the valuation process and that focus on issues and valuation problems that have arisen.[71] Regular communication between fund management and a fund's board on valuation issues – particularly issues involving fair value pricing – should minimize the possibility of a finding that the board failed to act in good faith in connection with a fair value determination for a fund portfolio security.

VII. CONCLUSION

The critical role that daily pricing plays in the mutual fund business makes valuation a continuing subject of regulatory and public focus. The staff's recent guidance reconfirms the importance of adopting and implementing reasonable procedures for valuing fund portfolio securities, including in particular securities for which market quotations are not "readily available." Fund groups should continue to devote careful attention and adequate resources to the appropriate handling of these matters.

[71] 1999 letter at 8.

Ms. Tara Baird
Chief Clerk
Committee on Governmental Affairs
Subcommittee on Financial Management, the Budget, and International Security
446 Hart Senate Bldg
Washington, DC 20510

Re: Response to Senator Akaka Question (January 27th hearing regarding mutual funds)

Dear Ms. Baird:

In response to your request I am taking this opportunity to respond to the following question posed by Senator Akaka in conjunction with the above referenced hearing:

"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 due to the transaction, and why?"

Answer: As a general matter we believe that the critical information that should be disclosed is not the amount of compensation that is received, but rather whether potential conflicts of interest exist which could affect the objectivity of recommendations given to an investor with respect to a mutual fund purchase. For example, if higher compensation is paid on the sale of proprietary funds or different classes of fund shares, written disclosure of that fact should be made. There may also be limited circumstances where it would be appropriate to disclose the actual amount, or at least the percentage sales charge applied to a particular transaction. In that regard, SIA has strongly supported a recommendation of the NASD Breakpoint Task Force to include percentage mutual fund sales charge on confirmations to facilitate investors ability to determine that they received breakpoints to which they are entitled.

We trust Senator Akaka and other members of the subcommittee will find this response helpful, and we are pleased to have it included in the official hearing record.

Sincerely,

Marc E. Lackritz

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March 1, 2004

The Honorable Susan M. Collins
Chairman, Governmental Affairs Committee
Hart Senate Office Building
Washington, DC 20510

Re: Question Posed by Senator Akaka About Revenue Sharing

Dear Senator Collins:

I have been asked by you to respond to the following question posed by Senator Akaka, which I am glad to do:

> In your statement, you indicate that you do not want revenue sharing to be allowed to continue. If revenue sharing is prohibited, how will consumers access mutual funds and what impact would this prohibition have on the industry and consumers?

In answering Senator Akaka's question, please let me first explain what revenue sharing is as I understand it, how it is occurring in the fund industry, and why I do not favor continuation of revenue sharing in its present form.

What is Revenue Sharing? According to the GAO, "Revenue sharing payments are compensation that investment advisers pay from their profits to the broker-dealers that distribute their funds." GENERAL ACCOUNTING OFFICE, MUTUAL FUNDS-GREATER TRANSPARENCY NEEDED IN DISCLOSURE TO INVESTORS 38 (2003).

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How is Revenue Sharing Being Handled at Present? The GAO was sent to gather facts about fund industry transparency, and came back with scant specific information about revenue sharing. The GAO did furnish some information about the outlines of the practice. It found the practice to be secretive, involving huge dollars, and growing:

> [T]he amount of revenue sharing payments, which are paid out of the fund adviser's profits earned from the management fee or income from other sources, are not typically disclosed to investors, except for possible general disclosure in a fund's prospectus or SAI. Funds do disclose 12b-1 payments and may disclose that they may make other distribution-related payments but do not have to disclose the total amount paid or identify the recipients of those payments. As a result, complete data are not available on the extent to which mutual fund advisers are making revenue sharing payments. An industry researcher said that the cost of revenue sharing does not show up in advisers' financial reports because there is no line item for it and costs that fund advisers may incur to pay for sales meetings attended by brokerdealer staff or other promotion efforts are not specifically shown in fund adviser income statements. According to an article in one trade journal, revenue sharing payments made by major fund companies to brokerdealers may total as much as $2 billion per year. These amounts have been growing. According to the officials of a mutual fund research organization, revenue sharing costs are hard to quantify but are rising. For example, the organization reports that about 80 percent of fund companies that partner with major broker-dealers make cash revenue sharing payments.
>
> The increased use of revenue sharing payments is raising concerns among some industry participants. Although revenue sharing payments are becoming a major expense for fund advisers, industry research organization officials told us that most fund advisers are not willing to publicly discuss the extent to which they are making such payments. A 2001 report on fund distribution practices states that "the details and levels of revenue sharing vary widely across the industry and are seldom codified in written contracts." In one industry magazine article, a mutual fund industry researcher referred to revenue sharing as "the dirty little secret of the mutual fund industry."

GENERAL ACCOUNTING OFFICE, MUTUAL FUNDS-GREATER TRANSPARENCY NEEDED IN DISCLOSURE TO INVESTORS 38-39 (2003).

Why I Oppose Revenue Sharing. According to the GAO's analysis, which I accept, revenue sharing is an ill-defined, poorly documented practice which "most fund advisors are not willing to discuss publicly." It has been referred to as the mutual fund industry's "dirty little secret." My only dispute with the GAO's characterization is that I question how any expenditure of $2 billion in mutual fund money per year can be called "little."

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I tell you bluntly that hidden, secretive, poorly-documented practices that result in the diversion of billions of dollars of mutual fund shareholders' money each year have no place in the industry. It is precisely this type of sleazy behavior that has caused mutual fund managers to become embroiled in the multiple scandals now besetting them.

I submit, very respectfully, that the burden of proof on "revenue sharing" belongs not on objectors like me, but on those who would contend that the secretive practice is necessary and valuable and should continue. That said, I turn to answer the question posed by Mr. Akaka.

If revenue sharing is prohibited, how will consumers access mutual funds and what impact would this prohibition have on the industry and consumers? If fund sponsors were barred from diverting $2 billion per year in advisory profits to finance distribution (marketing) activities, funds would not dry up or disappear. Vanguard finances distribution of its shares just fine, yet Vanguard funds charge no 12b-1 fees, and there is no "revenue sharing" since there are no advisory profits to hand out. Advisory profits are missing because Vanguard's own portfolio managers render their services at cost. Still, Vanguard survives and thrives.

From a distribution standpoint, one financing advantage that the load funds have is the load itself. The many millions of load fund shareholders who want to buy a mutual fund have been paying for selling costs via the load for decades. Load funds will survive the demise of revenue sharing.

So will no-load funds. Vanguard, noted above, is a no-load operation yet it does not engage in revenue sharing. Mutual fund board are free to spend money for legitimate expenses calculated to serve fund shareholders' interests. To the extent that fund boards or shareholders are able reasonably to conclude that distribution payments to add value for fund shareholders, the board can agree on assessments for that purpose, and shareholders are free to approve same. Proposals for such payments would have to be carefully studied, and the payments once made would need to be monitored to assure that the money is not being wasted. In theory, if not in practice, this is being done today through the promulgation and administration of 12b-1 plans.

Payments for distribution, in other words, need to occur as a fully disclosed, carefully studied management decision, rather than as a secretive, poorly documented, little understood unilateral decision made by the fund's advisor who, indirectly, is spending fund assets and personally profiting off the sales being generated.

In summary, I have tremendous respect for the mutual fund industry's resilience and its managers' capability to make good decisions once proper policy guidelines are laid down. Revenue sharing as it exists at present is an abomination. Outlawing the practice in its present form will not hurt actual or prospective fund shareholders. It will encourage transparency by promoting open, honest management decision-making. Outlawing revenue sharing will put

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increased focus on fund managers' accountability when they spend money derived from fund assets.

Thank you for giving me an opportunity to expand upon my views. Please let me know if I can be of further assistance to the Committee.

Sincerely yours,

John Freeman

John P. Freeman
Professor of Law