# MUTUAL FUNDS: WHO'S LOOKING OUT FOR INVESTORS?

## HEARINGS

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTEREPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

NOVEMBER 4, 6, 2003

Printed for the use of the Committee on Financial Services

**Serial No. 108–61**

U.S. GOVERNMENT PRINTING OFFICE

92–982 PDF WASHINGTON : 2003

For sale by the Superintendent of Documents, U.S. Government Printing Office
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APPENDIX

# MUTUAL FUNDS: WHO'S LOOKING OUT FOR INVESTORS?

**Tuesday, November 4, 2003**

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT-SPONSORED ENTERPRISES,
COMMITTE ON FINANCIAL SERVICES
*Washington, D.C.*

The subcommittee met, pursuant to call, at 10:07 a.m. In Room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Castle, Royce, Manzullo, Oxley (ex officio), Biggert, Capito, Brown-Waite, Frank (ex officio), Hinojosa, Lucas of Kentucky, Matheson, Emanuel and Scott.

Chairman BAKER. I would like to call our meeting of the Capital Markets Subcommittee to order.

This morning we have two distinguished panels of experts who will give opinions as to the necessity for modifications or improvements in the current statutory environment for the functioning of free and transparent capital markets within the country.

In recent weeks, due to efforts of State regulators and the SEC, unfortunate news has come to the public attention relative to individuals' conduct not consistent with current statutory law. As distasteful as those revelations are, I am confident that an aggressive enforcement authority at the State level as well as at the SEC will hold those individuals to account for their actions or omissions that are found to be inappropriate.

That in itself is disturbing enough, given the fact that we have 95 million Americans now invested in the markets. Over half of all working households or all households in the country are directly invested in the markets.

It certainly makes a fine point that we in the Congress have a direct obligation to oversee and assist in the modifications where professional guidance tells us it is necessary, but even beyond the stated criminal conduct which has now been identified, I have further concerns that where actions were taken completely consistent with current law, there are actions that can be taken through nondisclosure that diminish shareholder value without shareholders being aware that it is occurring, and I certainly believe that is an area where the committee should focus its attention.

This committee has previously acted on H.R. H.R. 2420, which sets out modest beginnings for reform. That was first reviewed by the committee back in March of this year, before the revelations were made that we have recently been made aware of. In that light, I am not confident that the content of H.R. 2420 as drafted today is sufficiently broad in scope and for that reason look forward to comments of those who are professionals in this area as to their guidance and recommendations where the committee may strengthen that proposal.

Certainly one area that remains of some degree of controversy but I believe remains very important to overall reform is that of the appointment of an independent chair for the governance of a mutual fund board. I do believe that much of the conduct currently deemed to have been illegal could have been at least stemmed, if not prevented, by strong managerial oversight, aided with an independent chair and perhaps the appointment of a compliance officer as well.

Those are two points which I believe the committee should spend some time and consideration of those recommendations. The risk is far too great to leave these matters unresolved. The worst action the Congress could take would be not to act in any fashion whatsoever.

The concerns by investors, the lack of certainty, the fear that one cannot place their money in the hands of a professional fiduciary for enhancing their professional future is grave. When we have 95 million Americans investing, that is a tremendous source of capital providing for business expansion and job opportunities, and if that money should sit on the financial sideline it would come at grave cost to our economic recovery. So I believe we have a very strong responsibility to act, to act quickly, and in a manner that is appropriate, given the circumstances that we face.

With that, I would like to recognize Ranking Member Frank for his opening statement.

Mr. FRANK. Thank you, Mr. Chairman.

I should note that the ranking member of the subcommittee, the gentleman from Pennsylvania, who has been very, very diligent in his work here, is diverted by something called an election which they are having in Pennsylvania. I live closer to the airport so I was able to vote at 7 this morning and get here. Unfortunately, we implemented a new system and, instead of pulling levers, I had to color in lines. I was never good at that in third grade and never got much better.

Chairman BAKER. Would the gentleman yield on that point?

Mr. FRANK. Yes.

Chairman BAKER. Mr. Kanjorski brought to my attention the fact of the election today. We did try to accommodate the members.

Mr. FRANK. I appreciate that.

Chairman BAKER. The difficulty was with the panel of members we have this morning. We could not readily reschedule.

Mr. FRANK. I understand, Mr. Chairman. I didn't mean that as a criticism.

Chairman BAKER. No, but just for the record.

Mr. FRANK. The way Mr. Spitzer is going, he is not worrying about elections any more, so he did not have to show up at the polls like the rest of us did.

There are a serious set of issues here. Mr. Chairman, as you know, you received a letter from 32 of the 33 people on this side urging you to agree with us that the efforts that have been going on for over a year to curtail State activity in the regulatory area be put to bed.

We think that was always mistaken. We think particularly at this point it is a very poor idea. There have been various versions of it, to require everything be disgorged, to keep them out of business altogether.

It first surfaced at the request of some Morgan Stanley people during Sarbanes-Oxley. Subsequently, Mr. Chairman, as you know, not on mutual funds, but dealing with SEC powers, language was included that would curtail State authority. There were arguments about how much. Mr. Spitzer and Secretary of State Galvin of Massachusetts, with whom I work closely, have both told me this would severely impair their ability to go forward.

The problem is that, partly because of that controversy, in July when this committee met to mark up legislation, I believe at your request, Mr. Chairman, the bill that the SEC had requested for enhanced SEC powers was pulled because it included that section. You subsequently had a colloquy with Mr. Donaldson about it.

Now I understand that there is a meeting this afternoon of State regulators and the SEC to begin to work out procedures. I am all in favor of that, but I am very unhappy about it going forward with some sword of Damocles being held over their head, as if it is chained to the wall, not a threat.

I do not think there is any chance of Congress passing it, but there are two problems with the continued pendency of this preemption. In the first place, it has held up action on the SEC bill, and there were two bills that we considered on our agenda in July. One would have strengthened some regulations on the mutual fund and do not propose to go further because of some things that we learned, and I agree with the further proposals you have made, and I think we should go forward.

That bill was held up going to the floor, not on our request. We were not opposing it when it came out of committee. I would agree with you it ought to be strengthened, but we also had the bill that at the SEC's request would enhance their powers. The SEC has been criticized; the head of our regional office in Massachusetts just left. I think it would have been a good idea if we give them those enhanced powers.

That has apparently been held up, while people, including yourself, Mr. Chairman, await the outcome of these negotiations. I do not think we ought to be waiting for a surrender from the State regulators in principle, anyway, but I certainly do not want to see the SEC bill held up while those negotiations go forward, so I would urge you to agree that that SEC bill should go forward. We ought to mark it up right away, if you would just drop that preemption piece.

On the mutual fund aspect, that bill came out of committee. Frankly, someone asked us why the Democrats hadn't co-sponsored it. Well, my answer is: It was reported out of the committee. You cannot under the rules cosponsor it. But then I was told that the report of the committee action has just been filed from July. That is a big slowdown. I didn't realize that.

Yes, we could have co-sponsored it, if we had realized—frankly, the polls were held up. I want to go forward and let's have another markup. The vote was reported out.

I just reviewed your new proposals. They seem to be things on which we can get a consensus, so I would like to move forward, but I do think we have a serious problem with the bill the SEC requested for increased powers being held up and continued to be held up over the pre-emption. I know you said you didn't think, Mr. Chairman, that it would have interfered, but I said Mr. Spitzer, Mr. Galvin, both seem to have done so.

I am glad to see that the chairman and Mr. Spitzer are coming together. The holiday season is coming. It is a time of healing and reconciliation. That is bad news for the press, because more fighting is better for them, but it is good news maybe for everybody else. But I would hope that we would celebrate this new union here, a civil union—but a union—I do not want to get into other issues. Let's say it is a union of civility, not a civil union. Let's consecrate that with an agreement that this proposed pre-emption was not a good idea.

So I would urge you again, Mr. Chairman, the chairman of the subcommittee, let's activate the SEC bill, let's have a markup, and let's withdraw the pre-emption part.

The other part I would note with regard to the SEC, I realize they asked for new powers and didn't get them. But much of last year after Sarbanes-Oxley, we fought to give the SEC enhanced staff. We fought very hard to give you more money, and then the SEC requested some flexibility in hiring. The gentleman from Pennsylvania, Mr. Kanjorski, worked with Mr. Baker to give the SEC not just a significant increase in money, probably the biggest increase outside the Pentagon, which always wins, but some flexibility in hiring, subject to the people then hired being fully protected. The SEC did give some of that money back.

I wonder, is there anything we can do—and I recognize it is hard to do all this right in a hurry, but we—everything the SEC has asked for that would enhance either its staff capacity or its regulatory powers we tried to support. So I would say to Mr. Galvin, if there is anything further we can do to beef it up, we would be glad to do that.

Last point, Mr. Chairman—I would appreciate just 30 more seconds—I want to say a word in defense of politicians. We are not always everybody's favorite role model, but let's be clear that what we have here, the lead has been taken in the mutual fund protection of the average investor not just by State regulators but by State regulators who are elected to office. Mr. Spitzer is elected Attorney General of New York. Mr. Galvin is elected Secretary of the Commonwealth of Massachusetts.

I think it is not accidental that this concerns the average investor, the smaller guy. It is not a systemic issue as much as it is equity for the individual. I do not think it is an accident that elected officials who have to maintain that contact were in the lead on this.

Finally, again, Mr. Chairman, I hope that we can put preemption to bed and go forward with good legislation.

Chairman BAKER. I thank the gentleman.

Mr. Oxley.

Mr. OXLEY. Thank you, Mr. Chairman. I would yield to you whatever time you may consume.

Chairman BAKER. I thank the gentleman.

I do feel it appropriate to respond to the gentleman from Massachusetts' comments with regard to holding up legislative reform concerning H.R. 2179.

I did not intend to get into this arena today, but since we have been invited so strongly, I will ask Mr. Cutler at the appropriate time, have any constraints, by failure to pass H.R. 2179, been an inhibition to the SEC's authority to pursue wrongdoers and bring them to accountability?

I would also indicate that in conversations with Mr. Spitzer and others we have sought in good faith to reach an accord which we believe is potentially achievable and make clear that we do not intend nor have we, in any way, inhibited State authority to pursue wrongdoers at any level to investigate, punish, or bring about any penalties.

The only discussion has been and remains with regard to the remedy stage of those negotiations where, as a result of actions taken by Attorney Generals, the national market structure would be modified.

I believe Mr. Spitzer has indicated on occasion that he accepts the view that the SEC should maintain primacy as the securities regulator but does have concerns as to the triggering mechanisms that would be required to institute such a fail-safe.

Having said that, this committee was first on the block—was out of the block long before there was a scandal, did conduct a hearing and can produce from the records statements from many members in opposition to H.R. H.R. 2420 and its consideration. If we take the elements of H.R. 2179 that were merely enhancements of current authority, did not create new causes of action, did not give any new power that the SEC does not currently have, they were enhancements to the current body of enforcement law, you look at H.R. H.R. 2420, which is by far the more aggressive remedy to the current conflict we face, creating new causes of action, creating new methods of accountability, establishing at one point the necessity for an independent chairperson to govern the Board, which this committee sought to delete, I think we can go back to the record if we so choose and discover who were the folks in favor of reform prior to the current conflict and who were, in fact, obstructing its passage.

A letter sent to me indicating that I have, in any way, inhibited procedural consideration of something that is in the public good I find absolutely intolerable.

I thank the gentleman for yielding.

Mr. OXLEY. Thank you Mr. Chairman.

Thank you for holding this timely hearing. It is often said that we have become in the past two decades a nation of investors. While that is unquestionably true, I believe it would be more precise to say we are now a nation of mutual fund investors. By an overwhelming margin, these pooled investment products have become the preferred way for some 95 million Americans to access stock markets, so we ought to make sure these investors are well-protected.

It appears that we are now in the early innings of what is now the biggest scandal in the 80-year-old history of the mutual fund industry. We do not know everything yet, but what we do know is troubling. Some have called the revelation shocking. Large institutional investors have been given preferential treatment to the detriment of individual investors and in violation of law in the funds' own stated policies.

According to the firms themselves, some fund managers and executives have essentially been stealing from their own customers. At one large fund company, portfolio managers seemed to be market timing their own funds as far back as 1998, were not terminated and not even disciplined until a September subpoena brought this information to the public's attention.

Perhaps the most troubling aspect of all this illegal conduct is that it appears to be so widespread. We cannot say that a few bad apples have violated the fiduciary duty owed to shareholders. We cannot say that only a handful of firms have mistreated their mom and pop investors who were supposed to be the industries bread and butter, and we cannot pretend that all of the fund companies were aware of this conduct.

This committee was aware of mutual fund and investor issues long before these recent revelations. It has been my view, and certainly one shared by Chairman Baker and others, that the review of fund practices was inevitable, given the committee's work over the past few years. We have examined almost every other segment of the securities industry, including Wall Street's analysts conflicts and IPO allocation abuses, the accounting profession, corporate boards, the stock exchanges, credit rating agencies and indeed hedge funds.

In this post-Sarbanes-Oxley world, the public demands full disclosure of all relevant information, and rightfully so. Indeed, our system, as we said time and time again, is based on trust; and once that trust is broken, we have a clear breakdown in our system.

The committee's year-long review of mutual funds makes clear that more transparency is needed with respect to fund fees, costs, expenses and operations. There should be more useful disclosures regarding fund distribution arrangements so that investors are aware of any financial incentives that may influence the advice they receive. There should be stronger leadership by fund directors and clearly fund directors receive better oversight of the industry by the SEC.

Chairman Baker's legislation which passed this committee by a voice vote in July addresses these issues in a responsible and measured way. In light of the recent scandals, I think few would disagree that it would be appropriate to consider strengthening this legislation.

Mr. Chairman, congratulations on an excellent effort in this area, and I yield back.

[The prepared statement of Hon. Michael G. Oxley can be found on page 124 in the appendix.]

Chairman BAKER. Thank you, Mr. Chairman.

I would be remiss if I did not acknowledge your constant and continuing interest in the subject and ensuring that good public policy come out of this committee, and I appreciate your leadership.

Chairman BAKER. Does any other member wish to make an opening statement? Anyone at this side?

Mr. Scott is next?

Mr. Scott.

Mr. SCOTT. Thank you very much, Chairman Baker.

I thank you and Ranking Member Kanjorski for holding this hearing today regarding the mutual fund industry.

I also want to thank the panel of witnesses today for their testimony.

When I look back at this committee's earlier hearing on mutual funds, I feel as if we were looking at an industry that, at that time, was squeaky clean, but we now know that there are widespread practices where these funds are clearly not acting in the best interest of long-term investors.

According to an SEC survey, one-fourth of the Nation's largest brokerage houses helped clients engage in the illegal practices of trading mutual funds after hours, and half of the largest companies had arrangements that allowed certain customers to engage in market timing.

Given that more than half of all United States' households now hold shares in mutual funds, any discussion today will have an impact on millions of investors. We must look out for long-term investors, and we must restore and reinforce investor confidence in mutual funds.

Hopefully, this hearing will help us understand whether mutual fund investors are receiving fair value in return for the fees they paid. Late trading, market timing, insider trading, all should be no-nos. We have got to look into this problem forcefully. The American people are looking for help so that we can restore investor confidence in the trading of mutual funds.

Mr. Chairman and the committee, I look forward to this very important hearing this morning.

Chairman BAKER. Thank you, Mr. Scott.

Mr. Castle.

Mr. CASTLE. Thank you, Mr. Chairman; and thank you very much for having this hearing. I put you in the category of one of these crusading people trying to do something about this.

I think it is very important to understand the numbers. I will submit a full statement for the record, but I think it is important to understand the numbers. Because it was just two decades ago—that is only 20 years ago—that 6 percent of American households had mutual fund shares that were valued at $134 billion. Today, it is 50 percent.

I have heard 95 million people, families, is the right number, but it is 50 percent of our households have $7 trillion at stake. That is about 50 times larger than what existed before. That is more than the debt of this country, which everybody thinks is the highest number in the world.

Mutual funds represent about 10 percent of the total financial assets; and the number of funds have grown in that 20 years from 500 mutual funds in 25 years, really, in 1980 to approximately 8,000 mutual funds today.

Now most of these operate, I would believe, within the bounds of the laws in regulations of this country, but some do not, and investors suffer, and therein lies the rub. I must just say that pride cometh before the fall because, as we went through the corporate matters and the GSC issues, we are the only ones who are really clean, we do not have any problems.

I have heard about stale pricing, market timing, commission overcharges, lack of independent boards of directors, completely interlocking boards of directors, lack of transparencies, nobody really knows who owns what in terms of management ownership or salaries or even the contractual nature by which they operate. There had been enforcement issues which fortunately are starting to be addressed. 12b-1 fees are still being charged by mutual funds which have closed, which is amazing that something like that can happen.

So I think there are tremendous problems as far as the mutual fund industry is concerned. I think these hearings are very, very important. If nothing else, I cannot imagine that the people who are running mutual funds are not paying a heck of a lot of attention to what we are doing, so just the fact of having these hearings is extraordinarily important. I think there will be changes in behavior.

But I must just say this, Mr. Chairman, before we get into the details of all of this. I think we need to put the tools in place to make sure that 5 or 10 years from now that we have put good laws and rules and regulations in place dealing with everybody at the State and the Federal level.

I am very concerned that as we go through this process, the usual drip, drip theory of people saying we do not need this, we do not need that, will take place and we will get it right. On the other hand, I do not believe that we individually and perhaps collectively have all the knowledge with respect to what has to be done.

I think I know something about the mutual fund industry, and every day I read something new or different. I do not want to say I can write the law. We really need to write this law properly and carefully and make sure that it is enforceable.

Eventually, the end goal, frankly, is protecting our investors—we say the smaller investors, but particularly the non-institutional investors, whether they are small or not, but we must fully evaluate the situation in order to do that.

I have a lot of questions I want to ask. My 5 minutes of questioning will not be enough for that from these individuals.

You know, obviously, where has the SEC been?

I think Mr. Cutler has come forward and helped with that, the illegal practices, we talked about that, the higher redemption fees and how they might affect the market timing. The bottom line, Mr. Chairman, is let's make sure we get something done. You have always been a good leader in this area and I thank the ranking members who care a lot about this issue.

To me, this is an opportunity to do it correctly. Frankly, if we take the time to do it correctly, we will have done the investing public a good amount of good; and I hope to be able to do that.

I yield back the balance much my time.

[The prepared statement of Hon. Michael N. Castle can be found on page 126 in the appendix.]

Chairman BAKER. I thank the gentleman for his statement.

Mr. Emanuel, did you want to reclaim your time?

Mr. EMANUEL. Thank you, Mr. Chairman; and thank you for holding the hearing today and for those who are attending today to testify.

I want to pick up on what my colleague from Delaware said about the 95 million Americans who are now invested in mutual funds.

Unfortunately, what we have uncovered, whether it is market timing, late trading, or insider trading, that principle has been turned upside down. In fact, what we have seen recently is a managers win-investors lose mentality. I think that what we are doing here can be done in a smart, thoughtful, bipartisan way, as we did during the Fair Credit Reporting Act debate. We can take action to restore that trust for investors so that they don't pull their money out so unnecessarily and hurt themselves even more than they've already been harmed. I think it's also important to emphasize that, although we're facing a crisis, mutual funds are still a safe place to invest. Anything we do either legislatively or regulatorily should strive to restore the basic principle of the fiduciary responsibility.

As we continue to look at this issue, there are two points I want to bring to light:

One is a question I will be asking about the hot IPO. Have State of Federal regulators looked at what happened in the hot IPO market and how mutual funds allocated the shares they received? Was there systemic and endemic abuse back then as it related to that market and the IPOs that were allocated? Were these allocations going to average investors or were they going to the managerial class and special investors?

Another issue I'd like to raise is how I believe this scandal relates is general debate we've been having in Congress about the notion of privatizing social security. I will tell you, if there is anything that has ever shed light on the dangers of privatizing social security, it is what has happened here in the mutual fund industry and the "managers first" culture that has developed in the last 5 or 6 years; and I hope those who are rushing headlong to privitize social security would take a deep breath here. This scandal should be a flashing yellow light to all those who advocate the benefits of privatizing what has been a very good system, that is, social security, both as an insurance policy and a retirement policy.

So for all those who have invested in mutual funds, whether for their life savings or their kids' college savings, we have an obligation to make sure their trust is restored. So I thank you for holding this hearing and look forward to the answers to the questions.

[The prepared statement of Hon. Rahm Emanuel can be found on page 128 in the appendix.]

Chairman BAKER. Thank you.

Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

We thank our distinguished witnesses for coming here to testify on the oversight of the mutual fund industry.

This summer we saw officials from New York, from Massachusetts and from the SEC. We saw them unearth a number of alarming market-timing activities within the fund industry. I encourage investigators and I am encouraging prosecutors to vigorously pursue those who have betrayed investors. I also sincerely believe we should use these revelations as an opportunity to improve the fund industry going forward, and I hope all parties involved will work together in a way that punishes the wrongdoers, that corrects inadequacies in regulation and results in a better climate for America's investing public.

To that end, I am encouraged to see that there are a number of proposals being put forward by both interested and disinterested parties. In particular, I am pleased to see that both the SEC and the Investment Company Institute are looking at specific actions that can be taken such as requiring all trading orders to be received by 4 o'clock and devising a mandatory redemption fee for in-and-out investors and exploring fair-value pricing mechanisms and, lastly, improving compliance procedures at fund companies.

In my view, the largest burden must fall on the fund industry itself to create better, more effective compliance policies.

Once again, Chairman Baker, I thank you for having this hearing today. It is of great importance that this committee remains vigilant in ensuring that the investor marketplace that so many Americans invest in is fair, is transparent, and I look forward to working with my colleagues on this issue and yield back.

[The prepared statement of Hon. Edward R. Royce can be found on page 132 in the appendix.]

Chairman BAKER. I thank the gentleman.

Mr. Lucas.

Mr. LUCAS OF KENTUCKY. Mr. Chairman, I am looking forward to hearing the testimony from the witnesses.

Chairman BAKER. Thank you, sir.

Mr. Hinojosa.

Mr. HINOJOSA. Thank you, Chairman Baker.

I want to thank you for holding this third hearing on mutual funds this year and for the additional hearing the subcommittee will hold the day after tomorrow, on Thursday, on the same subject.

Mr. Chairman, I believe that this is going to be a very interesting hearing, based on all the news reports I have read on, one, the development in the mutual funds industry; two, the SEC's involvement; and, three, the role New York State Attorney General Eliot Spitzer has played in the investigation of malfeasance at certain mutual funds.

I was alarmed to read in yesterday's CongressDaily P.M. that Senate Governmental Affairs Chairwoman Susan Collins stated at a hearing before her committee that, "clearly, much more must be done to protect mutual fund investors, whether it is through legislation, tougher enforcement actions, new and stronger regulations, or all three of those I mentioned."

Governmental Affairs Financial Management Subcommittee Chairman Peter Fitzgerald inferred at that same hearing that "Federal law not only allows but codifies an incestuous relationship between the mutual fund board of directors and their investment advisors and managers." If they are correct, then the mutual fund industry is in dire need of reform.

What I would truly like to learn today is if this series of events in the mutual fund industry is merely limited to particular funds or if these recent scandals represent a more serious systemic problem within the mutual fund industry that might require Congress to enact legislation to correct the situation.

Many believe that adequate laws and regulations exist to police late trading and market timing issues raised in the suits against the mutual funds in question. I am not certain that I want the current allegations of abuse to cause an overreaction of legislation nor regulations to sweep up legal late processing with the illegal allegations. However, like most of my colleagues here today, I would like to learn more about market timing and late trading.

Mr. Chairman, I look forward to the witnesses' testimony and to their views on whether adequate laws and regulations exist to police late trading and market-timing issues. For these reasons and more, this hearing is both timely and helpful.

With that, I yield back the balance of my time.

[The prepared statement of Hon. Rubén Hinojosa can be found on page 131 in the appendix]

Chairman BAKER. I thank the gentleman.

Are there other members desiring to make an opening statement?

If not, then it is my pleasure at this time to welcome to our hearing Mr. Stephen Cutler, Director, Division of Enforcement, for the Securities and Exchange Commission, who is accompanied here today by the Investment Management Director, Mr. Paul Roye, of the Securities and Exchange Commission.

As you are aware, your statement will be made part of the official record. To the extent possible, limit your remarks to 5 minutes for purposes of questions from members.

We welcome you here and look forward to your comments. Thank you.

**STATEMENT OF STEPHEN M. CUTLER, DIRECTOR, DIVISION OF ENFORCEMENT, SECURITIES AND EXCHANGE COMMISSION; ACCOMPANIED BY PAUL F. ROYE, INVESTMENT MANAGEMENT DIRECTOR, SECURITIES AND EXCHANGE COMMISSION**

Mr. CUTLER. Thank you, Chairman Baker, thank you for having me, Ranking Member Frank and distinguished members of the subcommittee. Good morning. Thank you for having me here to testify today on behalf of the SEC concerning abuses relating to the sale and operation of mutual funds.

Chairman Baker, I know you have been a champion for mutual fund reform; and I commend you for those efforts and for convening these important hearings today.

The illegal late trading and the related self-dealing practices that have recently come to light are a betrayal of the more than 95 million Americans who put their hard-earned money into mutual funds. Quite simply, those Americans haven't gotten a fair shake. For too many of them, the phrase "trusted investment professional" was a misnomer, as they weren't worthy of their trust.

The SEC is fully committed to ensuring that those who broke the law are held accountable and brought to justice. That process has already begun. Since Mr. Spitzer announced his action against Canary Partners and Edward Stern in early September, here is what we have done on the enforcement front. We sued Bank of America broker Theodore Sihpol for having allegedly facilitated late trading by some of his clients. We charged Steven Markovitz, senior executive of the Millennium Hedge Fund Group, with late trading and barred him from associating with an investment advisor.

We also obtained an industry bar and imposed a $400,000 civil penalty on James Connelly, an executive with mutual fund complex Fred Alger Management, Inc., in connection with his alleged role in allowing certain investors to market time his company's funds; and we sued Putnam Investment Management and two of its portfolio managers, Justin Scott and Omid Kamshad, who we allege market timed their own mutual funds.

In each of these cases we have worked closely with Mr. Spitzer, Mr. Galvin, and others who have also filed their own charges.

Today, in conjunction with the Secretary of the Commonwealth of Massachusetts, we are announcing still another enforcement action, this one against five Prudential securities brokers and their branch manager. We allege that the defendants defrauded mutual funds and their investors by misrepresenting and concealing their own identities or the identities of their customers so as to avoid detection by the fund's market-timing police. This allowed them to enter thousands of market-timing transactions after the funds had restricted or blocked the defendants or their customers from further trading in their funds.

In addition to these enforcement actions, on September 4, the Commission sent detailed compulsory information requests to 88 of the largest mutual fund complexes in the country and 34 brokerage firms, including all of the country's registered prime brokers; and just last week we sent similar requests to insurance companies who sell mutual funds in the form of variable annuities.

Let me briefly highlight some of the most troubling findings, but I have to point out these are only preliminary and are still the subject of continued active investigation by the SEC as well as our State colleagues.

First, more than 25 percent of responding brokerage firms reported that customers have received 4:00 p.m. prices for orders placed or confirmed after 4:00 p.m..

Second, three fund groups reported or the information they provided indicated that their staffs had approved a late-trading arrangement with an investor.

Third, 50 percent of the responding fund groups appear to have at least one arrangement allowing for market timing by an investor.

Fourth, documents provided by almost 30 percent of responding brokerage firms indicate they may have assisted market timers in some way, such as by breaking up large orders or setting up special accounts to conceal their own or their clients identities, as we allege in the case we filed today.

Fifth, almost 70 percent of responding brokerage firms reported being aware of timing activities by their customers.

And, sixth, more than 30 percent of responding fund companies appear to have disclosed non-public information about the securities in their portfolios in circumstances that raise questions about the propriety of such disclosures.

The Commission staff is following up on all of these situations closely.

I should also point out that we have been actively engaged in enforcement and examination activities in other important areas, many of which have already been mentioned here today involving mutual funds.

The first is mutual fund sales practices and fee disclosures. We are looking at just what prospective mutual fund investors have been told about revenue-sharing arrangements and other so-called shelf space incentives doled out by mutual fund management companies and mutual funds themselves to brokerage firms who agree to feature their funds.

We have already issued a Wells Notice of the staff's intention to recommend charges against one firm based on inadequate disclosure of shelf space fees.

Our second area of focus is the sale of different classes of shares in the same mutual fund. Very frequently, a fund will have issued two or more classes of shares with different loads and other fee characteristics. We have brought enforcement actions against two brokerage firms and certain of their personnel in connection with their alleged recommendations that customers purchase one class of shares when the firms should have been recommending another.

The third area is the abuse of so-called break points. Quite simply, we found numerous instances in which brokerage firms did not give investors the volume discounts they were entitled when they purchased mutual funds.

Yesterday, the NASD and the SEC announced that 450 securities firms were being required to notify customers that they might be due refunds because they were not given break point discounts, that nearly 175 of those firms were being required to conduct comprehensive reviews of mutual fund transactions for missed break points and that a number of those firms were being referred for possible enforcement action. This week, together with the NASD, we will be issuing notices to those firms.

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

Representative Castle mentioned in his opening remarks 12b-1 fees of funds that have closed, and that is another area that we have been looking at.

Before I conclude, I do want to take a moment to address reports that several months ago an employee in Putnam's call operator unit told our Boston office that individual union members were day-trading Putnam funds in their 401(k) Plan.

The SEC receives on the order of 1,000 communications from the public in the form of complaints, tips, E-mails, letters and questions every working day. That is more than 200,000 a year. We have made and are continuing to make changes in how we handle these complaints, including giving more expeditious treatment to those that raise enforcement issues and instituting a monthly review of all enforcement-related matters that come to us by the division's senior management. We have room to improve in this area, and we are going to improve in this area, but, let there be no mistake, the dedication, commitment and professionalism of our enforcement staff are second to none.

In our just-concluded fiscal year, 679 enforcement cases were brought. That is a 40 percent jump from 2 years ago. We accomplished this with almost no increase in resources, and included in those totals are some extraordinary achievements: $1.5 billion in disgorgement and penalties designated for return to investors, using Sarbanes-Oxley fair funds; 60 enforcement actions against public company CEOs; nearly 40 emergency asset freezes and TROs; groundbreaking cases against brokerage firms and banks for their roles in the Enron scandal, against an insurance company for its role in facilitating an issuer's financial statement fraud, against the stock exchange for its failure to enforce its trading rules and against a mutual fund management company for its failure to disclose a conflict of interest in its voting of its fund proxies; the largest civil penalty ever obtained in a securities fraud case; and dozens of financial reporting cases involving Fortune 500 Companies and their auditors.

With the recent badly-needed budget increases you have given us, we have now begun to see additional resources. They allow us to identify problems and to look around the corner for the next fraud or abuse.

With respect to mutual funds, I know that the agency's routine inspection and examination efforts will be improved by adding new staff, increasing the frequency of our examinations and digging deeper into fund operations. We are working aggressively on behalf of America's investors to ferret out and to punish wrongdoers wherever they may appear in our securities markets.

At the same time that the Commission is looking backward to identify past wrongdoers, the Commission has been engaged in a comprehensive regulatory response designed to prevent problems of this kind from occurring in the first place.

My colleague, Paul Roye, Division Director of our Investment Management group, can answer any questions you may have about those initiatives; and I ask that the written testimony that he provided yesterday on the Senate side be made part of the full record of this subcommittee as well.

Chairman BAKER. Without objection.

Chairman BAKER. Thank you very much for your fine statement.

[The prepared statement of Stephen M. Cutler can be found on page 173 in the appendix.]

Chairman BAKER. I now wish to welcome the Honorable

Eliot Spitzer, Attorney General of New York; and on the record I want to acknowledge your good work in bringing to account those who have clearly violated securities law for the benefit of investors. I have nothing but admiration for the work you have pursued for so long and assure you I have no intent to, in any way, inhibit future activities of that sort. Welcome.

**STATEMENT OF THE HONORABLE ELIOT SPITZER, ATTORNEY GENERAL, STATE OF NEW YORK**

Mr. SPITZER. Thank you, Congressman Baker. I appreciate your having this hearing and your kind words.

Chairman Oxley as well, thank you for your presence and your leadership on these issues.

Also, of course, many thanks to Congressman Frank who is a great friend for many years. I appreciate your kind words and support for State jurisdiction and also your reminder that today is Election Day. I will make sure I get home to vote.

I feel compelled to begin by referring back to a quotation I have used elsewhere, but it is, I think, very instructive here. It is one from Paul Samuelson, who was, of course, not only a Nobel Laureate but a firm and wise observer of our capital markets. He said this about our mutual fund industry 35 years ago when we were beginning to piece together the governing structure of our mutual fund industry. He said and I quote: "I decided there was only one place to make money in the mutual fund business. As there is only one place for a temperate man to be in a saloon, behind the bar and not in front of the bar, so I invested in a mutual fund management company."

Unfortunately, even 35 years ago, wise analysts understood that those who were really going to make money were the managers of the funds, not necessarily those who were investing; and they understood the distinction of the dichotomy, the schism that existed between the managers and those to whom they owed a fiduciary duty, those who were investing. That is the problem we were trying to confront today in several different ways.

Unfortunately, the record is now overwhelmingly clear. Despite protestations of purity I think we have heard for several decades from the mutual fund industry, where the industry tried to distinguish itself from other sectors of the capital markets where they would gladly acknowledge there were significant problems, significant violations of fiduciary duty, unfortunately, now we are seeing widespread abuses.

This is no longer a case of one or two bad apples sullying the entire crate. It begins to appear that the entire crate is rotten. When we have numbers that are being generated by the very worthy analysis of the SEC that demonstrates 25, 50 percent of the various funds were participating in or had knowledge of improper activity, we have got to come to the conclusion the problems are structural, they are systemic, and these are not just one or two individuals who are, unfortunately, tarnishing the reputation of others.

The cost to investors has been huge. From market timing alone, academic studies predict that those studies practices are costing investors upwards of $5 billion a year.

The late-trading costs are harder to calculate, but they are, in addition, very, very significant.

We also have the very—the somewhat different issue, which I will address momentarily, disparate fees, where pension fund advisors seem to be paid less than mutual fund advisors for essentially the same services.

And because you, Mr. Chairman, and others have recited the numbers, the vast numbers involved in terms of investment dollars in the mutual fund sector, the mere 25 basis point deferential in advisory fees paid would correlate to a $10 billion loss for investors.

The conclusion is that even small, marginal differences in fees paid correspond to enormous losses in return for investors. As a consequence, your efforts here today are critically, critically important.

What begins to emerge, unfortunately, is an image of 28 distinct sets of rules, one for insiders and one for everybody else, a set of rules for those who are big enough to play, because they know who to call, how to craft a separate arrangement, how to send sticky assets into a separate fund to get preferential treatment, whether it is late trading, timing, at the expense of the small investor whom we were supposed to be protecting.

The other unfortunate conclusion is that boards should have known and—boards could have known and, even with minimal due diligence, boards would have seen evidence of this improper conduct.

With all due respect to the cases that Mr. Cutler's office has made, Mr. Galvin's office has made and my office has made, these are not hard cases to make. It is like picking low-hanging fruit. What that suggests to me is that not only should we as prosecutors have been there sooner but it begs the question, where have the compliance departments been of these mutual firms?

It is an unfortunate tale that we have seen over and over and over again in every corner of the financial services sector. They come before us and they say, trust us. We have compliance departments. We have self-regulatory organizations.

They have failed. They have utterly betrayed the American public, and they have exhausted the reservoir of trust that existed. It is a sad tale, and how we move forward from here is going to be difficult to figure out.

One emblematic moment for me was about a year ago when the mutual fund industry said, we do not want to disclose to the public how we vote our proxies. They said, we know this is your money, but it would be too expensive to tell you how we are voting your proxies.

It was an outrage. It was outrageous.

With a straight face they tried to tell us this was a cost they could not absorb. They are wrong. Thankfully, the SEC overrode them, but the mere fact they would make that argument I think demonstrates the arrogance of the industry and, unfortunately, the callous disregard that they had for the fact that they have a fiduciary duty to those whose money they are handling, the American public.

One final point before I get into two areas of where we can move forward, I believe, and that is this: We had, and you referred to this number, 6 million investors several decades ago, 95 million investors today. We have seen a tremendous democratization of the marketplace. Everybody in this room believes it is a wonderful thing. It has kept our capital markets vibrant, permitted the capital to be there for industry to expand. The question is, have we protected the small investors who do not know how to navigate through the very complicated world of the capital markets?

I think the answer we are beginning to see, whether it is the research issues of last year, where research simply was not accurate which was being disseminated to small investors, or this year, where the mutual funds are, as a colleague across on the other side of the Capitol said yesterday, are routinely skimming money off the top, it has got to be our conclusion we are not adequately protecting the tens of millions of Americans whom we have invited into the marketplace and whose capital we want to see flowing into the marketplace.

Let me make two final quick points if I might, sir:

First, with respect to the particular areas of impropriety we have seen, late trading and market timing, the rules were reasonably clear. There we need vigorous enforcement. We will see it. We are beginning to see it. The laws there do not necessarily need to be rewritten, although I am sure that together we will come up with some ideas. A hard and fast 4 o'clock cutoff, even the industry has proposed that. Everybody in the industry understood it. There we have an issue of enforcement.

The larger issue and the one, Mr. Chairman, your bill was designed to address, and I know it has bipartisan support, is how do we change the governing structure of the mutual fund industry. I think there we need to really step back and ask the question, have the boards properly protected those to whom they owe a fiduciary duty? And the answer is, quite simply, no, they have not. They did not do that job properly.

Although I think H.R. H.R. 2420 is a very good start and moves us in the right direction, there are a few things that I think could be added to it. Some of these ideas are in there in some way shape or form now, but I think it will be articulated with some greater specificity. Let me just roll them off, and I will be done.

The first, we need a uniform, complete, categorized disclosure of the fees that investors pay for advisory services, management marketing services and trading costs. We need it to be done simply, in a way that is straightforward, in a way that is broken out so everybody can understand it and compare it across one fund to another. Much as you go into a supermarket and you see a nutritional chart that tells you how much fat, carbohydrates—I confess I do not look at it too often, perhaps I should—it should be nutritionally sound, there should be an equivalent information disclosure that is readily understood by investors.

We need also to require boards to demonstrate that they have negotiated advisory and management fees that are in the best interest of their shareholders and perhaps—I say perhaps—require that they obtain multiple bids for those services. This is a complicated area, but nonetheless I think we know that the sole bid and nature of these pledges and the fact that you have a Fidelity or an Alger or a Putnam going in and giving to a board only one option and the board then votes on that one option has led to an environment where there is not adequate negotiation over those fees. Hence I think we have the disparity in fee structure that I was referring to earlier with respect to the 25 basis points for services that are paid for.

Third, we can consider—and this would be a complicated issue. We could consider asking management companies or boards to put in a most-favored-nation clause that would stipulate if somebody is providing or getting identical services for a lower fee they be given the lower fee.

It is a standard contract in the private sector. Many people insert it just to ensure they get the benefit of the prevailing market cost of any particular product. It is something that we could consider asking boards to put in, again, as a way to ensure that they get a fair market price.

Perhaps most important we need an independent board chairman. Mr. Baker—Congressman Baker, you alluded to this. It is absolutely essential. Without the board chair there simply will not be the presence of mind on the board to exercise the independence that is required.

I think we also need independent directors. I will leave to Congress to figure out how many and how you define that. Clearly, there has not been independence on the part of the boards of the funds themselves. That is an essential component as we move forward.

I would also suggest that we should—since there has been an abject failure of compliance that perhaps we would want compliance departments no longer to be buried within the management companies or the advisory companies but to have the compliance departments report solely to the independent board chairs. If we can create that separate reporting line, move compliance into an area where they will be independent, perhaps we could reinvigorate their performance.

I think these are some ideas we have had over time. I look forward to participating with the committee on both sides of the aisle. I know there has been enormous interest on the part of many members on this issue, and I look forward to working with you again.

Let me clear up one issue. I have worked stupendously I hope, despite the occasional barbed comment, with Mr. Cutler with the SEC. We share a common objective, we work together, and we look forward to doing so as we move forward.

Thank you.

Chairman BAKER. Thank you, sir.

[The prepared statement of Hon. Eliot Spitzer can be found on page 228 in the appendix.]

Chairman BAKER. Let me continue with the line you brought up with regard to independent chair and compliance officer. I suggested yesterday to members of the Senate committee that we have a requirement for a fund to create a compliance officer responsibility that reports directly to the independent members of the board.

It would seem from your work that there were clear violations of existing statute. In some cases, individuals who were engaging in wrongdoing were actually told by their managerial superiors to stop and do no longer; and the actions continued anyway. In that case, it almost really doesn't matter what the law says, if you have a person intent on breaking it, and that is why we need strong enforcement authority to go after those folks.

The more difficult area I think is reflected in your comment as to the overall structure and countermeasures that might be needed to be created to keep good people good, so that somebody's always watching the shop. Then, on top of that, a disclosure regime, perhaps the comparability standard you suggest, but the ability of an average investing person to look at what they are being charged and understand the net value returned and to have that comparability between funds.

So three targets: One is to understand from your perspective—and I think you perhaps initially indicated—are there any changes in statutory provisions with regard to criminal misconduct that the statutes do not currently enable you to pursue; secondly, what other mechanisms beyond the independent chair and the compliance officer might you think advisable as this committee goes forward; and then the review I have suggested in the legislation of a model thousand dollar investment being used as a standard for all fees to be deducted to show the recipient of the fund return exactly what they were charged and for what reason.

Some have suggested that we need to go to an actual hard dollar calculation per every account. I have some concerns about that because of the complexity of doing so and the cost related—legitimate cost related to that calculation, and it is just a boilerplate thousand dollars or $10,000 sample sufficient for your purposes.

Let me express my appreciation for your support of H.R. H.R. 2420 and the independent chair.

You want to hit those three things quickly?

Mr. SPITZER. Sure, I will try.

With respect to existing statutes, I think I can fall back on the Martin Act, which is perhaps particular to New York. We have not had an absence of statutory authority, because we obviously are in a position to invoke New York State law as well.

Having said that, I believe that every case where we have found wrongdoing constitutes straightforward fraud under the Federal securities laws, and I would defer to Steve's views on this as well, but I think we have not disagreed that every case where we have brought charges or have wanted to have brought charges there has been a sufficient predicate in the existing civil or criminal jurisdictions granted under the Federal securities laws and consequently I am not sure we need to expand the straightforward definition of fraud under—in 10b of the securities laws that has served us well for—I do not know—70 or so years, now.

Having said that, I think at perhaps a regulatory level the SEC will consider refining the rules relating to the 4 o'clock cutoff in terms of the NAV or pricing mechanism. I do not want to speak for them, but I think that is an area where some additional rigidity will lend guidance, although I do not want to suggest, in any way, shape or form that any of the misdeeds we have highlighted can be attributed to a misunderstanding of what that law was. There simply is not an ambiguity there that provides a defense for the acts we are charging.

So, yes, I think there are some forward steps we can take, but I think we also have a broad framework that permits us to charge fraud.

In terms of the director issues, I think let's move forward, certainly, by getting independent directors and independent compliance department, additional disclosures.

I think that the issue that you frame as a $1,000 model portfolio is perhaps better because of its simplicity as compared to the individualized determination of the individual portfolio of the investor. I guess I am tempted to say I am an agnostic on that.

I would like to see what these pieces of paper look like. Maybe it is a matter of doing both.

Maybe it is a matter of driving home—I think the argument that is most powerful to investors is when they see what the compound interest effect is over time of the differential and fees. I have often said that compound interest is the eighth wonder of the world. Many investors will say, the 25 basis points on a $1,000 portfolio is only $5, and I am happy. I am not going to switch from one fund to the next because of five, whatever it might be. I think when investors see what the net impact is over a decade of investing, that is when it is driven home to them how dramatic this impact is.

Perhaps what I would add to that is a time horizon that would show that if fees are set at this point, which they are, right now, your portfolio, based on a projected return at the end of the decade would be why, and if fees were 50 basis points lower or 25 basis points lower, here is what your return will be. Because only then can it be driven home for investors how much this will really cost in a calculation.

And I think these numbers are right. Somebody has estimated if you were to do that 25 basis points over 10 years for a $100,000 portfolio, the impact of that would be $6,000, $6,000 over a 10-year time horizon. So I think at that point people say, wait a minute, if this is $6,000, I will either go to my board and say negotiate harder or I will switch to a different fund with lower fees. So it may not be a static analysis at this 1-year time frame, what is it, but perhaps over a longer time frame, what would the impact be on the investor?

Chairman BAKER. Let me just address one other question raised earlier. You and I have recently discussed the issue of SEC primacy with the regard to the States Attorney's General's abilities to pursue wrongdoing. I think I have made clear that I have no intent nor make no effort to, in any way, impair your ability to go after wrongdoers. However, there may be a triggering mechanism that we can mutually pursue that would put Mr. Cutler or the appropriate SEC person at the table when a market structure issue is going to be determined. Not that that in any way precludes you from making that judgment, but in consultation with.

Now, we haven't reached agreement, we don't have language, but I merely want to establish on the record we are working together to seek a standard which would be operatively successful from your perspective while enabling the SEC to express its opinion.

Mr. SPITZER. Mr. Chairman, thank you for raising that issue. I suppose in moments of weakness I acknowledge that the SEC is the primary enforcer in the securities markets, and I will concede that point.

Chairman BAKER. Brilliance comes in flashes.

Mr. SPITZER. It does, indeed. I have not been willing to concede that we need to install a new triggering mechanism. I have often believed our press releases are sufficient and Mr. Cutler sees them and reacts. We have, I think, in New York, a good record of enforcing the law and bringing the SEC in to cases when our negotiations with defendants, in the context of injunctive relief, would begin to impinge upon market rules that we believe are the SEC's primary domain.

Having said that, I believe that the current law is sufficient to ensure that there is a fair dynamic between the SEC and state regulators, the 80-plus years where there has been this duality of enforcement. I cannot think of a single case where a State has acted in a way that has created a rule of law or a regulatory conundrum that the SEC has needed to respond to in the context of an enforcement action.

The concerns that have been raised have led to conversations between the SEC in not only New York, but all the States to make sure that there is an adequate flow of communication back and forth to ensure that we don't, as we move forward in our increasingly integrated capital markets, stumble upon or create such a situation where there would be a problem.

So, to sum it up, I am comfortable that the law, as it now exists, is absolutely adequate; we do not need to try to craft anything legislatively that would address this problem. I am always happy to work with, in fact, believe it is my obligation, and the obligation of any enforcement entity at any level, to work with the SEC and others to ensure that we continue to not disrupt the markets in any way inadvertently. But I believe we are moving towards an understanding of how that communication should work.

Chairman BAKER. And to put further point on it: You do not wish to write national securities law as a States Attorney General.

Mr. SPITZER. No, we have never tried to write national securities law. That is the domain of Congress and the regulatory authority. Congress, at the legislative level, Congress—and the SEC at a regulatory level.

Having said that, we, in our injunctive relief, have always and will continue to need to craft measures that respond to the nature of the abuse. Those injunctive measures that we negotiate with individuals who have committed either civil or criminal wrongs obviously cannot, because of the supremacy clause, be inconsistent with Federal law. Sometimes they supplement obligations and we impose additional obligations on malefactors because they need additional compliance programs or other measures ensure they don't break the law as we go forward.

So we have been very careful not to write rules that apply to the national markets. Obviously, last year in the global settlement with investment banks we only did that because we had the SEC with us, and therefore we were crafting a larger rule that applied to a significant number of entities. But we will, in our injunctive relief, obviously need to impose measures on firms that perhaps vary from, though are not inconsistent with rules and regulations that have been crafted by the SEC.

Chairman BAKER. Thank you.

Mr. Cutler, Mr. Spitzer has exhausted our time, so I will come back to you on the next round.

Mr. Frank.

Mr. FRANK. Mr. Chairman, let me just say to Mr. Spitzer, there is one other area where you are in specific agreement with the SEC when you say you can't think of a single case where State regulators have interfered with the need for a national market. Neither can the SEC. I asked Mr. Donaldson that his last time here; he said he couldn't think of one, he would check the records. And I haven't heard from one yet, so I think that we are in agreement.

But there is still pending a bill—and there is a legitimate disagreement here and that is still pending with regard to State authority. And I want to get your specific response, because Mr. Spitzer has, in the past, been critical of some of your efforts. And I am glad that we seem to be moving toward some agreement, but the SEC enforcement bill that I mentioned, when it was introduced by Mr. Baker, he spoke highly of the bill, and I thought it did a lot of good things, and as I understood, they were all from SEC.

By the way, that particular bill that we are talking about, the one that is being held up while we still wrestle with the preemption issue, it has on page 11, section 3, Investment Company Act of 1940, increasing penalties, strike 5,000, put in 100,000; strike 50 and put 250; strike 50 and put 500,000. And then enforce the Investment Company Act, strike 5,000 and put in 100,000; strike 250,000 inserting a million.

In other words, this bill contains significant penalty enhancements, which I think we ought to have. And I don't think it ought to be held up over what is dwindling dispute over preemption.

But let me ask you, though. The bill that we have before us—and by the way, the proposal that was put forward to restrict State authority didn't just restrict their authority vis-a-vis the SEC. On page 25 of H.R. 2179, it talks not just about the Securities and Exchange Commission, but by any national security exchange or other self-regulatory organization, this bill would preempt your ability to add requirements where a regulatory organization—and let me ask you whether this would be an impediment to your enforcement efforts, Mr. Galvin's, and many other State officials. And I am quoting:

No law, rule, regulation, judgment, agreement, or order may establish making and keeping records, bonding, or financial or operational reporting disclosure, or conflict of interest requirements for brokers, dealers, et cetera, that differ from or are in addition to the requirements in these areas established by the SEC or any national security exchange or self-regulatory organization.

I don't think we are contesting—I hope nobody would try to contest. You can't differ with them, the supremacy clause. As Earl Long once said to the racist: The Feds have got the atom bomb; you don't win that fight.

But where there is silence, where either a regulatory organization or the SEC hasn't done anything—and we are not talking here just about laws, rules, and regulations, but judgments, agreements, or orders. Would enactment of that language significantly interfere with your ability to do your job?

Mr. SPITZER. Yes, it would. And I think you have zeroed in on two of the particular portions of the amendment that would be, in fact, were problematic to me. It was the extension not only from the—of drafting that extended the prohibition not only to SEC rules and regs, but also anything emanating from an SRO. And I think that was fundamentally, I won't say perverse, but it was intentionally problematic to me because the SROs have been failed regulatory organizations. I think we can see that.

Mr. FRANK. And I would say since then, as we have seen with some of the SROs, it has gotten problematicer.

Mr. SPITZER. Problematicker. Exactly. I will have check the source for that word, but it has been——

Mr. FRANK. We have a certain rulemaking power here.

Mr. SPITZER. Okay. I will defer to you.

The other area, the other words in there that were problematic to me—problematicer—were in addition to. And I think that is where I really stumble, because obviously we cannot do anything inconsistent, we wouldn't want to, we wouldn't try to, we shouldn't. But in addition to is where in injunctive relief we often impose upon malefactors, obligations that do differ in, from and are in addition to, because——

Mr. FRANK. In other words, it seems to me that language—and again, that was put forward. That is what is holding up the bill that would enhance the penalties that I just read. It says, in effect, going forward, you can't treat an offender differently than you treat everybody else. I mean, when you talk about it—it is not a rule here. And, again, I repeat, I hope we would drop that and go forward and bring forward on to suspension that SEC bill.

Now, on the mutual funds. I want to acknowledge a change of heart here. On the independent compliance officer, I believe that is in the bill; I am all for it. Most of what is in the mutual fund bill went through this committee without objection, and as far as we were concerned, was ready to go to the floor. We did raise some objections to the independent chairman requirement being imposed on mutual funds only. That was the one I had. I must say, it was probably because I had not seen independent chairs elsewhere in the corporate world being much of a safeguard, but I am guided by what you and others have said, and I am now prepared to say, given the crisis we have seen here, we can go forward with that. I also agree with the chairman, who brought forward—the chairman of the subcommittee—some additional factors that have come out because of your investigation. So we are ready to go forward.

Let me ask Mr. Cutler now. On the question of the SEC and the extent—what can we do to help? Let me ask you in particular: We fought hard to give the SEC more money and more flexibility. Is that a transitional problem? You just couldn't hire all those people at once? Is it too much money overall? What can we expect? Have we overappropriated for you, or did we just give you too much to eat too quickly?

Mr. CUTLER. I certainly don't think you have overappropriated for us. I mean, I think the Commission was starved for a long time, and with this committee's help, I think we finally got some of the resources that we have needed. We obviously want to go about the process of hiring people in a way that is appropriate and deliberate and thoughtful and intelligent so that we can get the right people in the door to do the job that we need to do. And we are in the process of really ramping up. We obviously couldn't do that the day the money came in the door, but we are well on our way to getting——

Mr. FRANK. I figured that—in fact, if you go back to the debates, those of us who were pushing for the additional money over and above what the administration was asking for and appropriated for voting, pointed out that there would be a time lag. So we weren't talking about a couple months, but the 6 or 7 months after that.

But you answered the essential question, which is, the fact that you did give back some of the money—and I appreciate that. If you can't spend it wisely, yeah, it is a good idea to give it back. That should not be held in the future to mean that there is a permanent limit. It was a temporary inability to spend the money for the staff, and the appropriate staffing levels should then go back as you are able to do that.

Mr. CUTLER. I couldn't agree with you more. No one wanted the agency to spend the money in a way that was unwise; but that doesn't mean we wouldn't want the money or need the money.

Mr. FRANK. As you know, we did collaborate with you in doing legislation that gave you more hiring freedom.

Let me ask now about H.R. 2179, the bill that is being held up as we debate the preemption issue. How important is that? My understanding was that those were mostly thinking that were requested by the SEC. And what is your assessment? How helpful would it be if we were to pass H.R. 2179? Which again I would hope we would do quickly on suspension.

Mr. CUTLER. I think many of the enhancements in that bill are very important to us, but more importantly to the investing public. They increase penalties, they allow us more flexibility to get penalties in administrative proceedings, they allow us to go after money that we otherwise couldn't under current law because of homestead and other exemptions. So there are a lot of important pieces of that bill.

Mr. FRANK. I appreciate that. And as I reread the bill, there are a couple of sections in there that specifically enhance the authority both to get the penalties and increase the penalties with regard to mutual funds. So, yes, I think that something that we ought very much to deal with.

Finally, for both or all three of the witnesses. We had a mutual fund bill that, as I said, passed this committee unanimously with differences only basically over the independent chairman. I am prepared to concede now we should go forward with that. The chairman has got some other provisions. Are there other statutory changes? Have you, between you, proposed all that you have? Obviously, it is important to note some of these things were already illegal, and that is why H.R. 2179 is important, because it is one thing for it to be illegal, it is another for there to be a serious penalty to the point both—and people should understand, when we are talking about the seriousness of penalties, this applies both to the incentive to the regulator to go after it but also to the deterrent effect. So we want to get the—let me just put it this way. If there are any others, send them forward.

Let me go back to the philosophical point—it is Election Day—Mr. Spitzer. And I really mean this one very strongly. I think it is very relevant, because in our culture, elected officials are often compared unfavorably in intellect, integrity, devotion to the public duty to high-level appointees. We are necessary to the system, but people sometimes almost wish that we weren't. And there was an argument particularly as you get sort of arcane. After all, we are not talking basic arithmetic here. When we talk about market timing and late trading and there are a lot of fairly complicated and sophisticated things going on. Like trading, maybe not, the difference between 4 o'clock and 4:30 is easily grasped, but some of these other issues are a little more complex.

I would ask Mr. Spitzer if you would reflect on the fact that it was yourself, Secretary Galvin, and some others who were elected officials who took action here. And let me throw out a hypothesis that just really occurred to me as I was thinking about this, and it is just the beginning of a thought. And that is, the SEC plays a very important role. It is the national regulator. It is charged with keeping the system working. And I am wondering whether there might not be a tendency for the appointed national regulators with their very heavy responsibilities to focus more on systemic risk, to focus more on the overall functioning.

What you and your colleagues in the State level have done here, to a great extent, is to focus on unfairness to individual investors. In some cases, there were losses that offset gains. But the primary thing that comes out of the most recent things is that it is the small mutual fund investor. Someone who is in it through his or her retirement plan, or has relatively small amounts of money, is not sophisticated enough or is smart enough not and try to make stock picks on his or her own, or as in the case of some of us, have so many conflicts of interest; if you try to buy an individual stock, that you had better buy mutual funds so people don't start yapping at you about anything else.

But do you think that there is something to the fact that elected officials would be particularly sensitized to the question of the role of the smaller individual investor, as opposed to a focus on the broader systemic issues? Not that you would do one to the exclusion, but that the necessary focus on the systematic issues could diminish some of the attention given to the little guy.

Mr. SPITZER. I think there may be some merit to that analysis. I think that it is certainly ingrained in the tradition of the attorneys general across the Nation, that our primary focus has been protecting the smaller consumer; the individual consumer has a grievance; and as a consequence, sometimes some of the issues that will arise that will make their way to our plate would fit that paragon and are therefore somewhat distinct from what the SEC might look at.

I think there has been—let me just add this one last reflection very quickly. I think there has been a very healthy dynamic between States and the SEC over the decades and in reinforcing each other. Where one has perhaps failed to see something, the other picks it up. And I think that is the healthy nature of the federalism that we have established, and I think maintaining that proper balance is something we all strive to do, and working at it is something we are obligated to do.

Chairman BAKER. The gentleman's time has expired.

Chairman Oxley.

Mr. OXLEY. Did the Chairman wish for me to yield briefly?

Chairman BAKER. If the chairman so desires.

Mr. OXLEY. Sure.

Chairman BAKER. Mr. Spitzer, returning to the point at hand relative to the features of H.R. 2179. And Mr. Cutler as well. It does provide enhancements. It does provide national notice of service, for example, doing away with the geographic limit on service. Some good things.

Has the lack of passage of H.R. 2179 failed—caused you to fail in bringing to justice anyone who has been found to violate the law?

Mr. CUTLER. No. I think these are important enhancements. But do I think I have some very powerful and critical tools already? Of course we do. And that is why we are bringing the cases we are bringing.

Chairman BAKER. And then with regard to H.R. 2420, Mr. Spitzer, I think you generally agree it is a good start; it may need enhancements, we may need to do more. Along the lines of your suggestion of the independent Chair, I had others where you should not have simultaneous management of a hedge fund and a mutual fund by the same managers, those kinds of issues. But on its face, H.R. 2420 is plowing new ground.

Mr. SPITZER. Absolutely. And I think it is a wonderful step forward.

Chairman BAKER. I thank the gentleman and I yield back.

Mr. OXLEY. Thank you, Mr. Chairman.

Mr. Cutler, I wonder if you could describe, first of all, to a layman the difference between legal market timing and illegal market timing.

Mr. CUTLER. I am glad you asked, Mr. Chairman, because there is something of a misperception. Some people have a sense that all market timing is illegal. And market timing, just to remind everyone, is the practice of buying into and selling out of funds on a rapid basis, buying into a fund today and selling it tomorrow. And on its face there is nothing illegal about that. And the question is, does it violate, or does the fact that a mutual fund management company is allowing it to take place, does it violate a promise that the mutual fund company made to investors usually embodied in a prospectus that would say something to the effect of, we are not going to allow this practice. And if a mutual fund management company says we are not going to allow it, and then they allow it, that is a violation of law. And certainly among the cases that have been brought so far, that is one type of violative market timing conduct.

Mr. OXLEY. And does that tend to be boiler plate with most of the prospectuses?

Mr. CUTLER. Certainly a good number of them say we don't allow it, we prohibit it. Now, there are some that say—and one example is Putnam, which is a firm that we have already sued in connection with the trading of its port—market timing of its portfolio managers. What Putnam said was: We don't like timing, and in order to stop it or to discourage it, what we do is we impose redemption fees so that if you are into and then you immediately get out of a fund, we are going to make you pay a 1 percent penalty.

But then the prospectuses go on to say, but you know what? We are not going to impose that kind of restriction on 401(k) plans. And that makes for a much different kind of situation.

Mr. OXLEY. Okay.

Now, Mr. Spitzer, you had said that the fund directors could have short-circuited this with due diligence in terms of market timing. That is correct?

Mr. SPITZER. Oh, absolutely. And the reason for that, sir, is that if you were to look at the redemption rates and the ratio of redemptions to the underlying asset value, what you would often see in some of the funds where there was the most frequent timing by outsiders—or insiders, for that matter—is that the rate of redemption so far exceeds the underlying asset value that you know that there is a cycle, that there are people trading in and out more rapidly than should be permitted, and, therefore, at a minimum, inquiry should have been triggered.

Could I add one more notion to what Steve said? And this in no way disagrees with him, but this is maybe in addition to what he said.

In addition to the prospectus, there is also the issue of insiders doing this when outsiders are not permitted to do it, which obviously would be impermissible. And also, whether payment was made under the table—and that is not cash under the table necessarily, but whether some other quid pro quo was being offered in order to induce behavior that might have been permitted, might not have been permitted, such as the sticky assets that were referred to, that have been referred to so often, where people would say, we will put $100 million into a bond fund if you let us tie into your international fund. Those sorts of payments also add another issue, that would obviously make this improper and illegal behavior.

Mr. OXLEY. Improper and illegal?

Mr. SPITZER. That is correct.

Mr. OXLEY. Why did the fund directors—in your estimation, why did the fund directors fail in this regard?

Mr. SPITZER. I am not—I am always loathe to address issues of motivation. I believe, and I think it is fair to say in some cases they didn't address it because they themselves were the ones who were doing the timing. I think those are the cases that have been most egregious to us and most just jarring in terms of violation of fiduciary duty, where you have the CEO of one fund, who himself was timing his own funds to the detriment of investors, and, in fact, sent the timing police—they have what they call timing police who are supposed to detect it.

He sent the timing police off on one beat and then he traded in a different precinct. I mean, this was a guy who was really Machiavellian in what he was doing in a way that was a gross betrayal. I think there it was an intentional oversight. I think in other cases, it may have been a lack of attention, which is why what we are hoping to do is to get boards and compliance departments to wake up and look at something that they should have been paying attention to, because these issues have been addressed in the academic literature and in the trade journals.

Mr. OXLEY. Mr. Cutler, the obvious question is, where was the SEC during this time? And what tools do you have to be able to spot that kind of activity?

Mr. CUTLER. And I think that is a fair question. I am not charged with responsibility for our examination and inspection program, but I have done some thinking about this. And I suspect that one of the things that was happening—and I am just trying to put this in some sort of context—is that this was going on at a time when the mutual fund industry, interestingly, was beseeching the Commission to give it more tools to combat market timing: We don't like market timers. Help us beat these guys back. Give us more power to impose higher redemption fees. We don't like timing.

And so I think—and, you know, I am speculating here. My sense is that people weren't at the time thinking, gee, mutual fund companies are going to be complicit in something that they are telling us they are trying to beat back.

Now, I think in hindsight obviously, you know, do we wish that we had identified this problem earlier? Absolutely. And, you know, I am confident that with the additional resources that we have gotten and are in the process of getting and Chairman Donaldson's risk assessment program that we will be in a position to identify these issues like this before they come up.

You know, by definition, once we bring enforcement actions, the wrongdoing has already occurred. Right? And so in some ways, you are always following the misconduct. And I think the challenge that we have is to identify problems like this, potential problems like this before it is ever necessary to bring a law enforcement action.

Mr. OXLEY. As a practical matter, it would be virtually impossible for the SEC or the Congress to essentially outlaw market timing; correct?

Mr. CUTLER. Well, in fact, I don't know that you need to. Because we where it violates a prospectus term, I think that is a violation. As Mr. Spitzer added, where you have got situations where you are trading off something that is to the advantage of the advisor, and potentially to the detriment of shareholders, we have got the power to go after that. And I think Mr. Roye, on behalf of the regulators at the SEC, is working on sort of beefing up what it is that mutual funds would be required to disclose vis-a-vis their market timing policies.

Mr. OXLEY. And that, coupled with a high redemption fee or a substantial redemption fee, in your estimation, would at least begin to solve that problem?

Mr. CUTLER. Again, I am tempted to defer to Mr. Roye, if I could.

Mr. OXLEY. Of course.

Mr. CUTLER. Because he really knows the policy. When people violate the law, that is when I go after them.

Mr. OXLEY. Mr. Roye.

Mr. ROYE. I would be glad to address that.

I think that you hit on several solutions to the problem. I think the way we look at it, there have to be multiple pieces to the solution here. Steve alluded to the disclosures. Quite frankly, the disclosures are not specific enough in some cases. We want funds to disclose exactly what they are going to do to curb market timing activity, when they are going to do it, and when they are going to make exceptions to that policy. So, one very clear disclosure.

Mr. OXLEY. And the SEC can do that, clearly.

Mr. ROYE. And we have the authority to do that, and we are working on form changes currently to effect that change.

Now, if you really want to eliminate market timing, the economists will tell you that the way to do this is to eliminate stale pricing. It is that timing and international funds, where you are buying securities, where the market closed 10, 12 hours earlier, and you have pricing at 4 o'clock, that arbitragers are trying to take advantage of that difference in the pricing, inefficiencies in the pricing. And so what we said to the funds is that they have an obligation to fair value price the securities in the fund's portfolio.

Now, you are moving from an objective market closing price to your estimate of what you think that security is worth in light of significant market moving type of events. We have told funds they have to do this in a staff letter that went out in 2001. We are looking at recommending that the Commission make a very firm statement in this area to eliminate the possibility of market timing activity. And then on top of that, we have been looking at, again, giving the fund industry additional tools to thwart the market timing activity such as mandatory redemption fees.

Last year we did a letter for the industry allowing them to delay exchanges since a lot of that activity is moving from one fund to another. So we see a multifaceted approach. And then last but not least, a role for the board of directors here in overseeing this activity, monitoring the types of information that Attorney General Spitzer talked about in overseeing this activity.

And then the addition of a compliance officer, which was part of Congressman Baker's bill to oversee and help the board in monitoring that activity.

Mr. OXLEY. Thank you, Mr. Chairman.

Chairman BAKER. Mr. Emanuel.

Mr. EMANUEL. Thank you, Mr. Chairman.

In my opening statement, I made reference to the late 1990s hot IPO market. And I was wondering, Mr. Cutler or Attorney General Spitzer, in any of your investigations or any of the issues that you are looking at, have you seen any preferential treatment during that period of time where the philosophy of managers wins, investors loses dominated how those IPO allocations are done? And I don't want you to tip your hand if you're already investigating.

Mr. SPITZER. And I won't do that. Thank you for the admonition. Last year—and I think Steve would agree with me on this—we spent a great deal of time looking at the IPO issues related to—issues relating to spending distribution of hot stocks and the uses—the improper uses that were made by investment banks and the distribution of those stocks, the ulterior motives that underlay the distribution most frequently in our experience last year to CEOs of client companies, where we believed—and I still believe that the spinning is violative of the fiduciary duty of the CEO to the company; it should be a corporate asset, if anybody gets it. But also the question arises, how were the investment banks that are doing the underwriting making the determination about the distribution of those hot stocks; and, as a consequence, as part of the global resolution that was signed, I believe, last Friday by a Federal judge, there is an outright prohibition on the receipt of hot stocks by CEOs of publicly traded companies.

Now, we did not last year, that I am aware of, nor have we yet investigated the interception of spinning with mutual funds, but certainly it would be a fertile area to examine. And I take your point, and we will do so.

Mr. CUTLER. Well, I guess I would start by saying, first there is an NASD rule that expressly prohibits an individual associated with a mutual fund from receiving a hot IPO.

Having said that, we have already brought cases involving the allocation of IPOs within a fund complex or that—to be more specific, I can point you to a case we brought called Nevis Capital, where what we allege is the managers actually in that case, interestingly, were directing hot IPOs to a fund; and the allegation is that they were doing that to the detriment of some of their other customers for, in some way, their own benefit, that is, that they stood to receive more fees if the mutual fund did well. They thought that that would bring in more investors. So, interestingly, in that case they were favoring a mutual fund over other customers.

We have brought other cases involving the failure of some fund companies, including Van Kampen and Dreyfus to adequately disclose that their performance was heavily influenced by the receipt of IPOs.

The one thing I think we haven't seen is precisely the point that you were making. That is, that managers were taking IPOs instead of giving them to mutual funds. But certainly the area of whether IPOs are equitably allocated by investment advisors has been a topic that the SEC has been concerned about and has brought cases on.

Mr. EMANUEL. As we think about this legislation and the rules of the road we want to write. Do you think there is any conflict of interest in the ownership of the mutual funds? That is, have any of these problems happened because insurance companies or commercial banks have now gone into this area? Do those types of ownership structures create any problems related to the management and the operation of mutual funds?

Mr. CUTLER. Well, certainly among the allegations in the cases brought so far are conflicts between brokerage firms that are affiliated with mutual funds. Indeed, as I mentioned in my oral statement, we have been looking very closely at whether there is adequate knowledge on the part of customers and disclosure to customers that when they are dealing with a brokerage firm that they understand that that brokerage firm may be making money as a result of the sale of the mutual fund that they are recommending.

So, I mean, I take your point. I mean, there are some conflicts here. I don't know how sort of far out they reach, and maybe Mr. Roye has a sense of that.

Mr. ROYE. I was just going to refer to Mr. Spitzer's complaint. If you look at the complaint in the Canary case, a beautifully drafted complaint that the New York Attorney General did, I think it laid out just those kinds of conflicts within the Bank of America situation where you had deals being cut to benefit other parts of that organization at the expense of mutual fund investors; and I will let Mr. Spitzer address that.

Mr. SPITZER. Thank you for the compliment on the drafting. I didn't do it.

But it is vertical integration that often leads to these conflicts, and it is vertical integration that can twist the incentive structure so that you will have an effort to sell improperly, or also, in a more mundane way, vertical integration that will permit information flow such that it facilitates processing of trading patterns. And, indeed, in the Canary context, that was very integral to what happened. It was easier to integrate the information and process the trades because of the vertical integration of ownership. Now, that does not mean that we want to eliminate that vertical integration, but certainly it means that it raises issues that have to be thought through.

Mr. EMANUEL. As we look at this, one of the patterns we should closely study is how ownership structure has related to any conflicts of interest. Obviously, we are not going to regulate that insurance industries can't own mutual funds or commercial banks own investment banks. But we may need to take a look at creating not new walls but new rules of the road relating to cross ownership and the cross selling that goes on, so that the product lines don't create internal conflicts of interest in the future. Do you have any guidance on this issue?

Mr. CASTLE. [Presiding.] Could we keep the answers brief, please, so we can keep moving?

Mr. CUTLER. I would certainly say that where there are conflicts that haven't been managed appropriately we have the power—I know Mr. Spitzer has the power to go after those conflicts and ensure that those who don't appropriately manage them are held accountable.

Mr. EMANUEL. Do I have time for another question?

Mr. CASTLE. We will have a second round, Mr. Emanuel. We would like to get through everybody first, if we could. Since I have deposed the chairman temporarily here, I yield to myself for 5 minutes. I am kidding. I was next anyhow.

Let me ask you this, Mr. Spitzer. You have been pretty critical of the SEC enforcement activities, ripped them, I would say, in some cases, and lately, yesterday in the Senate and here today a little bit you are making nice. It has become sort of Steve and Eliot and everyone seems to be getting along. Is there a reason for this? Do you have a different view of what they are doing? Or is Mr. Cutler doing such a wonderful job that you have been won over? Or are you just mellowing in your older age? It is helpful to us to have you this way.

Mr. SPITZER. No. Well, let me be very serious about this. I have at various times articulated I think a frustration that we might all feel and probably all do feel that if the abuses are as widespread as the evidence is now suggesting they are—and indeed I think the SEC's examination and the data that Mr. Cutler revealed yesterday suggests whether 25 or 50 percent in different context of wrongdoing, there is a wealth of wrongdoing that could have been caught and should have been caught by compliance, by boards, by regulators, by prosecutors. There is a frustration we all feel, obviously, that we didn't catch it sooner.

As a consequence, I think at different times I have asked the question not merely because it is fun or meant to be a barbed comment but I think a question that deserves to be asked of law enforcement is what do we have to do differently in order to catch it next time? Therefore, should we be doing something differently so that this problem does not expand to its current proportions before we intercede as well?

I think it is in that spirit that I have tried, perhaps not always as gently or deftly as I might, to say we have to examine our own processes.

Mr. CASTLE. Let me ask Mr. Cutler sort of a follow-up. How do you feel about where the SEC is right now? I mean, I am also somewhat critical of what I thought was a rather lax enforcement before. Obviously, we are all at a heightened awareness now than we were before. Do you feel that, without even starting to change laws which are clearly going to do with the regulations, do you feel that the SEC is up to where it should be in terms of the enforcement? And do you feel that we should clearly have both a State and a Federal component to this? I happen to agree with that, but I would like to hear your views on that briefly, if you could.

Mr. CUTLER. Sure. Well, first, let me say I don't think enforcement at the SEC has been lax, as I mentioned in my opening remarks. We have an obligation to be everywhere in the marketplace, and I think the 679 cases that we brought last fiscal year reflects that. I do think where we have room to improve is are we doing a good enough job identifying potential problems? That is, once we have identified them, I think that we are second to none in going after them, investigating them, litigating them, bringing the accountable people to justice.

Mr. CASTLE. But identifying is an important part of that is—not to argue with you. But identifying is an important part of that. I mean, that is not something you just sort of gloss over. I mean, clearly if there are market-timing issues, and we saw some problems in New England and places like that, you can't just say, well, we weren't good at identifying them.

Mr. CUTLER. Right, And I agree with you. Identifying is very important, and I think we are taking steps to get much more proactive in that area. I know within the enforcement division itself we have decided actually to bring to the division people that have subject area expertise, that is, people who are more tapped in to what is happening in the trading and markets area, who are more tapped in to what is happening in the mutual fund area, more tapped in to what is happening in the corporate accounting and disclosure area, so that we can be better at seeing around corners. And I am determined to do that. With your help, we have gotten more resources, and I think we are getting there.

Mr. CASTLE. Thank you.

Mr. Spitzer, I am going to go back to a different subject. I own some shares of companies. I get these proxies in the mail about electing directors, and what is my 150 shares worth, and I frankly generally throw them out. We are talking about electing independent—you are talking about electing independent chairmen of the various mutual funds. We can define that—I have no problems with that, somebody who doesn't have ownership or whatever, and we can define the word independent. But the actual election process sort of bothers me.

I assume that most of the mutual funds are incorporated under your State laws, or mine, for the most part, and perhaps others. But, you know, is it going to be done by a proxy business, or is it just going to be independent in that the person doesn't have a direct interest in it but happens to be a good friend of the person who is doing it? The nomination process corporately and mutual fund-wise is so protective of those who are sending out proxies and election statements it is almost impossible, in my judgment, to get the true independents we would like to see.

Personally, I would like to have John Bogle running all of my mutual funds, if I had my druthers, but I don't think that is going to happen. But how do we get that done? I mean, I don't see—I think most mutual fund owners don't even understand they have ownership rights or voting rights in any of these things, much less actually really go to the level of independence that some of us are talking about. I am all for it, but I am worried about being able to really do it.

Mr. SPITZER. I agree with your concern. We have to breathe life into a statute, that you can define independence as aggressively as you wish, but, nonetheless, if you have somebody there who doesn't bring enough aggressiveness to the job it won't mean a great deal. I think this is where we have to—and this is perhaps why I was also suggesting we would want to build into the statute some objective rules which would govern precise activities, such as most-favored-nation clause, such as multiple bids.

In other words, if we really believed an independent board was going to act independently, you could stop right there and say, we want an independent board, boom, full stop; and everything else would follow based upon their behavior. If we—we all share, I think, your concerns to a certain extent, although I think the right people will fulfill that mandate, and certainly prospectively they understand what that job requires. I think if you add to it certain additional requirements, such as I have already mentioned, maybe that will give us certain benchmarks by which we can measure their behavior or minimum thresholds that they would have to satisfy.

Mr. CASTLE. Thank you, Mr. Spitzer.

Mr. Scott is recognized for 5 minutes.

Mr. SCOTT. Thank you very much.

Let me ask you—going back to the debate with Mr. Frank and Mr. Baker on the deterrence and restitution issue, it seems to me that national markets should have a single regulator; that given the ability of 50 different States to override Federal laws just doesn't seem to make sense; that there should be a uniformity in our markets; but yet, bearing Mr. Frank's point, that we should preserve the State authority to investigate, to prosecute securities fraud, collect the penalties, and discouragement funds. Is that at the end of the day—because I do know that you and the SEC will be getting together later today. Is that by—to look into the future, is that what we are going to wind up with? Doesn't that make sense?

Mr. SPITZER. Yes, it does. That is why I think I began my comments earlier by saying that I have never disagreed—in fact I have affirmatively stated, obviously, we need one primary regulatory—it is the SEC—we need uniformity in the marketplace, and that is what you seek when you have one primary regulator.

Having said that, you used the word override. We certainly—because of the supremacy clause, we clearly can't override an SEC reg or Federal statutes, obviously. What we can do—and here is where I think you get shades of gray and areas of greater complexity.

In individual consent decrees, injunctive relief that we get at the end of enforcement action, we will often impose upon a wrongdoer—classic example to be a boiler room operation where they have been selling phony stocks or have been playing games with stock pricing. We would force them to do certain things, have some compliance programs that are not inconsistent with Federal law, do not override Federal law but supplement and set a higher bar for them in terms of their behavior. I think that is what we have tried to do with due delicacy not to obviously disrupt or create a lack of common law in the capital markets. But in those enforcement actions we have often felt it was incumbent upon us to sanction the wrongdoer by imposing that sort of injunctive relief.

Mr. SCOTT. Thank you.

Mr. Cutler and Mr. Roye, I would like to go back to the market-timing issue. It seems to me that you said that, of course, late trading is illegal. Market timing is not illegal. Is that right? It is not illegal?

Mr. CUTLER. Well, it is not per se illegal. That is, there can be circumstances, and you have seen many of them already, in which it is, because of things like quid pro quo arrangements or prospectus disclosure, that the market timing contravened.

Mr. SCOTT. Why wouldn't you recommend that we make it illegal? Is that possible, to make it illegal?

Mr. CUTLER. I will let Mr. Roye——

Mr. ROYE. Let me respond to that. I think it is important to note that probably every investor at some point is making a timing decision, trying to determine when to buy a fund, when to get out of a fund, when to move from one fund to another. You have mutual funds that actually cater to market timers. They are sold on the basis of we welcome market timers. You have funds that it doesn't make sense to market time, like money market funds where there is a stable net asset value. You know, there are funds that do have market timing issues. It is disruptive to their performance.

To this point, we have relied on the funds to articulate what those procedures are that they are going to follow to discourage this activity to protect the rest of the fund's investors. So I think the question becomes—it is not per se illegal. We need to recognize that there are circumstances where timing, does make sense but also where it is harmful. And, indeed, where it is illegal we need to come down on it. But where it is harmful, we need to make sure that there is someone monitoring the situation, that they have the appropriate controls in place and that funds have all the necessary tools to deal with that type of activity.

Mr. SCOTT. Also, the market timing seems to me that it would have a very—something you haven't touched on yet, but a profound impact on foreign markets, particularly in treating with foreign securities after their markets close or before ours close. How serious a problem is that? What is the impact that that has on market timing?

Mr. ROYE. Well, I don't know exactly. I haven't seen any studies that really go into that type of impact. But what I can tell you is that when investors and large investors are moving in and out of the funds, the reason a lot of portfolio managers don't like it, is because it means that they have to sell securities or they have to maintain high cash positions to deal with that kind of activity, and that can adversely impact performance. But I haven't seen any information to indicate that it is being disruptive to foreign markets, and I would have to defer to the economists on that.

Mr. SCOTT. Well, the indication that I have some information—for example, a strong rally in the U.S. markets after the close of foreign markets could prompt market timers to purchase mutual funds with Asian stocks—that is a possibility—on the expectation that prices in those stocks will rise when the Asian markets open, creating the potential for strong gains in the value of mutual fund shares the next day.

Mr. CUTLER. Maybe I could help here. You are certainly right, that the opportunities to exploit inefficiencies in mutual fund pricing are most acute in funds that hold foreign securities, where Mr. Roye said earlier the closing price in the Tokyo market, for example, would have been 14 hours old before a fund sets its net asset value.

Mr. SCOTT. That is why I am saying, on that evidence alone, it seems to me, the damaging impact it could do to world markets ought to put some emphasis on our ability to make such a practice illegal.

Mr. ROYE. Well, I am not sure you can draw the real connection between that type of arbitrage activity, where investors are moving in and out of the fund to take advantage of that activity. I think that, you know, in order for it to have an impact on foreign markets, you have to have sales of securities in those foreign markets driving those markets down.

And I don't think that is what we are seeing, but I think what you are pointing to is that this opportunity is what affords the market timing advantage here, and what we are trying to do is to get the funds to deal with that in terms of having accurate values of those securities. We are trying to move them from using these stale prices, if you will, to a more accurate price, which candidly has to be some guesstimate on their part as to what the real value of those securities are to eliminate these arbitrage opportunities. Then you couple that with something like mandatory redemption fees, and maybe we can eliminate the problem you are talking about.

Mr. SCOTT. Could I ask one more quick question—real quick? I just want to go back to Mr. Spitzer real quick.

You said in your testimony, Mr. Spitzer, that the mutual fund directors rarely negotiate lower fees for their shareholders and that fund managers are rarely replaced. You highlight that the chairman of the board of directors of the fund is almost always affiliated with the management company. These are some real important observations you have made. Can you elaborate very briefly on how widespread this problem is and recommend what forms that this committee or the SEC should take to deal with this problem?

Mr. SPITZER. I cannot give you a quantification, but I will endeavor to get that information to you in short order.

In terms of a remedy, I think this is what speaks to the—or what I think is a very wise idea, which would be to have an independent board share; and I think the definition of independence is something we can grapple with to make sure there is a sufficient buffer between the board share and the management or the advisory company, a critically important step we have to take. Again, because of the inadequate negotiation matters, perhaps the notion for a most-favored-nation clause or an obligation to get multiple bids again to ensure that there is an actual arms-length transaction that reflects the true market valuation of the services being provided.

Mr. SCOTT. Thank you, sir.

Chairman BAKER. [Presiding.] Ms. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Before I begin my questioning, I would ask unanimous consent to submit for the record testimony from Hewitt Associates.

Chairman BAKER. Without objection.

[The following information can be found on page 234 in the appendix.]

Mrs. BIGGERT. I think this question will probably be directed to Mr. Roye, but if somebody else thinks he would like to answer, I want to talk a little bit about illegal, late-hour trading.

In Mr. Spitzer's testimony, I believe that you said that you thought that the current rules surrounding illegal late-hour trading were sufficient, but just needed to be enforced. And I have concerns that if we do change the current trading rules outright, it could put at risk the fairness and, potentially, even the cost effectiveness of 401(k) plans for participants. And it is my understanding that current SEC rules require that orders to purchase or redeem fund shares must be received by the fund or their agent before 4 p.m. Eastern Standard Time if they are to receive that day's closing price.

One option reportedly under consideration would change the current regulations by requiring all entities, and that would include the record keepers, to submit mutual fund trades to the mutual fund by 4 p.m. And in 401(k) plans, this would effectively mean that 401(k) record keepers would have to complete this by the 4 p.m. deadline. And the processing takes quite awhile, so those investors in 401(k) plans would have to make their investment decisions several hours earlier than 4 p.m., and that would put them at a substantial disadvantage with respect to the other fund shareholders.

Could you address this?

Mr. ROYE. Yes, I can. I think you highlight what really ends up being a trade-off here; and as a staff person, I can tell you that we are thinking about the hard 4 o'clock cutoffs and alternatives to that; and I can't speak to what the Commission ultimately does with that. You know, we have a situation where it has been discussed, widespread abuse of the late trading obligation on the part of intermediaries that sell fund shares.

Now, I want to emphasize that some of these intermediaries are regulated by the SEC and some aren't, and indeed some of the pension plan record keepers, they are not subject to SEC jurisdiction. So we have a situation where, if there is widespread abuse, we don't have jurisdiction.

There is a requirement that they comply with the 4 o'clock cutoff, and orders that come in after 4 o'clock are supposed to get tomorrow's price rather than today's price. And they are supposed to have controls in place; indeed, all the mutual fund contracts essentially require the intermediaries to have controls and procedures in place to deal with this, and we found that they don't exist. As the Attorney General pointed out, there has been a massive breakdown in terms of how those procedures and controls are working.

The further you get away from the fund, the greater the risk of abuse; and if we can change the rule so that these orders have to hit the fund by 4 o'clock, then we can eliminate the problem. We are looking at people that we don't regulate, and we see that they don't have the controls in place. We are very concerned.

But you are correct. There is going to be a trade-off here because it is going to narrow the window of opportunity for certain investors to make their investment decisions.

I guess I would point out that a lot of investors are long-term investors, and hopefully, when they go into a mutual fund, they are taking a long-term perspective, and ultimately, it shouldn't really matter.

I know it is going to impact some investors.

We do have within our regulatory framework currently this issue we have variable insurance products, variable annuity, variable life insurance, they already live with the hard 4 o'clock rule. And investors are buying mutual funds for those products. So that is the trade-off.

Mrs. BIGGERT. You know, isn't it something as simple—like a time stamp when an investor decides to buy at 3:59 and it is stamped, then the calculations can be done?

Mr. ROYE. I will let Mr. Spitzer and Steve tell you how people have circumvented those problems.

Mr. CUTLER. It is pretty easy to time-stamp a ticket and then, as has been revealed in some of these cases, have the customer call back at 4:30 and tell the firm whether they actually want the order to go or whether they want the firm to toss the ticket. And that is what happened here. There is nothing that is fail-safe; but as Mr. Roye said, you know, moving this deadline closer and closer to the fund companies themselves can only help prevent abuse.

Mrs. BIGGERT. Thank you. I see my time has expired and I yield back.

Chairman BAKER. Mr. Matheson, do you have a question?

Mr. MATHESON. Thank you, Mr. Chairman. A couple of questions I wanted to ask.

One is, the Investment Company Institute has come out with their recommendation about this 2 percent redemption on transactions where it has been held for less than 5 days. Do you—what effect will that have in an effort to eliminate illegal late trading?

Mr. SPITZER. I think the 2 percent notion is a good one whether it is 2 percent, 1 percent, 8 percent. Some calculus will have to be drawn to figure out what the fees should be imposed upon. It goes more to timing than to late trading, the quick in and out, although theoretically it could apply to late trading as well.

What you are really trying to do is eliminate the profit margin, and those who are arbitraging based on timing are really looking for thin margins, but they are doing it over and over again with such speed and such volume that they end up doing quite nicely over time. Two percent per trade, the ICI obviously believes it would be sufficient to discourage it. Some imposition of a fee like that would make sense.

In fact, there have been many funds that imposed a fee when you had a sequence of trades within some time frame. Unfortunately, as Steve just said, any system can be circumvented.

What these funds did was waive the fee for those who were favored investors, who were giving them sticky assets with whom they were in cahoots. So they said, well, we will just ignore the redemption fees and go ahead and do your timing. If it were applied and if it were done fairly it would certainly be helpful.

Mr. MATHESON. Mr. Cutler, you mentioned this survey that had been done of a number of broker-dealers, and some of the issues about percentages, that were aware of market timing having taken place and whatnot were pretty high. You also mentioned—in response to Chairman Oxley, you said there is market timing that is appropriate and inappropriate.

Do you have a sense with your survey how that breaks down in terms of firms that were aware that it was going on, but the type that was okay versus the type that is not okay?

Mr. CUTLER. I would recast that into legal and illegal, as opposed to appropriate and inappropriate. We are looking hard at all of those instances, and it may well be that some of them are not illegal; but I can tell you, in a disturbing number of cases, we believe that there was prospectus disclosure, for example, that would have been inconsistent with the notion of allowing or entering into a market timing arrangement with an investor.

Mr. MATHESON. And do you think you have the tools to bring enforcement action when this is illegal—market timing?

Mr. CUTLER. Yes, I do. Again, are there other—are there enhancements to those tools, including some of the ones that have been talked about here today in H.R. 2179? Yes. But I think, as you have seen already, we have—we do have the arsenal to go after this sort of misconduct. That is why we brought cases to date, and that is why you will see many more cases in the coming months.

Mr. MATHESON. You have tools in terms of the regulations that are in place, but I also want to touch upon—conversation that you had with Mr. Frank about the resources to do so. And we have got over 8,000 mutual funds. You said in your testimony earlier the

SEC receives over 200,000 tips in a year. It seems to me, when we were looking in Congress to upgrade the resources going to the SEC, that was actually before this mutual fund issue came into play.

I am curious what your perception is, if you think that the SEC is given adequate resources to truly perform their enforcement function.

Mr. CUTLER. Again, I think we have a big integration function or integration responsibility and challenge ahead of us to make sure that the resources that you have already given us are used intelligently and wisely; and we are still in the process of doing that.

Where I think the biggest difference will be made is in the examination and inspection program that the Commission has. Up until the recent allocation of resources, there were 350 people that were doing examinations of the 7,000 mutual funds—I think I have got the right number; 8,000, sorry to have understated it—8,000 mutual funds across the country. That probably wasn't enough. We now have more people devoted to that function, and that is where you really get your intelligence at the SEC from the people who are, on a daily basis, walking into funds, examining them, walking into investment advisors and examining them. And I think that again—I don't oversee that program, but I think we are well on our way to beefing up that program to put us in a better position to be able to see around those corners.

Chairman BAKER. Mr. Manzullo.

Mr. MANZULLO. Thank you. I have a pretty simple question.

Attorney General Spitzer, you had referred to the mutual fund industry as a cesspool in the Senate yesterday. I mean, first you have direct discharge of effluence, then the cesspools, septic and then water treatment. So this is pretty high up on the level of sludge that you used.

Mr. SPITZER. You know your engineering better than I do.

Mr. MANZULLO. I live on a farm, so I know about that stuff. My comment would be, or rather my question is, in the midst of all the fines and the penalties, is there a way that these can be transferred or passed on to the investors themselves in the mutual fund through an increase in some type of a fee or something, some type of fees, or are these personal judgments?

Mr. SPITZER. If I understand your question, can we pass back to the investors some of the funds that we recoup?

Mr. MANZULLO. That actually wasn't the question, but that is a good follow-up on it.

My first question was, if, for example, Canary agreed to pay $40 million in fines, I don't know how much of that was fine and how much was restitution, but can the fine that the mutual fund itself pays end up actually being paid by the investors?

Mr. SPITZER. I see. Will the investors be footing the bill because their costs will increase? I understand.

I suppose it is always a possibility when you impose a fine on a corporate entity that the owners of that corporate entity, namely the shareholders, whether it is a mutual company or not, will end up being assessed their proportionate share, which is why we try to impose fines upon individuals and individual decision-makers who have been responsible for the wrongdoing.

So, yes, as a theoretical matter, if you were to fine any of the major mutual fund families a significant sum of money, is it conceivable that somehow that gets referred back? We will endeavor to take it out of the fees that are paid, that have been paid into them already, and perhaps not permit them to allocate.

Mr. CUTLER. I think it is actually useful to be pretty precise here. When you charge a fund management company with wrongdoing—and that is what, to date, we have been charging—that is not the mutual funds themselves, that is the advisor to the funds. And it certainly isn't our intention here to have investors foot the bill for the wrongdoing that fund management companies were engaged in.

Mr. SPITZER. If they were to charge them back is the problem. How do you prevent them from charging it back? We will endeavor to make sure that that doesn't happen.

Mr. ROYE. Let me just point out that the Investment Company Act provides that you can't raise the management fee unless you go back to shareholders. The shareholders would have an opportunity, if that were to go on, to weigh in and vote no.

Mr. MANZULLO. I presume by the answers of all three of you that you will closely monitor the payment of those fines, the source of the fines and actually the fund itself for the next several years to make sure that those are not passed on to the fund investors.

Mr. SPITZER. That is correct. And we are all, collectively in the funds that we receive, creating restitution funds that will go back to the shareholders themselves. Of the 40 that was paid by Canary, 30 is in a restitution fund and 10 is the straight fine. That goes to the government, but 30 is going back to the shareholders.

Chairman BAKER. Mrs. Capito.

Mrs. CAPITO. Just to follow up on that, on the restitution fund of the 30 million, how is that disbursed to the shareholder? Do you get a certain percentage, certainly full restitution or is it full restitution?

Mr. SPITZER. We don't yet know. We have only recently closed that transaction, and we are going to figure out what is the most appropriate way to ensure that that 30 million goes back to those that were injured in proportion to their—the magnitude of their injury. It is an issue that we and the SEC are grappling with simultaneously with respect to the global deal last year where there is a significant restitution fund.

There are tough judgment calls that have to be made in terms of how you determine who the recipients should be, and what proportion to their injury. We are trying to work those issues through right now.

Mrs. CAPITO. This question may reveal my naivete, but let me ask a question in terms of the issues of transparency and the fees that we are investigating and looking at right now, when we are in an up market. Has this become a function of our investigation because we have been in a down market so long? Because even when the market is going up, people aren't complaining about which way their investments are moving.

Mr. SPITZER. Actually, I think not. I don't dispute the premise of your question which is that ordinarily in a down market, people will be a bit more aggressive in their complaints and allegations, perhaps, are more rapidly made.

The issue of late trading and timing really are a response not to the direction of the market but to the volatility of the marketplace; and the arbitragers who take advantage, up or down, really need volatility. They don't care if the market is trending one way or the another.

The information that was brought to us that triggered the set of inquiries wasn't brought to us because of a particular loss. It was just because of an understanding of the impropriety and the structure of the trades that were being conducted.

Mrs. CAPITO. Thank you. I have no further questions.

Chairman BAKER. If there is no objection from anyone, I think we are going to mercifully say thank you to our first panel. We do appreciate your courtesy in appearing here, and your testimony has been of significant help to the committee and its work. We look to working with you in the days ahead toward an appropriate resolution.

I would like to welcome the patient members of our second panel for their courtesy in appearing here today and moving forward. I would like to welcome back no stranger to the committee hearing room, the Honorable Arthur Levitt, former chairman of the Securities and Exchange Commission, who has been before this committee on many occasions.

## STATEMENT OF THE HONORABLE ARTHUR LEVITT, FORMER CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. LEVITT. Thank you very much, Chairman Baker and Ranking Member Kanjorski and members of the subcommittee that have lasted so long this morning. I will try to be brief.

I would like to thank you for inviting me to share my thoughts on allegations and, unfortunately, burgeoning evidence of self-dealing in the mutual fund industry.

As regulators and lawmakers examine the sale and operation of mutual funds, I think it is important at the outset to remember that mutual funds represent the very best vehicle from which the individual investor has access to our markets. Regrettably, the industry has taken advantage of this fact. Investors simply do not get what they pay for when they buy into a mutual fund, and most investors don't even know what they are paying for.

The industry often misleads investors into buying funds on the basis of past performance. Fees, along with the effect of annual expenses, sales loads and trading costs are hidden. Fund directors, as a whole, exercise scant oversight over management. The cumulative effect of this has manifested itself in the form of late trading and market timing and other instances of preferential treatment that cut at the very heart of investor trust. It would be hard not to conclude that the way funds are sold and managed reveals a culture that thrives on hype, promotes short-term trading and withholds important information.

The SEC and other law enforcement, such as the New York Attorney General, no doubt will aggressively investigate and prosecute criminal activity. But for the longer term, it is well past time to consider meaningful change in the administration and governance of mutual funds.

I hope the industry recognizes the grave threat these questions represent to its health, and that it will embark on substantive efforts to reform itself along with the necessary hand of the SEC.

I would also like to thank Chairman Baker for his reform efforts in performing a vast civic benefit; he is often a lonely voice on behalf of investors. I believe that reform may include the following areas:

One of the most effective checks against egregious abuses of the public trust is broken: the strict oversight of truly independent directors. Many so-called independent directors have professional or collegial ties with fund managers or, themselves, are recently retired managers. Fund boards, in my judgment, should have only one inside director. Everyone else on the board should meet a strict definition of independence from the fund complex.

Equally important, the chairman of the fund company must be independent. That is one of the best ways to improve accountability for management practices. He or she should sit on a reasonable number of boards. For board members or chairmen to be compensated for services on as many as 100 boards is simply not reasonable.

During recent weeks, State and Federal authorities, working together, have uncovered egregious and sometimes criminal violations of the public trust. Such miscreant entities should be required to appoint to their boards an investor ombudsman for a defined period of time. The largest mutual funds pay money management advisory fees that are more than twice those paid by pension funds. It is essential that investment company boards be required to solicit competitive bids from those who wish to undertake the management function. Furthermore, boards should justify to their bosses, fund shareholders, why they chose a particular investment advisor and each year should demonstrate that they have aggressively and competitively negotiated management fees.

Sadly, funds have moved away from a culture of diversification and probity in favor of an almost phrenetic competition to market investment products as if they were soap or beer. The fund industry should themselves proactively ban performance advertising. Such misleading hype encourages bad practice such as portfolio pumping to boost quarterly performance. Companies that don't accept the importance of change to protect their franchise and continue to promote and hype performance should be required to advertise returns only after the effect of fees and taxes has been applied. What millions of American investors currently see in magazines and newspapers is just plain deceptive.

Despite the SEC's efforts to persuade the use of plain English, the language of the industry is still hopelessly arcane. What average investor understands the meaning of 12(b)(1) fees, closed end funds or ABC classes of shares. Mutual funds have a long way to go before they start talking in the language of investors.

Executives, fund managers and directors of a fund complex must be required to disclose their compensation. A fund's shareholder should know how much they are paying someone to invest their money and if the incentives of that manager's compensation is in investors' long-term interest.

In addition, the trading by managers of fund shares or securities that are part of a fund's portfolio should be prohibited in favor of long-term ownership. Having run several large sales organizations, I totally reject the specious argument that such practices are essential to retain competent managers or that such practices hone skills or approve commitment.

I suspect market timing issues are far greater than the industry acknowledges. For instance, the closing down of unsuccessful funds that are then exchanged for a new fund within the same complex could well be considered an example of a market timing strategy with funds moving back and forth between stock and a money market fund.

In 1940, the Investment Company Act stated that mutual funds are to be organized and operated in the interest of shareholders. We should consider a legislative amendment that precedes those words with a statement that it is the fiduciary responsibility of directors to ensure that funds are organized and operated in such a way.

Not long ago, most investors bought directly from mutual funds themselves. Today, more than 80 percent of funds are purchased through brokers and not nearly enough of them disclose revenue-sharing deals that pay them more to put clients in a certain company's funds. The brokerage system of selling mutual funds continues to be riddled with conflicts, revenue sharing, sales contests and higher commissions for homegrown funds should be banned.

I have long wrestled with the issue of soft dollars. It is clear that the practice of allowing higher commissions in return for broker directed research has created great potential for abuse. At the very least, investors should know what commissions they are paying and what the money is going toward. Disclose it and do it simply.

More broadly, in light of the many abuses of this practice, Congress should seriously consider revisiting the safe harbor it granted to soft dollar arrangements shortly after the abolition of fixed commissions in 1975. "seek simplicity and distrust it," someone once remarked; I can't help but wonder if they worked in the mutual fund industry.

Mutual funds have a lot to answer for. But I have come to know many in the business and most realize that without investor trust, our markets simply can't function. I hope that they will speak out and that they will be the voice of meaningful and yet pragmatic change. In the last year, the voices in corporate America and on Wall Street were largely silent in the face of scandal. Mutual funds, given their very form and function, cannot afford to be. Thank you.

Chairman BAKER. Thank you very much, sir, for your statement.

[The prepared statement of Hon. Arthur Levitt can be found on page 218 in the appendix.]

Chairman BAKER. Our next witness is Mr. Don Phillips, Managing Director of Morningstar, Inc.

**STATEMENT OF DON PHILLIPS, MANAGING DIRECTOR, MORNINGSTAR, INC.**

Mr. PHILLIPS. Mr. Chairman, thank you for the opportunity to appear before this distinguished committee.

At Morningstar we currently cover mutual funds in 17 countries. As such, we have seen how the fund industry has evolved in different settings with various structural and regulatory approaches.

As a general rule, funds are structured in one of two ways, contractually or as corporations. The United States has wisely embraced the corporate structure of fund management, which is why the industry is governed by the Investment Company Act and not by an investment product or investment services act.

In the U.S. And other countries where the corporate structure has been embraced, funds have enjoyed great success. The reason is clear. The corporate structure places investors' interests first. The beauty of the corporate structure is, it places the investor at the top of the pyramid. An independent board of directors is created to uphold shareholder interest and to negotiate an annual contract with a money manager to provide services to the fund. As defined by the 1940 act, the fund management company is not the owner of the fund but rather the hired hand brought in to manage the assets.

While today's fund executives live by the letter of the 1940 act, they don't always embrace its spirit. Go to any industry gathering and you rarely hear investors referred to as shareholders and even less frequently as owners. Instead, they are customers. In the vernacular of today's industry leaders, fund management companies are manufacturers of products that are sold through distribution channels such as mutual fund supermarkets to customers who operate presumably on the premise of "buyer beware." .

In effect, today's fund leaders have inverted the relationship envisioned by the framers of the 1940 act. Rather than being at the top of the pyramid, fund investors today find themselves at the bottom of the food chain. While the U.S. Fund industry does have a good long-term record of serving investors, this record owes not to the superior moral nature of fund executives, but rather to the industry's high level of transparency that has been brought about by the corporate structure of funds.

In Morningstar's opinion, H.R. H.R. 2420 aptly sought to bolster this transparency. Its adoption, especially in its strengthened version, would go a long way towards better protecting the 95 million shareholders who put their faith in mutual funds.

As for other issues this committee might consider in the efforts to protect investor interest, Morningstar would like to submit the following four principles:

One, apply the same disclosure standards to investment companies as to publicly traded operating companies. If mutual funds are indeed corporations, let us treat them as such. Unless there is a compelling reason to draw the lines differently, there is no good reason to treat publicly traded investment companies, mutual funds, any different than publicly traded operating companies, stocks.

However, because equity shareholders have historically had a louder voice than have fund shareholders, it is not surprising that disclosure standards for stocks remain far higher than those for funds in many areas. It is time for someone to speak up for shareholders and level the playing field.

Every week we speak with mutual fund portfolio managers who tell us that before they buy stock in a company, they look to see how management is compensated. They want managers who eat their own cooking and whose interests are aligned with theirs. An equity investor has access to detailed information on the compensation and on the purchase and sales of aggregate holdings of senior executives and other insiders at an operating company.

Stunningly, fund investors are denied access to the very same data about the managers of their funds. Such sunlight might well have been beneficial in the recent cases of several Putnam portfolio managers and Strong Funds Chairman Richard Strong, who have been accused of market timing their own funds. Could you imagine these executives engaging in such actions if they knew it would become public information that they were trading so rapidly?

Why should such information that has long been disclosed on corporate insiders not be available on fund insiders? It is time to level the playing field.

Two, bring more visibility to the corporate structure of funds and the safeguards it provides. The typical mutual fund investor is largely unaware of the corporate structure of funds. In fact, the names and biographical data of fund directors are not even included in many fund prospectuses, but instead are relegated to the seldom-read statement of additional information.

To remedy this situation, Morningstar suggests that each fund prospectus begin with an explanation of the fund's corporate structure such as the following:

"when you buy shares in a mutual fund, you become a shareholder in an investment company. As an owner, you have certain rights and protections, chief amongst them an independent board of directors whose main role is to safeguard your interests. If you have comments or concerns about your investment, you may direct them to the board in the following ways: by bringing more visibility to the fund's directors and by alerting shareholders to their role in negotiating an annual contract with the fund management company." the balance of power may begin to shift from the fund management company executives where it now rests to the shareholders and directors where it belongs.

In addition, we believe it is highly beneficial, if not essential, that the chairperson of the fund board be an independent director. In an operating company, there is only one party to which directors, be it independent or not, owe their loyalty, the stockholders.

In a mutual fund, there are two parties to which the nonindependent directors owe their allegiance. One is the fund shareholders, the other is the stakeholders in the fund management company; only the independent fund directors have a singular fiduciary responsibility to fund shareholders.

We also believe that this independent chairperson should be responsible for reporting to the fund shareholders in the fund's annual report, to address the steps the board takes each year in reviewing the fund's management performance and the contract that the fund has with the fund management firm. Only by having more visibility for the role of directors can they truly fulfill their function.

Three, insist that fund management companies report to fund shareholders as they would to owners of a business. There is particular room for improvement in the way costs are communicated to investors. For many middle-class Americans, mutual fund management fees are now one of their ten biggest household costs. Yet the same individual who routinely shuts off every light in their house to shave a few pennies from the electric bill is apt to let these far greater fund costs go completely unexamined. Getting these fees stated at a dollar level that corresponds with an investor's account size is an important first step.

We have truth-in-lending laws that detail to the penny the dollar amount a homeowner will pay in interest on his mortgage. Isn't it time for a truth-in-investing law that would bring the same common-sense solution to mutual funds, the retirement vehicle of choice for a whole generation of Americans?

Four, ensure that all shareholders are treated fairly. Our final point is one that we wouldn't have thought needed to be raised 6 months ago, but in the wake of the recent fund trading scandals, it has become a significant issue.

Morningstar supports fair-value pricing policies and the consideration of higher redemption fees for short-term trades. In addition, we support a hard close for mutual fund pricing. If a trade order is not in the fund's possession by 4 p.m. Eastern, it should be transacted at the next day's price.

By bringing more visibility to the corporate structure of funds and by leveling the playing field between publicly traded operating companies and investment companies, this committee can demonstrate to American investors that mutual funds will continue to operate on one of the cleanest level playing fields in all of finance.

Thank you for the opportunity to speak before you.

[The prepared statement of Don Phillips can be found on page 221 in the appendix.]

Chairman BAKER. Our next witness is Mr. Mercer E. Bullard, President and Founder of Fund Democracy, Inc.

Welcome, sir.

**STATEMENT OF MERCER E. BULLARD, FOUNDER AND PRESIDENT, FUND DEMOCRACY, INC.**

Mr. BULLARD. Thank you, Chairman, and thank you for the opportunity to speak before the committee today. What I would like to do is, first, I would like to applaud you for addressing these issues before mutual fund regulation became the regulatory issue du jour, and I hope that the committee and the House and the Senate can get together and now get some effective fund legislation done.

What I would like to talk about is to clarify a little bit about what is an issue of some confusion, and that is the nature of these different frauds and how to look at them and think about what is the proper role of Congress in dealing with them.

One fraud is actually almost a year old. That is the Commission overcharges scandal that the SEC and other regulators discovered earlier this year where they found that in 30 percent of the cases in which fund shareholders were entitled to receive discounts on commissions, they did not receive them. This kind of systemic failure is the first example of fund directors and fund managers simply not doing their jobs.

What could be more fundamental than making sure that your shareholders are not being overcharged? And what is even more shocking, as you heard Mr. Cutler talk about today, about actions being taken by the NASD and the SEC to require these broker-dealers to find out who they overcharged and, imagine that, repay them the amount they overcharge.

The question is, how is it, 6 months after this fraud was uncovered, these fund boards are not doing the same thing? If you were a fund director, wouldn't you think the first thing that you would do when you found out your broker was overcharging your shareholders would be to say, Well, not only is this disgraceful, and I am considering firing you as a distributor, but I would like you to pay back the amount that you stole from my shareholders. Obviously they haven't done that, or else the NASD and the SEC wouldn't have to be forcing broker-dealers to repay the amount they overcharged their investors. Perfect example, number one, the fund director is not doing their job.

The second example is late trading. Late trading resulted because the SEC as a practical matter said, You don't have to get your order in by 4 o'clock because, as Congresswoman Biggert pointed out, there is a problem with some 401(k) plans getting orders in time to meet that 4 o'clock deadline. The regulatory issue is whether it is received by 4:00, not whether the fund receives it by 4:00. All that fund directors have to do to the extent that the fund was receiving orders after 4 o'clock is make sure there are procedures in place to ensure that they were received before 4:00 and cannot be canceled, and then to do spot checks to make sure that was happening. The pervasiveness of this fraud demonstrates that simply was not happening. And this again, like the Commission overcharges, is fundamental compliance.

The third example is market timing. The market timing we are most concerned with is market timing that violated fund prospectuses. If you are a fund director, the first thing you should read would be the fund prospectus, and when you see a requirement in there, it immediately becomes incumbent to be sure that that requirement is being complied with. You do that by having procedures in place designed to enforce that requirement and by doing spot checks.

It is very simple doing spot checks. You ask to see the cash flows of the fund, and if the intermediaries won't provide it, you insist on receiving it. Once again, the pervasiveness of this fraud demonstrates fund directors were not doing it.

The worst example is the case of stale pricing, which you heard Paul Roye tell you earlier is flat out illegal. It is illegal to keep that 14-hour-old Japan stock market price when you know there are events that have affected its value and it is obvious there are events that affected its value. That is why 28 members of the boilermakers' union were market timing funds, because they knew the value of the fund was now underpriced. It is incredible to me that apparently the fund directors and the SEC didn't know.

And what is most embarrassing about the stale pricing is that this was something that had been raised in the popular press for years. There were academic studies, at least four that I know of, where the academics went in and looked at the actual cash flows of these funds; and what they identified was that there was a massive amount of exploitation of stale prices. These were a matter of record and have been a matter of record for years.

Since 1997, the SEC has been on notice that this is a significant problem; and until 2001, it did not come out and say that it was illegal. So what we have is a consistent failure to deal with open and notorious frauds, and the main problem is, at the fund management level and at the fund director level they are not doing their jobs.

I applaud Chairman Baker for seeking to increase the independence of boards, but like Chairman Levitt, I think something more is needed. His idea of an ombudsman, as well as the SEC's proposal about a chief compliance officer and my proposal about a mutual fund oversight board, essentially share that same characteristic, which is that someone needs to be breathing down the necks of fund directors to tell them what their fiduciary duties are and to make sure they are doing them.

With respect to the ombudsman and the compliance officer, the key there is they cannot be appointed by or be employees of the manager; they have to be completely independent for them to fulfill that role. But at a minimum, I think Congress is going to have to take some kind of step that changes the structure in a way that gives fund boards that kind of oversight.

Thanks very much. I would be happy to take questions.

In particular, Congressman Emanuel, I thought the answers to your questions about possible conflicts in IPOs was inadequate, and I would be happy to follow up on that if you would like.

[The prepared statement of Mercer E. Bullard can be found on page 46 in the appendix.]

Chairman BAKER. Our next introduction is requested to be made by Congressman Royce.

Mr. ROYCE. Thank you, Mr. Chairman. I would like to once again welcome fellow southern Californian, Mr. Paul Haaga, to the committee room. As you know, Mr. Haaga has previously appeared before this committee, and I would like to thank him for returning. He is the Executive Vice President and a Director of Capital Research and Management Company. And Mr. Haaga comes before us today, not as a former SEC official or a current investment executive, but rather in his capacity as Chairman of the Investment Company Institute.

I look forward to his testimony, and I yield back, Mr. Chairman.

Chairman BAKER. Thank you. Please proceed at your leisure.

**STATEMENT OF PAUL HAAGA, JR., CHAIRMAN, INVESTMENT COMPANY INSTITUTE**

Mr. HAAGA. Thank you for the kind introduction, Mr. Royce. I can safely say that it is the nicest thing anybody outside of my family has said to me in the last couple of months.

Thank you, Chairman Baker and distinguished members of the subcommittee. My name is Paul Haaga, and I am here as Chairman of the Investment Company Institute's board of governors. While I appreciate the opportunity to appear before you today, I am appalled and embarrassed by the circumstances that cause you to convene this hearing. The abuses described to you this morning involving the conduct of some fund officials and others are shocking and abhorrent.

The Investment Company Institute commends SEC Enforcement Director Cutler, Attorney General Spitzer, and Secretary of State Galvin and urge that their vigorous enforcement efforts continue.

On the regulatory side, SEC Chairman Donaldson and his fellow commissioners and Investment Management Director Paul Roye have provided a strong blueprint for regulatory reform. We commend the SEC and the Congress for responding swiftly, and we pledge our full cooperation in crafting necessary reforms.

As we wrote in a USA Today commentary a few weeks ago, serving investors, above all other interests, is mutual funds' first and only commandment. It is the reason that so many individuals have become mutual fund investors. Yet we now know that some have ignored this commandment.

The abuses we have learned about are inconsistent with our fiduciary obligations, incompatible with our duties to shareholders, and intolerable if we are to serve individuals as effectively in the future as we have in the past. Simply stated, if we don't put shareholders first, we will no longer be the investment of choice for 95 million Americans, and we will no longer deserve to be.

Nothing I say here today will, by itself, restore investor confidence in mutual funds. For that, we will need action in several areas. First, government officials must identify and sanction everyone who violated the law. Second, shareholders who were harmed must be made right. Third, strong and effective regulatory reforms must be put in place to ensure that these abuses never happen again. Everything is on the table.

We pledge to you and other government officials our complete cooperation.

Now these necessary actions will be very visible and will be taken over the coming weeks and months, but the most important action will be the least visible. It won't happen on any timetable and in fact, our efforts to achieve this goal will never end. And that action is making sure that everyone involved with mutual funds adheres to the founding principles underlying the Investment Company Act of 1940. It is just three words, investors come first. I and the Institute pledge not just cooperation, but leadership in this last, most important endeavor.

Thank you again for the opportunity to testify here today. I would be happy to respond to your questions.

[The prepared statement of Paul G. Haaga Jr. can be found on page 195 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Haaga. I do appreciate your appearing and your statement today. Not that we can reach legislative accord this morning with just the opinions of this panel, but I suspect we will be addressing this subject frequently over the next few weeks. We have another hearing scheduled on Thursday with another distinguished group of panelists.

But it seems that there are some themes that are pretty clear if we start with H.R. 2420 in its current form, that disclosure of a portfolio manager's fees and their holdings, prohibition on simultaneous management of a mutual fund while operating a hedge fund, require that there be a—and defining fundamental objectives of the fund, using that legal jargon that the firm's market timing policy be defined as a fundamental objective so it is principally, prominently disclosed to the potential shareholder; not only establishing a compliance officer, which is now in H.R. 2420, but having that officer report to an independent board.

And sort of outstanding at the moment relative to the construct of independent members is whether it is maintained at a majority, whether it is three-quarters—the number at the moment is not decided—but certainly that the compliance officer should report to those independent members, that there be an independent chairman; that we consider recommending—I don't think we should establish by statute, but recommend to the SEC that they establish an enhanced redemption fee for the short-term trades at whatever level they think appropriate to have a market effect; require the SEC to clarify fair value pricing rules, so you can't use a stale price and profit from that arbitrage; enhance and perhaps, as contained in H.R. 2179, some increase of penalties for clearly established mutual fund violations; publication of the fund's code of ethics so people can pick it up and read it and see what their policy is.

And then perhaps sort of the bumper sticker for the whole effort along the lines of what Mr. Levitt indicated is language that—something to the effect that consistent with the high standards of fiduciary conduct, the funds should be operated in the interest of investors, not in the interest of directors, officers, investment advisors, underwriters or brokers; to set in place a clear statutory statement of the standards for ethical conduct.

Now that is just what I picked up this morning in the discussions. Let me throw it out.

Mr. Haaga, I will certainly give you an opportunity to object or suggest where modifications might be appropriate. And I am making this request in this context.

Perhaps the single most important thing for us to resolve is getting closure. And if, by the end of this session, if it were possible to get a bill out of the House and the Senate to bring resolution to this chapter of difficulty, I think it would be very helpful to the recovery of the markets next year. If we leave this unattended and unresolved into February or March of next year, I don't think that is a good thing for our economy.

So I base those suggestions on, how do we get closure quickly on a package that makes sense, that we can work with the Senate on over the next few weeks?

Mr. HAAGA. What are you doing the rest of the afternoon? We will come over and talk. I would love to discuss these things in order and have everybody comment on them.

Let me just say that we were in favor of most of the provision in H.R. H.R. 2420 as introduced. We suggested some changes. I won't characterize them as minor or major, but some changes.

We continue to certainly support the core principles involved in the bill and have a few concerns about a few things that need attention. But I think we are very close. And as you said rather than negotiate it here, I would like to meet with the staff and the members and go over it.

Let me tick off a couple of things in there. You talked about a bumper sticker. I think it was a solution here to establish that funds are operated in the interest of shareholders and not in the interest of managers. That is section 1 in the preamble to the 1940 act, so we don't need to enact that. We need everybody to read it a few times.

Chairman BAKER. Fiduciary standard, that is a little different from a financial company's perspective than a mutual fund's perspective. If I am going to do something that affects your material financial wealth, I had better have a good explanation or I am responsible. So that many of the judgments made in the recent months, it appears, were not consistent with a professional standard of fiduciary performance that is the addition that I made to Mr. Levitt's suggestion.

Mr. HAAGA. The boards have been mentioned a number of times here, so let me say something general about them.

You know, not every failure is a failure of all systems and not every system failure is a structural failure. Sometimes it is one of operation in a perfectly good structure. These problems that have been talked about today are ethical problems first; compliance problems to a lesser extent, but ethical problems first. It pains me to say that. I would much rather say it is a structural problem. I would rather say, if we organized ourselves differently, it would not have happened, but I can't. I would like to.

I hope as we go into these solutions, we don't fall into the trap of thinking that structural changes are going to solve everything. That is not to say there may not be changes in rules, in structures, et cetera, but let us remember exactly what the problem is and not take our eye off the ball. There were ethical lapses by some in the industry.

Chairman BAKER. Let me make clear, as best you understand it today, H.R. 2420, as passed by the committee absent the independent Chair, is a starting point for ICI today. You may consider additions to the bill as appropriate, but H.R. 2420 as it is currently constructed is something the ICI could support?

Mr. HAAGA. Yes.

Chairman BAKER. Did any of the other gentlemen want to comment on the list?

Mr. LEVITT. I would just comment that the notion of fiduciary responsibility does not address, in my judgment, the structural makeup of the industry, but goes to the very point that Mr. Haaga made that this is an ethical problem and this is an ethical response by clearly stating it as a fiduciary responsibility.

And I also believe it is absolutely essential that managers' compensation must be revealed and that the trading of stocks or funds by managers' trading, as opposed to owning—I have no problem with owning, I have a vast problem with trading. And as I said before, I reject as totally specious the argument that this is a way they can hone their skills. That just isn't so. So I think these two elements together would be very important enhancements that go directly to Mr. Haaga's correct observation that this is an ethical rather than merely a structural problem.

Chairman BAKER. Does anyone else want to make a comment?

Mr. BULLARD. I think those are excellent recommendations.

I would say with respect to the compliance officer, as I recall H.R. H.R. 2420, it is modeled to some extent on the SEC proposal, in which case I think the key issue—it is important that they report to the board, but it is probably more important that they not report to the fund manager. There has to be some complete separation so that they are an employee of the fund and have absolutely no allegiance or reporting obligation regarding the advisor——

Chairman BAKER. As suggested, it would be reported to the independent board member.

Mr. BULLARD. As far as separation of the hedge funds, I think that is an excellent proposal, and particularly if it goes deep enough to cover not just portfolio managers, but the research analysts where you can also have conflicts.

And as to the redemption fee, I suspect that the SEC would probably want some kind of statutory authority, especially if what you are looking for is for them to acquire a redemption fee. The problem with redemption fees has always been that it is not clear they are consistent with fund shares being redeemable securities; and to give them the greatest leeway, what you might want to do is give them rule-making authority either to require or to permit redemption fees as they see fit.

Chairman BAKER. Thank you very much.

Mr. Emanuel.

Mr. EMANUEL. Thank you, Chairman Baker.

Mr. Bullard, since you mentioned my earlier question about the hot IPO market and "spinning", did you want to address those issues?

Mr. BULLARD. In the response, there was no mention of the fact that in the late 1990s the SEC increased the amount of the percentage of an IPO that can be put into an affiliated fund from 5 percent to 25 percent. And I thought that was ill-advised at the time. And of course this was being done by, in some cases, the managers of those same funds.

So it goes to your second question, too: Are there some sorts of structural relationships between the manager and the fund that may pose a problem? What we don't know is, even after they increase that to 25 percent, what has been the impact of that? Is there a higher correlation of IPOs being stuffed into affiliated funds or not? Do we know whether it had an impact on the setting of the IPO price?

And, you know, my view is, when the SEC grants exemptions, which it has been quite liberal in doing lately, it should have a follow-up mechanism where it is going to check to see whether this is harming shareholders.

I don't know the answer to this, but it would not surprise me if stuffing IPOs in affiliated mutual funds had something to do with the Internet bubble we experienced. But because the SEC hasn't looked at that issue, we don't know the answer.

Mr. EMANUEL. Okay, thank you.

Chairman Levitt, do you see any reason for us to look into ownership issues relating to mutual funds, insurance companies, and banks, or is that really not a problem? Should we be addressing some of the cross-selling issues using the Canary and Bank of America case as an example.

Mr. LEVITT. I think it is a problem. I think, to the extent to which you diffuse the management structure by placing it as a subsidiary of a company, which has other interests, or to the extent to which it has become part of a brokerage firm or a bank, that is part of what I call a culture of salesmanship, as opposed to a culture of safety and preservation.

The aggressive selling that we have seen in certain brokerage firms and banks I believe is the tip of the iceberg. The kinds of inducement, in terms of compensation, continue to be a problem that plagues the brokerage industry, and I suspect is pervasive in the banks, as well.

I am not sure that there is any role for Congress to play at this point. I think that the undoing of the prohibitions of Glass-Steegel had the kinds of unintended consequences that many predicted, but I clearly believe that this makes the problem even greater for American's investors and commenting further, with respect to IPO's, once again it is another—it is another conflict, it is another instance where individual investors see that large investors are favored over small, and I think that, for Congress and for Americans, is an unfortunate by-product of all of this.

Mr. EMANUEL. Thank you. I would close, Mr. Chairman, by reiterating something I mentioned in my opening remarks. As we continue to look at these issues, and as some of my colleagues push to privatize about social security, I would hope that the issue will give them pause. This scandal should be a flashing yellow light to the privatization advocates. We have many issues to deal with here, but the notion of privatizing Social Security is one that should go by the wayside.

Thank you Mr. Chairman. I yield back.

Chairman BAKER. Mr. Castle.

Mr. CASTLE. A few things: Mr. Bullard's comment about the U.C. Internet and the SEC, you should look at. I think that's absolutely correct.

There are a whole heck of a lot of people out there who are, in my judgment, becoming traders who were never traders before, who are probably market timing or doing some things we probably need to pay attention to.

I would like to discuss our own involvement, and that is we, the customers and customer awareness, and I would hope that what we are talking about makes a difference as far as we are concerned.

Basically, the no load funds, inevitably have the same earnings or higher earnings than do the load funds, so if you have an advisor, maybe you want to use the load funds, but people should understand they may be getting hit with 4 or 5 percent they do not need to. The costs are generally printed. Anybody who does any reading about mutual funds can understand about where Vanguard is where they are concerned about costs. The publications, certainly Mr. Phillips' publications, Morningstar has all kinds of information in it.

The Wall Street Journal, USA Today, magazines, do this on a regular basis. There is a lot of literature that is out there. Even some of the advertising out there, some of them will say all of our assets are invested in this fund, I would have to assume it is true, and if it is, that is a factor that I would consider.

I saw an article one time saying that if a fund was named for an individual, it probably did much better. That was probably before Mr. Strong came along, and I am not sure I endorse that anymore. We were all in this together. This is a huge part of America's finances today. I am just really surprised at the figures of costs that have gone up in mutual funds, more so than the numbers of mutual funds. They have just gone up tremendously, and I try to get to the bottom of this. Unfortunately, I do not have time for all the questions I would like, but Mr. Levitt, because you mentioned it, I will deal with you.

You mentioned at the end of your testimony that you have always wrestled with the issue of soft dollars. I have, too, because soft dollars is a little hard for me to understand. It is clear that the practice of allowing higher commissions in return for brokerage directed research has created great potential for abuse. At the very least, investors should know what commissions they are paying and what the money is going towards.

Is my recollection correct that that comes out of the NAV, the net asset portion of it, as opposed to a separate cost when you are dealing with those soft dollars in which they are paying excessive amounts to the brokers who trade for them? Or if you do not know the answer, does somebody know the answer to that?

Mr. LEVITT. I think ultimately, yes.

Mr. CASTLE. In other words, it is a hidden cost is my point?

Mr. LEVITT. It is a hidden cost and it is ill-defined. It is justified in all kinds of ways. The most frequent response from proponents is that, you know, Congress gave us a safe harbor, and my answer to that and I do not have an absolute formulaic response to it, because it cuts in many ways, but I think Congress should revisit that safe harbor, and, at the very least, the definition of where those dollars are going should be much more clear.

Mr. CASTLE. Well, let me ask this of you and perhaps others, just to expand on that. You see the fees. You see them stated. You will see them in the literature that I referred to. You have a 12(b)(1) fee, other costs of doing business, 1.3 percent of doing business or something like this.

Is it my understanding those soft dollars are beyond any of those costs?

Mr. LEVITT. Yes, the directors realize——

Mr. CASTLE. And maybe there are hidden costs that we are not even seeing.

Mr. LEVITT. Directors take the trouble to ask whether those dollars are going toward the purchase of furniture or whether they are going toward research and what kind of research and whether they are justifying other kinds of paybacks.

Mr. CASTLE. Right.

Mr. LEVITT. And I do not think they do.

Mr. CASTLE. Right.

Are there other soft dollar or other hidden costs beyond the other stated costs that come out before they value what the mutual funds are worth, can any of you answer that?

Mr. Phillips?

Mr. PHILLIPS. Yes, there are.

What you see for expenses are the dollar costs that were spent for management fees, for operation fees, but none of the trading costs are included in that.

Mr. CASTLE. Which is part of the soft dollars?

Mr. PHILLIPS. For the brokerage costs and the soft dollars would be appended to that are not included in the expense ratio, nor is the friction. When a manager is trying to buy a lot of shares with a thinly-traded stock, let's say $10, they may push the price up to $11 before they accumulate their entire position.

When their forced buying stops, the stock may settle back to 10. The reverse may happen when they go to sell.

Mr. CASTLE. And all of this is not a tight negotiation. Theoretically they are exchanging it because of better research or information on IPOs.

Mr. LEVITT. That is why the advertising is so deceptive, in terms of talking about performance above all else. They know perfectly well that performance is no indicator, no—past performance is no indicator of future performance.

Mr. HAAGA. Let me clarify something.

I am a regular in this room. I was here in March on a panel with several fund industry executives, several opponents of mutual funds or critics of mutual funds, I call them, I do not think anyone is an opponent of the concept, but the one thing we all agreed that the structure of soft dollars need to be reviewed.

Mr. CASTLE. Is there a revelation of what they are? We do not seem to find out what they are at this point?

Mr. HAAGA. Certainly, we know what soft dollars are. Chairman Oxley and Bachus wrote a letter to the SEC about soft dollars among other items back in March, and again in June, instructing the SEC to do a study. Let me also point out: Mr. Levitt mentioned furniture and whether soft dollars were being used to buy furniture, or other items beyond research.

The SEC did a sweep of investment advisors and identified a number of cases in which soft dollars were being misused.

Not one of those cases involved an investment advisor to a mutual fund. Mutual funds have enough problems without adding issues that aren't problems to our list.

Mr. LEVITT. You are saying there is no abuse of soft dollars in your judgment?

That is the industry's position.

Mr. HAAGA. Excuse me.

That there is no abuse of soft dollars? I think we could always improve the structure of soft dollars.

What I am saying is, and I will say it, again: The SEC did a sweep of advisors, including a number of advisors to mutual funds and found no abuses. The soft dollars system, the rules relating to soft dollars, should be changed and should be tightened up. We believe that. That is what I said.

Chairman BAKER. Would the gentleman yield on one of your expense questions?

Mr. CASTLE. I will be happy to yield if you will yield back after that for one question.

Chairman BAKER. Oh, sure.

Just on the expense disclosure you were making reference to the portfolio transaction costs are really a big chunk potentially that are not clearly disclosed.

There is a statement in the annual report, as to the percentage of turnover, but you do not know correspondingly the expense ratio assigned to that brokerage fee. It can be as high as 2.5 percent. It can be far in excess of the operating expense percentage rate and in one fund I made reference to in testimony yesterday, in 2002, had $2 billion in assets under management, had $9 billion worth of turnover and there was no explanation, for 440 percent turnover rate. I cannot imagine what the expenses associated with that level of turnover meant to the average investor. It is a huge problem. I yield back to the gentleman.

Mr. CASTLE. Well, a lot of these funds are over 100. 400 percent is really high. A lot of them are well up there, at 50, 60 percent. That is a lot of turnover in the course of the year.

Just a question very briefly of all of you, because my time is up. Is there anyone here, any of the four of you, who would suggest to the investors, the half of Americans out there who are invested, that the mutual fund industry is so tainted at this point, not individual funds but in general, that we need to consider whether we need to be in mutual funds, or not?

We went through this with corporations and others as well. I do not think you are, but, if you are, I would like to hear that.

Mr. LEVITT. Absolutely not. I think mutual funds are a superb vehicle for America's investors, and I think what all of us are talking about are restoring public confidence in an industry that has been badly tainted by recent revelations and by shifts in both investor sentiment and management practices that were part of the bubble of the 1990s and bring us to an unhappy place with respect to not just funds and corporations and markets themselves, all of which have fallen into great public disrepute, and it is our communal job to restore that and doing what we have to do, and Mr. Baker has come up with a bill that I think certain refinements would go a long, long way toward the restoration of that confidence.

Mr. CASTLE. Thank you.

Chairman BAKER. Thank the gentleman.

Mr. HAAGA. Could I answer that one, as well?

Chairman BAKER. Certainly.

Mr. HAAGA. We talk a lot about the 95 million mutual shareholders. That is a lot of people and who we are here representing in addition to the Investment Company Institute and the nearly 170,000 people who work in the mutual fund industry and several million advisors and brokers who use mutual funds with their clients. I can tell you that the great, great majority of them are just as appalled as I am and just as concerned about recent allegations. They are not engaging in these practices and they want us to fix it and so I hope we will all take that into account when choosing the adjectives and adverbs that we throw around at the industry.

Chairman BAKER. I thank the gentleman.

Mr. Scott?

Mr. SCOTT. Yes.

Thank you very much, Mr. Chairman.

To Honorable Levitt, you are the former Securities and Exchange Commission chairman, and with that, you bring a wealth of knowledge and experience, as we debate this issue of trying to bring credibility back to investors in mutual funds.

You wrote a book, last year, I believe it was, called Take on the Street, and, in that book, you mention that the deadliest sin in owning mutual funds was the high fee cost.

I find that to be very interesting, particularly in view of the late trading issue or 10 percent of companies, fund companies, are guilty of that, 25 percent of dealer brokers are guilty of that, with the multitude of market timing issues that are violated, and I was just interested why, why you would single out that one as the deadliest sin?

Mr. LEVITT. Well, I consider it the deadliest sin because that is the one that American investors least understand, and it is the one unfortunately that the industry, the mutual fund industry, in their advertising, least addresses, but the impact of what appears to be very minor adjustments in fund costs is devastating and is really hidden, in terms of prospectuses and documents which are so difficult for the typical investor to understand.

I think, just in my judgment, there is no issue that goes more to the heart of whether an investor makes or loses money in a fund than what kind of fee structure there is. It is like running a 100-yard dash but starting out 10 yards behind the line. It is a great burden to absorb and I think it is the one that investors understand the least of all factors surrounding investment and mutual funds.

Mr. SCOTT. That leads me to my—the second point of my question: I am very interested in financial literacy and have put quite a bit of work in this committee, along with some others, in dealing with financial literacy, because I really believe that education is the key, that so many of the problems that we have now is because of a lack of financial literacy, and, certainly, in the area of investor education.

What recommendations would you make, from your experience, as to what we could do?

Mr. LEVITT. I think that you are absolutely right.

My experience has been that a dollar spent on educating investors has vastly greater velocity than a dollar spent on developing regulations or a legislation, and I would urge industries that have fallen into recent public disfavor, such as the accounting industry and the investment company industry, to devote a much greater portion of their marketing money towards educating investors how to be smarter investors, how to understand these statements, how to know the difference between load and no load funds and what a broker brings to the table and doesn't bring to the table and what a sector fund means and the risks involved in that sector funds and what it means if a fund has bad performance, closes down, creates another fund with a different name with the same dollars and what are the implications to the investor.

I think those dollars would be well spent in educational programs, and I would encourage both the investment company industry and the accounting industry, that are in the spotlight these days, to carefully consider reallocation of marketing dollars toward educating investors.

Mr. SCOTT. Within our Broker Accountability Act and also within the legislation that we are putting forward on financial literacy, one of the features we are putting in is a 1-800 number for constituents, for consumers, for people to gain information or get access to information.

We are sort of developing this, as a result of the issue of predatory lending, to get information out there before the action is done.

That is a requirement, also, with our Broker Accountability Act.

Do you feel the application of a 1-800 number that is marketed and made accessible to the markets would be an approach that might be worth looking at?

Mr. LEVITT. I think it is one part of a much larger program, and I think it is useful. At the Commission, we had such a number, and employees of the Commission and commissioners themselves spent time down there answering that 1-800 number, and I think it would be awfully useful to have managements of mutual funds be on the receiving end of 1-800 calls, to get a much greater feel of what it is like to be the man or woman in the street. There is no better way to understand what motivates, what misleads, what directs, what impassions investors than to be in the trenches.

Mr. SCOTT. Great.

I enjoyed your book, Take on the Street. It is a good book, and I recommend it, as well.

Mr. LEVITT. Thank you.

Mr. SCOTT. I will give you that little commercial plug.

Finally, I want to ask you: We are grappling with an issue of investor restitution and how we deal. I am working with Chairman Baker on a bill that sort of deals with a way to bring the SEC together with having a kind of a single regularity. It just seems to me that having fifty States, with the possibility of overriding Federal policy in this area, doesn't make sense, and I do know we have some very outstanding Attorney Generals, and Attorney General Spitzer does a very good job, but I would like to get your take on that.

It seems to me there ought to be room, and I am working both with Chairman Baker and our ranking member, Barney Frank, and I think that we are at a point where we are dealing with a conclusion of being able, but there just seems to me that there is some very substantive value in having a single regulatory function operating out of the Securities and Exchange Commission, while at the same time, protecting and allowing the States to maintain their authority, to prosecute, to investigate, and to deal with the collection of funds.

Would you not think that is the best solution?

Mr. LEVITT. After your endorsement of my book, you make it so awkward for me to have to disagree with you, but as you said those words, I kept thinking of something that is going on in New York

City, down at 6 Center Street as we talk, where a remarkable District Attorney of the State of New York is bringing a case against Dennis Kozlowski and has brought a myriad of cases, and there are Attorney Generals and securities directors around the United States that have a feel for the trenches and the individuals in those communities that cannot quite be replicated by a single regularity.

The way this should work, in my judgment, the beauty in our system in America, is to fuel the juices of competition by having a multitude of markets, not just one market. We have a dealer and auction and electric markets.

While I very much favor splitting off regulation from marketing in the New York Stock Exchange, I certainly would oppose a single regulator. Having run a market myself, the competition between regulators I believe is healthy, and by the same token, I think that, if coordinated appropriately, if you can work together in a cooperative reasonable way, Federal regulators have the resources, they have the law, they have the people power, but they can be supplemented in some instances by States and regulators who have a feel for the community and provide a better measure of investor protection than doing it just unilaterally in one single jurisdiction, in my judgment.

Mr. SCOTT. Let me ask you: How do you respond to the concerns of our Federal—our Fed Chairman, Greenspan, who testified before this committee, just the opposite of what you have said, and your present chairman of the SEC, who says that?

What is the difference, what is the—what makes you feel that their thoughts on this would not hold water?

Chairman BAKER. Mr. Scott, if I can jump in and maybe help a little bit. I think the gentleman's point can be aided by the observation we are not discussing the ability to investigate Prosecutor Fine.

What the gentleman's concerns have been aimed at is with regard to the remedies and only where the remedy affects national market structure, should the SEC be consulted and be maintained in a position of primacy with regard to a single national Federal securities market, and that is where he and I have joined together, not knowing exactly where the phone call is to be made between Mr. Spitzer and the SEC when he is negotiating a settlement, but if he is going to cross over the line at the end of the day and change a regulatory structure that impacts national markets, the SEC needs to be consulted in the event that should take place, but in no way does it limit or hope it limits his ability to pursue wrongdoers however he sees fit, and I thank the gentleman for yielding.

Mr. LEVITT. I think consultation is always desirable. I speak from a perspective of someone who ran a brokerage firm, who is greatly concerned about redundant regulation dealing with the NASD, the New York Stock Exchange, the American Stock Exchange, and the SEC. I also ran a self-regulating organization, and I also was a Federal regulator, and I have seen the system, and I believe that this system works and works well.

Are there offsets to it? Yes. Are there redundancies fueled occasionally by over zealous prosecutors who are seeking political gain? Yes. There is that danger. But the offset, in my judgment, is worth it, and I think a reasonable amount of coordination between the chairman of the SEC and State regulators can and has, in the past, addressed these issues.

It occasionally will move in the wrong direction, but by and large, I would not favor a legislative fix to this, at this point.

I think we are working pretty constructively on the two major areas of abuse that society faces today, and I would not like to send a message to the public that we, in any way, are trying to muscle any of those that they regard to be their protectors. Tomorrow morning on television, the question was asked of viewers if they had a case of securities fraud to whom would they make the first call, would it be to their State regulator, would it be to the NASD, would it be to the SEC. I will be curious to hear what the answer would be.

Mr. SCOTT. So, right now, you support joint jurisdiction?

Mr. LEVITT. I support the system as we have it now.

Mr. SCOTT. All right.

What would be your response to broker dealers and the patchwork of overlapping and conflicting State and local regulations, right now?

Mr. LEVITT. One of the mandates that I gave to the SEC was in the newly-formed Bureau of Inspections and Examinations to eliminate that overlap, and the SEC can do that by bearing down on self-regulating organizations and asking the question: Are you redundant, in terms of your inspections, and, if you remember, layoff.

That can be controlled, and I think it is a priority of the Commission to keep that from being burdensome to the industry.

Chairman BAKER. Mr. Scott, if I can, move on to the next.

Mr. SCOTT. Yes.

Chairman BAKER. Chairman Oxley?

Mr. OXLEY. I thank you, Mr. Chairman, and welcome to our second panel.

You are all familiar with the legislation that is pending, it was passed out of the committee, H.R. 2420, and I think all of us would agree that it is a good first step in trying to correct some of the problems, and this is something that Chairman Baker and I and others have worked on for quite some time.

First of all, let me ask each one of you if there is anything in that legislation that you do not agree with, or is there something else that we could add before we go to the floor?

Let me begin with you, Mr. Haaga.

Mr. HAAGA. There are no broad topics in the current version of H.R. 2420, broad provisions, with which we disagree.

I think we want to talk about some of the language, particularly the language that specifies the duty of directors and make sure those provisions are drafted correctly and appropriately. But other than that, I think we are ready, but we do need to sit down with a pencil to tighten certain language.

Mr. OXLEY. One of the controversial areas that was considered, as you know, was the—an appearance of the board chairman. Has the ICI changed its position on that particular issue, which I understand was opposed to that change?

Mr. HAAGA. Let me talk about that, for a minute. I think we agreed with so much and supported so much of H.R. 2420 that I think people picked up on one area that we substantially disagreed with, and I think it has gotten too much attention. I have talked to our directors.

Now, I am talking about American funds. I have talked to them about whether they want an independent chairman, and their response is that I think the response of many in the industry would be: For all practical purposes, directors are officially independent. They have a separate vote, a separate executive session of independent directors when they are going over the principal issues in which possible conflicts of interest lie. The contracts committee and approving the advisory agreement are separate meetings chaired by a lead director. That lead director, in effect, functions for all practical purposes as an independent chair, except in the circumstances where we are dealing with the administrative or non-controversial or non-conflict issues. So I think I would. We still do not think it is an improvement or a good idea to require it.

All mutual funds, have a two-thirds majority of independent directors, if the independent directors would like to vote for an independent chair, they certainly can. I would also add that it is no silver bullet. Three of the eight fund groups that have had the problems that have been cited so far, had independent chairs. One even had an independent compliance staff that reported solely to the board, so I think we want to be careful there.

Having said all of that, I would like to discuss with the staff and with the committee chair and others some way to get through this and get some agreement here and figure out how we can structure this thing, because I think we are getting held up on something that we can solve.

Mr. OXLEY. Mr. Bullard?

Mr. BULLARD. Yes, I would make one significant recommendation. If I recall correctly, the bill that was passed only required the Commission to do a study on whether commissions should be required to be excluded in expense ratio, and I think that is—that should be changed to either it should be required to be included in expense ratio, or even better yet, as Mr. Phillips suggested, all portfolio transaction costs should be included in expense ratio.

That expense can be larger than the entire expense ratio combined, and it is inexcusable that that is not something that the SEC has come out in front on and I would like to see the industry come out in front as well because that is an area where expenses vary greatly across different funds, so I do not know how you can compare funds when you do not have the tools with which to do it?

Mr. OXLEY. What about the issue of independent board chairman?

Mr. BULLARD. I am in favor of that. It, also, is not a cure-all. It goes without saying that all things being equal, an independent chair will be more independent.

I think the best argument the industry makes is who do you want setting the agenda? Does it need to be someone who is advisable from the advisor or running the meeting or can it be someone who isn't necessarily as knowledgeable?

My indication is the advisors and employees should be at the beck and call of the chairman, whether he is independent or not, and I do not think the chairman of this committee needs to be a mutual fund expert any more than the chairman of a mutual fund. The mutual fund's job is to make sure the shareholders are protected. Your job is to make sure the public interest is served and once you do, you go out and make sure you get the experts you need to get the job done.

Mr. OXLEY. Mr. Phillips?

Mr. PHILLIPS. I think visibility is perhaps even more important. We have had the case with Putnam with a number of whistle-blowers, but none of them thought to go to the fund trustees, which says that we may have the right structures, but somehow they are not working in practice. I had the opportunity to speak several years ago with a gentleman who was on the board of a major mutual fund complex and oversaw a number of funds, and he was an independent director. He was also on the board of a publicly traded company and he made the comment to me that being on the board of a publicly-traded company, his identity was well-known and he received at least a dozen or so letters per month. He said he didn't always enjoy receiving those letters.

In the aggregate, they made him a better director because they put him in touch with shareholders, but in working with mutual fund boards, he had never once referred a single letter from shareholders. There is no communication right now between investors and the independent directors who are supposed to be representing their interests. If we do not find a way to open up those communications and get some more visibility to the directors, it doesn't matter if they are independent or not. If they spend none of the time with the shareholders, ultimately they will end up reflecting the views of management, not the views of shareholders.

Mr. OXLEY. Why is that a failure? Whose fault is that? Is it the investors fault that they do not take enough time to get involved? Is it the structure? Is it a combination of those? What—and, obviously, the issue that we have is: Is it something that can be legislated?

Mr. PHILLIPS. I think it is incredibly healthy if we all think of mutual companies as investment companies and not investment products, even though top regulators oftentimes and other industry experts will refer to fund investors as customers. Mutual fund is not a product that you consume. The same way Ford Motor Company is not a product. When you buy corn flakes, that is a product. You do not have a board of independent directors to protect you on your consumption of corn flakes. There is a big difference between the two. Investors are more trained to be consumers. They do not think of themselves as owners. I think we need to put that front and center. The identity of the role of the independent director is something that has been relegated to the deep, deep, footnotes in marginal documents that an investor wouldn't typically receive.

I think we need to bring this front and center. In my mind, one of the things that was so great about the 40 Act, and the reason it served the industry so long and so well is it came at a time when no one trusted mutual funds and the framers of that Act went out of their way to ensure investors that if they were to put their trust in a mutual fund, that their interest would be put paramount.

I think the structure of the investment company is magnificent. As Jack Bogel said in this Sunday's New York Times, as an instrument for long-term investing, there exists in the mind of man no better vehicle than the mutual investment fund, but we need to get back to the spirit of it and the structure that that imposes as an investment company.

Mr. OXLEY. Thank you.

Mr. Levitt, welcome back to the committee.

Mr. LEVITT. Thank you.

I couldn't agree more with Don with selling mutual funds as soap and beer and corn flakes is just wrong.

About 10 years ago, the head of one of the top 25 mutual funds in America met with me and I asked him about the difference between directors of corporations and investment companies, and he said, frankly, investment companies do not need any directors whatsoever, and I guess that has conditioned my thinking about this. I very much support the notion of a lead director, and I think the most valuable additions to this very sound legislation in my judgment would be adding fiduciary responsibility to the mandate of the 40 Act and maybe most importantly, the revelation of compensation of managers and a ban on trading by managers. I think these—again, when I say a ban on trading, I do not mean they shouldn't own shares in the entities they manage, but they should not be allowed to trade in and out of them, and the revelation of their compensation I think is terribly, terribly important.

These are the additions I would suggest.

Mr. OXLEY. Well, obviously, you know, we have gone through that recently with the whole issue of publicly traded companies and more transparency and I think what you suggest certainly from our perspective makes a great deal of sense, in that more transparency normally provides for better governance and better understanding of the entire process.

Thank you all for an excellent panel.

Mr. Chairman?

Chairman BAKER. Thank you, Mr. Chairman.

Mr. Frank?

Mr. FRANK. Thank you, Mr. Chairman.

Mr. Haaga, you said you thought that the issue of the independent chairman, was getting too much attention. Well, I will explain to you why, the one issue in which there was any difference over the bill last time, and my advice is, give it up.

I am skeptical. I must say it doesn't make much difference one way or the other and I heard the static you gave. If, in fact, we did a survey of the companies and tried to find out what differentiated them, whether they had a separate CEO and chairman wouldn't matter much. I would have to say I was not a great connoisseur of corporate boards before taking on this position as ranking member.

I am singly impressed with them as a group. On the whole, the role of the corporate boards in almost all the standards I have seen is what Murray Camptom imputed to editorial writers. They come down from the hills after the battle is over and shoot the wounded.

I am all in favor if people think it would help, we could have one. I think that is all we are going to need, but I also have a question for Mr. Levitt, because he was an extremely distinguished chairman of the Securities and Exchange Commission, and one of the issues that is now before us is the bill, H.R. 2179, that is being held up because of the dispute, although it is a lessening dispute over pre-emption, and I would be interested in how important—I do not know if you were familiar with all the details of all of that, but there were a series of requests, too, from the SEC for more enforcement, including, I think you were here when I read some of the serious increases, with regard to the Investment Company Act; it would significantly increase the penalties that could be levied, generally by a 500 percent figure, and it would also make it easier to bring them administratively. How important is the penalty structure, as a part of this operation, Mr. Levitt?

Mr. LEVITT. I think the penalty structure is part of it but not necessarily the most important part of it.

Mr. FRANK. Well, I understand, but we get more than one peck. It is not a case of whether you get only one peck; I mean, there are several things, several things that you get, so I would be interested in an evaluation of the penalty structure in and of itself. There are two separate bills, a bill on mutual funds that the committee voted out that has been held up, not at our request, and then there was the SEC bill that didn't get voted on. They were not competitive. If we get time to do both, it wouldn't take very long.

Mr. LEVITT. I am just not familiar with those bills to be able to give any meaningful comment. I am familiar with——

Mr. FRANK. That is not a rule around here, you know.

Mr. LEVITT. I have been—in terms of penalties I have seen extracted in cases of egregious fraud, I have often felt that they were far less effective, in terms of the deterrence of fraud than humiliation and embarrassment.

Mr. FRANK. Okay. Let me ask because I agree we have a problem with the culture here, and it is helpful to have a separate CEO, but how do you build in, you were talking about this, Mr. Bullard, how do you build in this sense, Mr. Levitt, you talked about it, too, when you said we do not need directors.

Part of it is going to happen from the publicity. I must say as a mutual fund investor myself, I am now more aware of questions I should ask. I do not spend a lot of time on that, but I buy mutual funds and I ask questions. I will now be asking these questions and I think a lot of other people will, too, particularly those who buy mutual funds as fiduciaries for others. We have already seen this, with regard to pension funds and others, and people who kind of bundle other people's money and buy mutual funds will be more aware, so I think the transparency issue is going to work very well, but what would we do to try to institutionalize this, obviously, there are penalties, all these other things, but those are also signs there have been failures of the system. How—what would you build into the structure?

We have one bill brought out of committee, there will be others. Are there any structural proposals you would make over and above what we are already seeing to make it better? Let's start with—yeah, go ahead.

Mr. BULLARD. What I propose is there be a mutual oversight fund board appointed by the SEC that would have examination and enforcement authority, and the need for that is that regulators in general are very good at enforcement and interpreting and objective rules, and, when it comes to boards, what you are dealing with is the traditional area of State, corporate law, which is the meaning of a fiduciary duty, and the SEC is simply not going to be the best vehicle for setting forth fiduciary guidelines for fund boards that go to the level of detail you would need to combat the late trading. You need a group that is going to say we have this trading issue.

Here is what you need to do to satisfy your fiduciary duties, and to work with those boards and across all boards give them consistent guidance, as to what the expectations are, as to reviewing fees, reviewing trading, reviewing prospectus disclosure like market timing, and it is has to be a group of experts and a group that has enforcement authority. It would not be rule making authority. It would be the answer to what is a decades old problem in the industry and that is fund directors have been whipping posts of the fund industry for decades, and one thing I can say in their defense is there has been a real absence of strong guidance, exactly what they were expected to do at a minimum.

Mr. FRANK. Mr. Levitt, you ought to be allowed to comment on that.

Mr. LEVITT. I think that—I have said before that so much of this is a function of a cultural change that has swept America, and we are basically a friendly Nation. We go on boards of companies where we tend to know the chairman and other board members and we are reluctant to speak up when—once we are there.

I do not know that that, in and of itself, is going to change, and I am not certain that any piece of legislation is guaranteed to change board behavior, but I think, if the responsibility is spelled out very specifically, as being a fiduciary responsibility, if the guidelines for those that are the custodians of the investment company assets, the fund managers, are bound by specific restrictions that could be imposed, either by regulation or legislation, I think that is about as far as you can——

Mr. FRANK. Let me finish with this, Mr. Chairman. I just want to break in. Seems to me what you are saying in part is since there is not enough natural orneriness around, since we all are intimidated by disagreeing face to face. It is not a pleasant thing. People do not like to do that, they shy away from that.

The question is how do you build that in, and I think the question is you build it in by imposing legal liability. That is what we did, that is what the chairman of the industry did of the accounting industry. You basically say, I do not mean to be a bad guy here, but I got to protect myself, and when we kind of make it easier for people to be confrontational, I got to do that, and I say that because some of the criticisms we have heard of some of the people in the corporate world is: We make it too hard to find directors, because once you make them liable and once you hold them responsible, it is too hard to find directors.

I think what you are saying, it has already been too easy to find directors and it ought to be too hard to find directors and people ought not to take on directorships, unless they are able to be different than the normal social views.

Mr. LEVITT. I also do not think we are looking in the right places for those directors. It hasn't been written in stone that you have to be a CEO to be a director. As a matter of fact, I believe that CFO's and CIO's and educators and others and people of good judgment, chances are they will be as good at their direct to recall responsibilities as overburdened CEOs.

Mr. FRANK. I understand, but I would also stress, you have helped me understand what is at stake here, and I think, as I think about this, I would be less willing to yield to an argument that would make it too hard to be a director. It ought to be hard to be a director.

Mr. LEVITT. Yes.

Mr. FRANK. And we have to build in institutional mechanisms to overcome this natural tendency to, A, one, pick your friends and then to get along.

Thank you.

Chairman BAKER. Thank you, Mr. Frank.

Mr. Royce.

Mr. ROYCE. In addition to the issue of deterrence and adding criminal penalties as a way to change behavior, one of the real questions I have here is, on the question of compliance procedures: In these specific instances, where were the compliance procedures? Why weren't they strong enough for the funds or for the investment advisors?

In the chairman's bill, we have taken certain actions to set up a chief compliance officer, so we will have that in place, but I was going to ask Mr. Haaga: In your view, how can the industry right itself in this area of compliance?

Mr. HAAGA. I think I would like to answer that question and also say something about directors, in light of the previous comments.

The SEC has requested comments about a potential rule proposal requiring a specific compliance officer, it was both an SEC proposal and a provision in H.R. 2420, I think that is a very substantial assistance in this area and that we supported the rule, we support the legislation, and we look forward to complying with it.

On behalf of directors, I have just got to say: This whole discussion is unfair to independent directors in a lot of what is being written and what is being said.

I strongly disagree with Mr. Spitzer's characterization that this was a director problem, that they should have known. This was taking place in an area—in the delayed trading and market timing at an area—and a level where directors just cannot be aware of.

That is our internal compliance shops that ought to have been picking that up and in many cases were picking that up. Probably the only word that I have used more often than shocked or appalled in the past couple of months is surprised. I have been involved for 32 years, and this is the first time I have ever heard of someone being involved in late trading. I am sorry that happened, but I have a hard time blaming independent directors for not finding something that 32-year veterans couldn't find because they simply didn't know it was happening.

Mr. ROYCE. But the compliance officers would find it, that is their charge to find it.

Mr. HAAGA. I cannot guarantee that. I will say that it will be an enhancement and that they will find more things, and I am sure they will find late trading in the future. We do not need two wake-up calls.

Mr. ROYCE. Let me ask you another question, because we had the suggestion here in the earlier panel that, perhaps, mutual funds should actively bid out management contracts to multiple advisors.

On the surface, I think this sounds good, but are there issues involved here where we should be concerned about this proposal, in terms of its effect?

Mr. HAAGA. This issue comes up every so often over the years and it has a nice ring to it. It happens to be impractical. I think people who buy our mutual funds and set up their accounts with our companies are not expecting us to move management to another company. Let's remember that it is not just the shareholders. It is also advisors that they use and it is also the 401K Plan trustees who have selected the mutual funds and moving the investment advice away to someone else is certainly inconsistent with their expectations.

The observation that is always made is, you know, mutual funds are not mobile and if mutual funds were mobile among advisors, then there would be better bargaining. That overlooks the fact that even though mutual funds are not mobile, investors are mobile and I think we have all seen the studies and seen the charts. The three largest selling fund groups would be three groups that have way below average expenses. Something like 80 percent of all investors are in funds that have below average expenses.

So I think the results clearly prove that investors are mobile, investors are moving to the funds that are giving them the best results and the most appropriate, not lowest, but most appropriate expenses, and I do not think we have—we do not have to additionally make the mutual funds mobile, but I think it is a terrible——

Mr. ROYCE. But would it be a disincentive for starting new funds?

Mr. HAAGA. That would be one of the many problems involved in the proposal.

Mr. ROYCE. Mr. Levitt?

Mr. LEVITT. I would like to make a comment on that. I think Mr. Haaga represents one of the finest best managed funds in America, so I would not take his observations to apply across the broad spectrum.

What I would suggest is that directors carefully consider alternatives and define the fact that they have considered alternatives to justify the retention of management.

I do not believe that the continuation, the failure to change managers in the overwhelming number of instances is any more of a failure than the failure of analysts, sell-side analysts, who 98 percent of the time recommend buys rather than sales. That doesn't happen in a vacuum, and I think that it is, should be, the responsibility of directors to justify their selection, rather than merely going along with it.

Mr. ROYCE. And, so—and so you would move down that—down the path towards encouraging this.

Would you mandate it legislatively?

Mr. LEVITT. Generally speaking, I am reluctant to consider legislative mandates. Every time I have put something in stone, in terms of governance or issues of that kind, I have looked back and found that I have endured unintended consequences.

Mr. ROYCE. Thank you, Mr. Levitt. Let me ask one more question, if I could, Mr. Chairman, and I wanted to ask Mr. Haaga, Attorney General Spitzer, in his testimony here, pointed out that fund investors are charged some 25 basis points a year more than pension investors.

Are individual fund investors being treated in your view unfairly here or are there legitimate reasons for this cost differential that exists between the two investor classes?

Mr. HAAGA. I think there are very legitimate reasons. Among other things, we are dealing with a retail investment vehicle. We are not dealing with simple portfolio management. The sum of the cost differential is in the total expense, not just in the advisory fee, relates to the fact this is a big chunk of mutual fund expenses are paid to an individual advisor that advises the shareholder. Pension plans do not have that. They do not have individual advisors.

It is interesting to note that where mutual funds or some mutual funds organizations manage funds, manage and serve as administrators and do the whole management thing for some funds and then simply serve as a subadvisor, only as a portfolio manager for a fund, which is an area which is much more comparable to managing the pension fund. It is just portfolio management, and, in those cases, their subadvisory fees tend to be very close to what is being charged to the Pension Fund because, in those instances, the services are much better.

I guess I can go through a bunch of examples in our own firm and will not burden us with it, but I guess we can talk to the committee.

I would say we have 6,000 employees. 200 of them are portfolio counselors or research analysts, actually about 200 and a quarter.

The other 6,000 are providing a lot of services and most of them are involved in providing services to mutual funds. To only look at what the cost of the 250, is missing a huge point.

Mr. ROYCE. Mr. Chairman, thank you.

Chairman BAKER. Thank you, Mr. Royce.

I just have one sort of clarifying question. Mr. Spitzer indicated yesterday that pursuant to charging some individual firms with trading abuses, finding them in law to be guilty, that he would then move to discourage all advisory fees during the time in which the alleged allegations took place.

Given your comment earlier today, in favor of restitution for wronged individuals, is that an appropriate remedy in your view in those cases where you have reached a final accord in a court?

Mr. HAAGA. I would love to be responsive, but I cannot. I do not really know the facts involved, and, really, that is going to be between the Attorney General and the individuals, and I will go back to my previous comment about nearly 200,000 people. When you take money from an organization, you take it from everybody, so I hope maybe we can find some ways to punish the wrongdoers financially and not merely punish someone who is appalled by the wrongdoing, and that is all I will say on that.

Chairman BAKER. And I do not want to see folks get fined for defrauding an investor and have it go to a governmental agency. I want it to go back to the people. That seems to be a radical thought, but I really think we ought to give it a try.

Mr. Haaga.

Mr. HAAGA. That I can support unequivocally.

Chairman BAKER. Do you have anything else, Mr. Scott?

Mr. SCOTT. Thank you, Mr. Chairman.

I want to get your response, Mr. Haaga, and then from some of the others on two of the fundamental areas that is causing a lot of credibility thoughts with the investors of mutual funds.

One is the late trading, and the other is the market timing, and I wanted to get your response on how you felt we should deal with these, and, specifically, to one recommendation that you may feel, particularly with the late trading.

If we required that all orders be received by the fund, rather than by the dealer broker or his intermediary prior to the 4:00 p.m. Closing date at net asset value, would that eliminate illegal late trading?

Mr. HAAGA. I can never say for sure it would eliminate it, but I cannot see how you could do it.

You would need collusion and you would need it at the fund group, and we receive these things through technical systems and so I think about it, but I am having a hard time imagining. I use the term "slamming the window shut" and I think it really does.

Mr. BULLARD. Okay. Since we have already had allegations of collusion with fund companies, there is no reason to believe that a 4 o'clock cutoff time would prevent the same type of collusion with respect to that cutoff time. The more important questions is whether people are going to comply with the rule. There will be marginal improvement. One reason is that it will put intermediaries out of the potential business of evading the rules, but as Congresswoman Biggert pointed out, that will impose costs on 401K plans and it will impose disproportionate costs and disadvantages to people invested in those plans, as opposed to individual investors or other institutional traders. So the real question is here: Why do we have a compliance failure, because the rules were clear before, and, if they are clear later, it is not necessarily going to make compliance better.

Mr. HAAGA. I disagree with that, but I won't repeat everything I said.

Mr. Scott, if you don't mind, I would like to clarify or respond to a question that you asked earlier and that deserves a further response. You asked about the impact of the whole market-timing phenomenon on non-U.S. markets. Our firm, I won't say specializes, but we are well-known for our investments outside the U.S., or global international funds, and we have offices all over the world. To the extent that this market—these market-timing problems have made global and international funds less attractive and made them earn less money for shareholders and brought less money into them, there is going to be less U.S. money that is invested outside the U.S., particularly in emerging markets, which is a big area of our investment, and that will have an impact. So we need to fix the international funds for the U.S. investors to help the non-U.S. markets.

Mr. SCOTT. All right. I appreciate that. I think that those two issues, the late trading and the market timing, are probably two of the biggest concerns.

Let me ask about redemption fee on short-term mutual sales. Would that help with the market timing or would it have too burdensome an impact on the institutional and noninstitutional customers?

Mr. HAAGA. Well, it will have a burdensome impact. And that—we have come to that reluctantly. I think all of us have. But we have concluded that it is necessary to—in addition to all the other remedies that exist in the market-timing area, that this is something that is worth doing despite the imposition on shareholders.

There have been some studies about market timing that show that within the first one or two days you get at some enormous overwhelming majority of the advantages of market timing, you eliminate them; and so I think keeping a very short period we strike the right balance. It doesn't eliminate liquidity or doesn't reduce liquidity too much for shareholders. It lets them change their minds a few days after they invest it. But, at the same time, it gets at most of the market-timing problem.

Chairman BAKER. Thank you, Mr. Scott.

Gentlemen, I certainly appreciate your participation at our hearing today. Your perspectives are very helpful to the committee's considerations. We look forward to working with you in the days ahead and hopefully coming to a speedier resolution rather than slower resolution on these important matters.

Thank you very much, and our meeting is adjourned.

[Whereupon, at 2:06 p.m., the subcommittee was adjourned.]

# MUTUAL FUNDS: WHO'S LOOKING OUT FOR INVESTORS?

**Thursday, November 6, 2003**

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
*Washington, D.C.*

The subcommittee met, pursuant to call, at 10:05 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Castle, Kelly, Shadegg, Green, Toomey, Kennedy, Tiberi, Renzi, Kanjorski, Hooley, Sherman, Inslee, Capuano, Frank ex officio, Lucas of Kentucky, Crowley, Israel, Clay, Baca, Matheson, Lynch, Miller of North Carolina, Emanuel and Scott.

Chairman BAKER. [Presiding.] I would like to call this meeting of the Capital Markets Subcommittee to order. I again advise that members are in various stages of travel to the committee this morning, so we will have others arriving. But in order not to unreasonably delay the proceedings, I thought we could start with appropriate opening statements. I am told Mr. Kanjorski will be here momentarily.

The purpose of our hearing this morning is to continue the committee's work with regard to the adequacy of mutual fund oversight and regulation. I am particularly pleased to have the witnesses here today who can give us their particular expert view of recommendations for appropriate action. At the base of our consideration is H.R. H.R. 2420, passed out by the full committee, which sets in motion regulatory reforms the committee felt advised to adopt at that time. In the course of time since the bill was reported out, various inquiries have given the public knowledge of the broader base of concern about mutual fund management conduct. To that end, I will be appreciative of any perspective relative to H.R. H.R. 2420 and to any recommended additions which you might think advisable in light of the knowledge you have gained over the past months.

It is clear that given the number of Americans who now invest in the mutual fund industry, the number of households who are directly invested in the marketplace, that resolution of this matter takes on a particular sense of urgency. I do believe it is in the best interest not only of consumers, but in the marketplace as well, to have the issues of governance resolved and behind us at the earliest possible moment. The numbers of individual investors are enormous and the flow of capital they provide to the marketplace is very important. To have confidence shaken and to have those investments on the economic sideline is not in anyone's best interest.

To that end, I have discussed with Mr. Frank this morning, Mr. Kanjorski earlier, the desire to move the legislation at the earliest possible convenience and much of that process will depend, of course, on the agreements that can be reached on the various elements that perhaps would be part of a manager's amendment to H.R. H.R. 2420 on the House floor at a later time.

I am particularly pleased that the participants in our first panel were able to be with us today. Mr. Galvin, your work has been extraordinary, and that of Mr. Spitzer as well. Although we have not necessarily agreed on all perspectives, I do believe that it is important for the policymakers and the frontline regulators such as Ms. Schapiro at the NASD, all have some consensus approach to resolution of this problem. I look forward to gaining that agreement on all matters and moving forward expeditiously. I think we all share the same common goal of providing for a fair, transparent marketplace in which all stakeholders are treated the same and where all rules are applied equally. I applaud you for your efforts to this date and look forward to working with both of you in the future.

With that, I would yield to Mr. Kanjorski for his opening statement.

Mr. KANJORSKI. Thank you, Mr. Chairman, for the opportunity to offer my thoughts before we begin our second hearing this week on wrongdoing in the mutual fund industry.

As you know, Mr. Chairman, the recent troubles at companies like Strong Capital Management, Janus Capital Group and Putnam Investments, among others, have caused me great concern. This unease led me to call upon you in late October to arrange for hearings so that we could identify the steps that participants in the mutual fund industry and their regulators are taking to protect investors's interests and restore investor confidence in light of these scandals.

In my view, we have an obligation to American investors to monitor these developments. I therefore commend you for promptly responding to my request and others and convening these proceedings. With approximately 95 million investors and $7 trillion in assets, the dynamic mutual fund industry constitutes a major part of our securities markets. Heretofore, many experts had extolled the mutual fund industry for working to democratize investing of millions of average Americans, allowing them to easily participate in our capital markets with a diversified portfolio.

During the last 2 months, however, we have learned about several alleged and/or demonstrated incidents of market timing and late trading abuses in the mutual fund industry. Because investor protection is a priority of mine on this panel, I am very concerned that the effects of these events on small investors who likely lost money as a result of these transgressions and probably became further discouraged about participating in our securities markets.

I also believe that all participants in the securities industry have a responsibility to behave ethically and follow the rules. As a result, the announcement of each new case of misdeeds in the mutual fund industry has greatly disturbed me. Many parties are also now taking action to address these problems, including New York Attorney General Eliot Spitzer and Massachusetts Commonwealth Secretary William Galvin. The Chairman of the Securities and Exchange Commission has additionally noted that his staff is "aggressively investigating the allegations and is committed to holding those responsible for violating the federal securities laws accountable, and seeking restitution for mutual fund investors that have been harmed by these abuses."

In addition, the Investment Company Institute has unambiguously reaffirmed that shareholders's interest must be placed before all else. As you also know, Mr. Chairman, I believe that it is very important for us to explore market timing and late trading problems in the mutual fund industry, as we have not previously examined these issues in the 108th Congress. Earlier this year, we considered and improved H.R. H.R. 2420, the Mutual Fund Integrity and Fee Transparency Act.

In general, H.R. H.R. 2420 seeks to enhance the disclosure of mutual fund fees and costs to investors, improve corporate governance of mutual funds, and heighten the awareness of boards about mutual fund activities. Although we held two hearings in the Capital Markets Subcommittee to review numerous topics related to the mutual fund industry before marking up H.R. H.R. 2420 in the full committee, we did not specifically explore the issues of market timing and late trading. In light of the current public revelations about these abusive practices, I am consequently pleased that we are examining these matters now.

Furthermore, Mr. Chairman, I share your concerns that our panel must continue to conduct vigorous oversight to examine whether our regulatory system is working as intended and determine how we can make it stronger. It is my hope that today's proceedings will help us to better understand the current problems in the mutual fund industry. Our goal in any further legislative efforts in these matters should be to ensure that we advance the interest of average investors by preventing these problems in the future and improving the performance of the mutual fund industry in the long term.

In closing, Mr. Chairman, I look forward to hearing from our distinguished witnesses on these important issues. Mutual funds have successfully worked to help middle-income American families to save for early retirement, higher education and new homes. We need to ensure that this success continues.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 252 in the appendix.]

Chairman BAKER. Thank you, Mr. Kanjorski.

Mr. Castle?

Mr. CASTLE. Thank you, Mr. Chairman. I do want to get to the witnesses. I will try to be brief. I just want to thank you, and I want to thank Mr. Frank and Mr. Kanjorski. I think you are doing absolutely the right thing. I think these hearings have been invaluable, just the hearings themselves, regardless of whether there is a product from them or not have been invaluable. I think the concept of moving this along as rapidly as possible, as you have indicated about H.R. H.R. 2420 and the manager's amendment should put every one of us up here and everybody out there and everybody who is listening this or paying attention to this on notice that this is going to move quickly. I think we should. I think frankly there are abuses that have to be addressed so that we can prevent these abuses in the future.

On the other hand, I am cognizant of the fact that none of this is very simple. Every time I look at this or listen to one of our witnesses or have a meeting with somebody, I realize the complexities. It is not easy to have blanket rules that apply fairly to everybody. So we are going to have to work really hard to make sure we do it correctly. I think we are doing the right thing by moving forward rapidly, but we need to move forward in a way that is going to be beneficial to everybody involved, with whatever we are going to do versus what the SEC is going to do, or whatever.

I would also like to thank those who have really brought this to light. Mr. Galvin is one of those people. Mr. Spitzer is another. There is some discussion about the state versus the federal. My judgment is there is certainly a role for both. I think frankly if the States did not inspire this, perhaps the SEC would not be quite where they are today. I, for one, appreciate that. I also appreciate those good regulators represented here and otherwise who have come forward to make a difference. It just seems to me that there is potentially a good team effort here if we do all this correctly to take this industry, which is of extraordinary importance to the investing American public. Fifty percent of Americans have some involvement in mutual funds, and that may even be an understatement, if you really understood all your pensions and everything else.

It is just absolutely vital that we run it correctly. It is not to be run as some sort of a market-timing piggy bank for those who are trading by the second or whatever. It has really always been established to be more of a long-term investment vehicle and we have to return it to them. I think we are taking a lot of very good steps here. So I do appreciate the hearings, and I appreciate all that you are doing. I, for one, stand ready to help in any way I possibly can.

I yield back.

Chairman BAKER. Thank you, Mr. Castle, for that kind statement.

Mr. Frank?

Mr. FRANK. Thank you, Mr. Chairman. I very much agree with what the Ranking Member of the subcommittee, the gentleman from Pennsylvania had to say. I think we are ready to pass legislation that will strengthen the law regarding the protection of investors in mutual funds, both the mutual fund bill and then parts of the SEC's request, which would enhance SEC powers. But it is also clear that much of what has happened shows the importance of enforcement of the laws that are already on the books.

In that regard, particularly since I am going to have to be off at other meetings with some legislation, I welcome a former colleague of mine, of my colleagues Mr. Markey and Mr. Delahunt, the Secretary of the Commonwealth of Massachusetts, Bill Galvin, with whom I served in the Massachusetts House. I am very proud of the work that he has done in very thoughtfully and very seriously uncovering abuses.

I think it ought to be very clear. We in Massachusetts, of course, have followed Mr. Galvin's work very closely. There is sometimes the accusation that officials in the enforcement business are tempted to kind of demagogue or overdo it. Mr. Galvin's work has been meticulous. No one has proven or no one has even alleged any effort of excess. I want to repeat what I said on Tuesday, because sometimes I get the impression that when I say something, not everybody pays sufficient attention the first time. Mr. Galvin and Mr. Spitzer are elected officials. They are elected officials who have pioneered in the enforcement of technically complex, but quite important issues.

It is not an accident that the areas where they have taken the lead are areas which affect the equity interests of small investors. We have national institutions for the enforcement, and there is an understandable tendency on their part to be concerned about systemic matters; to be concerned about liquidity problems for the whole system. Sometimes in that framework, matters of fairness for individuals when they do not accumulate to a systemic risk, can get lost in the shuffle. Here we have two elected officials, the Attorney General of New York and the Secretary of the commonwealth of Massachusetts and others who have taken their responsibility to protect the individual investor very seriously.

I am glad they have done that. I am glad that we now have a consensus, I hope we do, that the authority that they now have to be participants in the enforcement process ought to remain undiminished. I think that argument ought to be considered settled, that there is no basis for any legislative action that cuts back on the role they have played. We have benefited as an economy, individual investors have benefited, and now I think the next step is for us to pass some legislation that will strengthen the ability of regulators, the SEC, the self-regulatory organizations, and the state authorities.

Sadly, given the great scope of this, there is room for all of them. We will not have too many enforcers. If and when we reach that point, I will be glad to have someone make the argument, but right now our job is to give them even better tools. They have done, particularly the State officials, a very good job of using the tools they have. So the answer is both to leave the current set of enforcement powers in place and to enhance the powers that the enforcers. I look forward to our doing that and I think we ought to be able to do it, at least begin the process on our side, before we bet out of here this fall.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Are members desiring to give additional opening statements? If not, then I would proceed at this time to the participants on our first panel, again extending welcome to both. At this time, I would recognize Mary L. Schapiro, Vice Chairman and President, Regulatory Policy and Oversight, at the NASD, and certainly no stranger to the committee room. Welcome.

**STATEMENT OF MARY L. SCHAPIRO, VICE CHAIRMAN AND PRESIDENT, REGULATORY POLICY AND OVERSIGHT**

Ms. SCHAPIRO. Thank you very much, Mr. Chairman. Good morning.

Mr. Chairman and members of the subcommittee, I very much appreciate the opportunity to testify today on behalf of NASD. NASD is the world's largest securities self-regulatory organization. They have a nationwide staff of more than 2,000 who are responsible for writing rules that govern securities firms, examining those firms for compliance, and disciplining those who fail to comply. Last year, NASD filed more than 1,200 new enforcement actions, levied record fines, and barred or suspended more individuals from the securities industry than ever before.

The reprehensible conduct that has brought us all here today, which cheats the public and degrades the integrity of American markets, will not be tolerated. Any broker or firm that misleads a customer or games the system can expect to be the subject of aggressive enforcement action. NASD strongly supports H.R. H.R. 2420 and calls on Congress for its prompt passage. Indeed, in those areas where NASD has jurisdiction, we have already begun the rulemaking process to implement some of the principles of H.R. H.R. 2420.

We have recently proposed a rule requiring disclosure of two types of cash compensation, payments for shelf-space by mutual fund advisers to brokerage firms that sell their funds, and differential compensation paid by a brokerage firm to its salesmen to sell the firm's own proprietary funds. Customers have a right to know these compensation deals which create a serious potential for conflicts of interest.

Due to their enormous growth in popularity in recent years, NASD has paid particular attention to how brokers sell mutual funds. While NASD does not have jurisdiction or authority over mutual funds or their advisers, we do regulate the sales practices of broker-dealers who provide one distribution mechanism for mutual funds. Our regulatory and enforcement focus has been on the suitability of the mutual fund share classes that brokers recommend, the sales practices used, the disclosures given to investors, compensation arrangements between the funds and brokers, and whether customers receive appropriate breakpoint discounts.

We have brought some 60 enforcement cases this year in the mutual fund area, and more than 200 over the last 3 years. Through our routine examinations, we have found that in one out of five transactions in which investors were entitled to a breakpoint discount, that discount was not delivered. Thus many brokers imposed the wrong sales charge on thousands of mutual fund investors, in effect overcharging investors by our very conservative estimate of $86 million in the last 2 years alone. NASD has directed firms to make immediate refunds, and in the next several weeks we will initiate with the SEC a number of enforcement actions seeking very significant penalties.

Brokers are also prohibited from holding sales contests that give greater weight to their own mutual funds over other funds. These types of contests increase the potential for brokers to steer customers towards investments that are financially rewarding for the broker, but may not be the best fit for the investor. In September, we brought a case against Morgan Stanley for using sales contests to motivate its brokers to sell Morgan Stanley's own funds. The sales contest rewarded brokers with prizes such as tickets to Britney Spears and Rolling Stones concerts. This case resulted in one of the largest fines ever imposed in a mutual fund sales case.

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

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

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

As we continue our examinations and investigations into these matters, we will enforce NASD rules with a full range of disciplinary options, including fines, restitution to customers and the potential for expulsion from the industry. Mutual funds have also been a focus of NASD's investor education efforts. This year alone, we have issued investor alerts on share classes, principal-protected funds, breakpoint discounts, and we unveiled an innovative mutual fund expense analyzer on our Web site that allows investors to compare expenses and fees of funds and fund classes, and highlighting when they should look for discounts.

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

Mr. Chairman, NASD supports H.R. H.R. 2420 and applauds the committee's efforts to bring increased transparency to the mutual fund industry. We look forward to working with Congress and the SEC on technical issues that may arise as H.R. H.R. 2420 moves forward and the SEC proceeds with rulemaking to implement its provisions.

I thank you, Chairman Baker and Ranking Member Kanjorski, for your leadership in this area, and again for inviting NASD to testify today. We are of course happy to answer any questions.

[The prepared statement of Mary L. Shapiro can be found on page 271 in the appendix.]

Chairman BAKER. Thank you very much.

For the introduction of our next witness, I was going to call on Mr. Frank. He has stepped out momentarily. In his absence, it is my pleasure to introduce the Honorable William Francis Galvin, the Secretary of the Commonwealth of Massachusetts, the Chief Securities Regulator for the Commonwealth, and express our appreciation again to you, sir, for your fine work, and look forward to your remarks.

**STATEMENT OF WILLIAM FRANCIS GALVIN, SECRETARY OF THE COMMONWEALTH OF MASSACHUSETTS, CHIEF SECURITIES REGULATOR**

Mr. GALVIN. Thank you, Mr. Chairman.

I am Bill Galvin, Secretary of State and Chief Securities Regulator of Massachusetts. I want to thank you, Representative Baker and Representative Kanjorski, for calling today's hearing to examine abuses in the mutual fund industry. I also again want to thank Senators Fitzgerald, Akaka and Collins for the hearing they held on the Senate side earlier this week. By my rapid transactions back and forth, I am beginning to think that I am a little involved in market timing myself.

Representative Baker, while we may not have seen eye to eye on all issues in the past, I do want to thank you for your leadership in this area. Months ago, long before the recent abuses came to light, you put the spotlight on mutual funds, governance fees and conflicts of interest, and you deserve much credit for your foresight and your commitment to America's investors in our securities markets. The bill you crafted, H.R. H.R. 2420, adds important disclosures and addresses areas of abuse that we have seen relating to fund sales practices and operations and I support it. In two specific areas I think it could go further, and I will address those in a moment.

Today, half of all American households are mutual fund investors. Americans have nearly $7 trillion invested in mutual funds. Mutual funds are about more than money under management. Mutual funds are about the hopes and dreams of middle-income Americans, the hope of a financially secure and dignified retirement, the dream of a college education for a child. Mutual funds are where America's dreams are invested. With the decline of interest rates paid on savings, mutual funds have in many instances become the substitute bank of necessity for middle-income Americans seeking a reasonable return on their savings. Investors have placed their trust in mutual funds with the understanding that they would be treated fairly; that fund managers would do their duty as fiduciaries. Unfortunately, we are here today because in too many instances the mutual fund industry has failed to live up to its fiduciary duty.

The common theme running through all the mutual fund issues that we have exposed in recent months is that the mutual fund industry is putting its own interests ahead of its customers. Mutual funds have often promised trust and competence and delivered only deceit and underperformance. Another reason we are here today is because industry self-policing and government oversight have failed to effectively protect the mutual fund investor. In too many instances, a culture of compromise and accommodation has overwhelmed enforcement efforts. Too often the guilty neither admit nor deny any wrongdoing, and routinely promise not to cheat again until they come up with a better way to do what they just said they would not do again.

The merry-go-round of accusation and non-admissions goes around and around, while investors lose. It has taken the coincidence of dramatic and tragic recent investor losses and aggressive state enforcement by people like Attorney General Spitzer and myself to convert investor outrage to a call for action. Any suggestion that state regulators have hindered federal enforcement of securities law is completely false. Any effort to restrict or preempt state enforcement must be called what it clearly is, anti-investor. Let's be clear. Mutual fund investors should have an equal opportunity for profit and an equal opportunity for risk. Mutual funds should be precisely that, mutual in all aspects.

Unfortunately, that is not the case. Our investigations have revealed that special opportunities exist for certain mutual fund investors at the expense of the vast majority. We have uncovered insider trading at its worst, fund managers exploiting their inside knowledge for personal profit at the expense of their customers. We have uncovered a pervasive pattern of breach of duty and corporate deceit at Putnam Investments, the nation's fifth largest mutual fund company. Simply put, investors were being cheated. In August, my office uncovered a hidden compensation scheme at Morgan Stanley, including cash prizes and other lucrative benefits designed to push Morgan Stanley funds on unsuspecting investors who were seeking honest advice.

Even more recently, this week, my office charged five former Prudential Securities brokers and branch managers with fraud in a scheme that enabled off-shore hedge fund clients to profit at the expense of mutual fund shareholders. The particular complaint alleges in vivid detail how a group of brokers, with the active connivance of managers and a see-no-evil attitude by the company, were able to manipulate the mutual fund trading system for the benefit of certain select clients, to the detriment of the fund. Company policies against market timing and short-term trading were clear. Disciplinary action was nonexistent. For the sake of enriching themselves and their hedge fund clients, the branch managers and registered representatives allegedly engaged in fraudulent tactics and financially harmful trading activity and no one stopped them.

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

As in the case involving Putnam, Morgan Stanley and Prudential Securities, state securities regulators are often the best and first to identify investment-related problems and to bring enforcement actions to halt and remedy these problems. H.R. H.R. 2420 is a positive response to the many problems investors in the mutual fund area now face, and I endorse its objectives. I endorse its provision to enhance the independence of fund board members and audit committees; to improve the disclosure of fund fees and expenses; to make board members responsible to oversee soft-dollar arrangements; to require the Securities and Exchange Commission to study soft-dollar arrangements, frankly I think they should be banned altogether, and other disclosure issues; to prevent funds from restricting share redemptions and require funds to hire compliance officers.

The bill can be improved, however. I believe the bill could do more. First, instead of studying and disclosing soft-dollar arrangements, I would ask you to consider an outright ban on them. Funds should simply seek the best price and execution for their portfolio trades. At best, soft-dollar arrangements obscure the true cost of mutual fund overhead and they artificially inflate funds's trading costs. In far too many case, soft-dollar arrangements constitute severe conflicts of interest for fund managers because brokerage firms provide benefits to those managers in exchange for a portion of the fund's trading transactions. Soft-dollar arrangements have been criticized for many years as a fundamentally abusive practice, so this is not a matter that requires further study. Instead, we must act now to draw a bright clear line prohibiting soft-dollar arrangements by mutual funds.

In addition, it may be appropriate to advocate that section 2(a)(1) of the bill be amended to restore the requirements that each investor receive disclosure of the fund costs and expenses paid by his or her fund account, rather than the costs payable on a hypothetical $1,000 investment. This would make disclosure more meaningful to individual investors. Prompt passage of this bill is important to bring the regulation of mutual funds to the level of regulation that their role in our financial system demands. The laws alone are not enough. They must be vigorously enforced.

Representative Baker, I know that you share my opinion that this sort of behavior, the corrupt culture, is deplorable, outrageous and unconscionable, a serious breach of duty and trust, a betrayal of customers's faith, and that their interests come first. In these cases, I am afraid, greed trumps good business practices. I want you to know that we will not rest until we get to the bottom of this and punish those responsible. Investment in our markets is built on trust. This behavior is equivalent to picking the customers's pockets. Market timing, which is essentially day-trading, sends a simple message to long-term investors, do as we say, not as we do. Fund customers, long-term investors, did not know their money was being managed by day and traders out for themselves.

These charges involve Massachusetts companies. The cases have had a profound impact on the image and reputation of local companies, and that is of great concern to me. I know people who work at these firms and so does my staff. These companies employ Massachusetts residents. They pay state taxes. They give to local charities. The actions of a few at these firms have put the jobs of many at risk, and threaten to destroy the reputations built over many years.

This further underscores that our markets are built on trust, and how fragile that trust can be. For a relatively small amount of money, management winked at corrupt behavior and risked the reputation and future of multi-billion dollar enterprises. This case should be a lesson to others. Our investigation took many weeks. It involved substantially my entire securities division. We deposed people, took pains to corroborate testimony, talked to legal and other experts before deciding to move forward with formal charges. We are very much aware of what impact our actions could have had, and we acted with a sense of sadness as well as a sense of duty to investors in Massachusetts and across the country.

Representative Baker and members of the committee, I again want to commend you for focusing attention on these issues. With tougher laws and vigorous enforcement, we can give our nation's investors the fairness and honesty they seek and the protection they deserve.

Thank you, and I would be happy to answer any questions.

[The prepared statement of Hon. William Francis Galvin can be found on page 254 in the appendix.]

Chairman BAKER. Thank you, Mr. Galvin.

I would start with you in just making a statement I have made on many occasions for the record in your presence, that I do not contemplate, nor do I think any other member contemplates, any statutory provision that would on its face preclude, hinder, obviate or in any way limit the ability of any state regulator to pursue any cause of action they believe pursuant to investigation worth pursuing.

The only question is with regard to provision 8(b) of H.R. 2179 as to whether that language would in any way have precluded any of the conduct that state regulators have engaged in, there being a difference of opinion. I do not view it as being restrictive in any way. But in trying to come to some accommodation, we recently had the voluntary association of yourself, Mr. Spitzer, the SEC, and NSIA, in trying to come to some closure on how to get to the principle, which is under the provisions of NISMIA, State legislatures are prohibited from enacting State law that would affect national market structure.

The theory, I believe, is consistent, but I would be hopeful, and not necessarily expecting a response immediately, but for your own evaluation, at least a consultative role with the SEC. I understand Mr. Spitzer, at least press reports as of yesterday, was contemplating potential settlements with various mutual fund violators and in the course of that announcement indicated that they would consult with the SEC in reaching final determinations in that matter. I think that would be a great way to get this matter behind us and move on. I think it has become unnecessarily distractive to the much broader and more important goals contained in H.R. H.R. 2420. I certainly would want to extend that concept to you and certainly would appreciate your thoughts if you have any on how we could move forward.

Mr. GALVIN. If I may respond, Mr. Chairman. First of all, thank you for the thoughtfulness. I do feel that the language of the previous bill that you referred to was problematic. I will tell you also that I think in many respects the problem that is allegedly solved is not a problem. I have not, and I am not aware of any instance where state action has preempted or prohibited the federal Securities and Exchange Commission from taking action, either in Massachusetts or elsewhere. As far as our conduct in Massachusetts, it has been our practice when we think it appropriate, which in most of these cases that is the case, to work closely with the SEC.

Chairman BAKER. I guess my point was, just to give you the reasoning for the approach, when Mr. Spitzer reached the Merrill settlement, it was without the SEC's involvement and there were market structure consequences. When the Merrill settlement was rolled into the Global settlement and the SEC was at the table, the problem went away. So that is the operative condition that from my initial reasoning for bringing up the concept, is just have the SEC at the table.

I think as a matter of practice, if that is what you are telling me you would normally engage in, all we need is some agreement, statement, NSIA leadership somewhere, that conceptually your initial motive in pursuing these matters is not to write national market structure rules, but to go after wrongdoers, and in the course of the remedy phase if it does affect national market structure, coordinate it with the SEC. That is I hope not unreasonable.

Mr. GALVIN. I do not think your stated goal is unreasonable at all. I was just starting to say that our experience has been that we consult with the SEC usually on many cases. But oftentimes, for instance in the Prudential case that I just referred to in my testimony, both the SEC and other regulators have been involved in reviewing that. There were aspects of that case that the SEC chose to charge that we did not. I believe they believe that it is in the better interest of the industry that they pursue aspects of that case, and we certainly consulted with them. Before we brought the complaint, we advised them.

Similarly in the case of Putnam, I personally called Mr. Cutler and informed him of our plans with regard to Putnam. I do not feel that I have to do that in every instance, and I do not think I should. I have to protect Massachusetts investors. But I do think it is important to consult with people, especially, as you suggest, when a remedy is being crafted that may have significant implications.

The larger cases that you referred to earlier, the Merrill Lynch case, and as you know, Massachusetts was assigned Credit Suisse First Boston in the Global settlement issues. There was consultation at every level, but I think those cases were somewhat unique because we were in fact not only operating for ourselves, but indeed for other jurisdictions, and indeed for the country, in investigating at NSIA's behest, the operations of Credit Suisse First Boston.

My concern is that these enforcement actions are often adjudicatory. They are adversarial. Any language that can be used by those who are accused to say, well, you do not have jurisdiction, will certainly be asserted by them. We have not seen instances, and I have yet to be told of an instance, where there has been a specific problem where something a state has done has prevented the SEC from taking action. I think the reality is that the States often hear about problems, as we did in Massachusetts on a number of issues, first.

Most of the cases, if not all of the cases, with the exception of Credit Suisse First Boston, which we brought in the last year, were cases that began in Massachusetts. The conduct began in Massachusetts. We were in a unique position to hear about it. We acted upon it. We pursued our investigation. We certainly did not conceal anything from the SEC. We conducted joint depositions with them in a number of instances.

So I really do not think there is a problem, but I understand your sincere interest in making sure that it does not affect national market issues. I certainly think consultation and further collaboration among the regulators on an informal basis is certainly worthwhile.

Chairman BAKER. I appreciate that. I am beyond my time, but it is my understanding that your inquiry with regard to the Strong fund, that there was a manager actually timing his mutual fund trades for the benefit of the hedge fund which he operated?

Mr. GALVIN. That would be no. The hedge fund cases that presently we have, although there may be others, in the Prudential case, Strong is not one of ours. Where we had managers actually doing it for themselves was Putnam. The thing that makes it particularly offensive is that the company knew about it for up to 3 years, and these people were left in charge. The company acknowledged on their own, after we issued a subpoena, that they had collaboratively taken about $700,000 in profit, these fund managers. It was clearly insider trading, but they took no action against it. In fact, they concealed it and they denied it, which is one of the reasons that we acted against Putnam so promptly.

I am pleased that you brought up the issue of hedge funds. I would like to invite your attention, Mr. Chairman. One of the things we have seen in our investigations is that for market timing to be worthwhile, there has to be a lot of money moving through. For instance, in the Prudential case that I just referred to, if you read the complaint in detail, it was hedge funds that were moving through. In fact, hedge funds in effect were being flushed through the mutual funds to take the benefit of the profit away from the smaller investors.

I think at least there should be some study directed, perhaps in your bill, H.R. H.R. 2420, given the role that hedge funds play, given the fact that they are largely unregulated, and that they are now interacting with this very large segment of our financial services system, I think that role has to be explored. I would also like to invite your attention to the fact that there are financial holding companies that are totally unregulated, that hold large equity interests in mutual funds, and make a great deal of profit off them. These are largely unregulated.

I think what we have to do is bring the regulation of mutual funds up to the role that it deserves, given the role it plays in our economy and given the role it plays in our financial services system. As I mentioned in my testimony, it is indeed the bank of necessity for many Americans and I think it has to be treated as that.

Chairman BAKER. Thank you. Just a real quick one. Mr. Galvin, I am sorry the time has gone so far. As I understand current rule, the Fair fund is a recipient of fines levied by the SEC for distribution back to defrauded investors. Do fines currently levied by the

NASD, are they subject to distribution pursuant to the Fair fund, or is that something not now permissible?

Ms. SCHAPIRO. It depends on the particular case, Mr. Chairman. For example in the Global settlement on the research analyst conflicts of interest, all of the NASD fines went to the Fair fund and were not taken in by NASD. In a number of cases that you will see over the coming year, that will also be the case.

We also strive in our own cases directly to get restitution to investors where they are identifiable, and do that through our own.

Chairman BAKER. In the interest of time, let me just request that if there are statutory reasons that we need to address to enable the expansion of the Fair fund reach from an NASD perspective, I would really request that. I am so far beyond the time limit, let me recognize Mr. Kanjorski.

Mr. KANJORSKI. I will take up the appropriate time, Mr. Chairman.

Let me back up from the specifics of the individual things that you are involved in, and ask some questions in terms of in these instances of prosecution of timing and late trading, were they clearly illegal under existing law?

Mr. GALVIN. Mr. Kanjorski, we believe they were, and I will tell you why. Our theory is that they are fraud because in most instances the prospectus that was presented to the average investor said there was not going to be any market timing, there were not going to be rapid trades.

Mr. KANJORSKI. If they had made a disclosure in their prospectus that there would be market timing, would that have freed them?

Mr. GALVIN. It might have in some of the cases, in some of the fact patterns, but it certainly would not have in the case, for instance, of the fund managers that I just referred to at Putnam who were market-timing their own fund. That was clearly a breach of their fiduciary duty. That was insider trading. It clearly would not in the case of the brokers who were promoting large fund passes-through, because clearly the practices they were engaging in, I am speaking now of the Prudential case, they in fact used 62 different bogus identities to conceal their various transactions. So I think that in general these things are there. If your point is that I think there needs to be a clearer definition of market timing, I would agree with that. I think maybe the bill that is under consideration might provide that opportunity.

One of the problems that I think we have seen in this industry is that they have a very great tendency to parse words. They will parse words even when practices that are clearly unethical, they will describe as not illegal. I think it is time to make sure that there is a parallelism between unethical practices and illegal practices.

Mr. KANJORSKI. Looking at some of the testimony that occurred in the Senate earlier, it seemed to me that there was an indication that almost 25 percent of the industry engages in these practices. From listening to your testimony, you said 3 years of practice at one of these companies. So this is a long-occurring situation, and very pervasive.

Mr. GALVIN. I believe it is. Mr. Cutler in his testimony before the Senate the other day referred to a survey the SEC had completed.

The 25 percent statistic was 25 percent that had late-traded, which is clearly illegal, no one is disputing that, and about half that had market-timed.

Mr. KANJORSKI. That being the case, that it has continued for a number of years, that it is pervasive in the industry, I mean, our job is not to guarantee very transaction is performed legally, but it certainly seems to me a governmental and regulatory responsibility that these things do not go unnoticed. So it seems to me that there is a fundamental breakdown in the regulatory system, both at the national level and even perhaps at the state level, of getting to this information. It further seems to me that the reason that happens is that we really do not have inside capacity to understand what these organizations are doing until a whistleblower comes forward or until an extreme situation occurs where we focus a great deal of light on the subject.

I was incensed to hear that one of the whistleblowers, I think that gave you the case, went to the SEC in March and nothing was done until you took action. So even though it had been pervasive and long-occurring before that, it did not seem to tilt. The explanation made for that by the regulator was, well, we were concentrating on other things. I am not sure that the American public or the Congress intends regulators to pick the flavor of the day, if you will, on what they are going to concentrate on. I can tell you quite frankly I assume that if I put money in a bank, the OCC or the Federal Reserve or the FDIC is regularly auditing and making sure and doing random audits, if not direct audits, to determine whether there is illegality, embezzlement or other activity occurring in that financial institution that threatens the depositor. That obviously is not happening in the securities industry.

It seems to me in some of these instances they just recently had gone through a review by the SEC and were found not wanting. That is short of shocking to me. It sort of says to me what we call regulation is not regulation. It is only emergency action taken after it escapes from confidentiality within the firm to the public and then something is done about it. For all intents and purposes if that whistleblower had not come to you, they would still be operating. They would still be rewarding themselves. Everybody would be going on. And you agree that what they were doing is clearly illegal under existing laws.

Mr. GALVIN. We do. Let me just speak to that. We frequently are benefited by people in the industry. I think that says good things about the industry. I want to leave the impression with the committee that there are very ethical people in the financial services industry. The fact is that people inside the industry get upset when they see these kinds of practices and come forward. I will tell you, since these issues have emerged more publicly even since last Monday's hearing, my office has been inundated with additional information relating to this.

I think the fundamental point you make is valid. Namely, there have to be more audits. There has to be clearer disclosure, required disclosure, both to regulators as well as to investors. There is a parallelism between mutual funds and banks in the sense that they are a repository for such a large part of our national savings. Obviously, there are differences, too, because there is risk involved, and that is part of the whole concept. But I do not think that excuses them from the oversight and presenting the information on a regular basis to regulators and to their investors, so that it can be examined and followed. I think there is where the gaps are presently in the system.

Mr. KANJORSKI. A lot of these firms are advertising extraordinary profits, when in fact it is not substantiated and they are not doing it. So they are misrepresenting in the marketplace. To limited investors who do not have the time to spend going through annual reports and all the studies, and with a fairly sophisticated knowledge of financial transactions, they rely on these representations as being true and accurate. Now, from your testimony and Ms. Schapiro's testimony, I gather we really do not know. These are open entities out there saying whatever they want to.

What I am trying to get at is, the one thing that we want to protect, it seems to me, is the small, unsophisticated investor, so they can stay in the equity markets without retreating to deposit accounts. Banks had a reputation for making loans and doing nefarious things in the 1920s. We solve it very easily by putting an insurance program into place, which meant that there would be a premium and bad actors would pay higher premiums. Following the insurance, it required auditing and investigation on a very real-time basis. Is there any merit to thinking about instituting a small investors insurance fund that would require more periodic audit and investigation techniques to be used on some of these institutions?

I know that the majority of the institutions are sound, honest, full of integrity. So in a way by doing that we would be punishing the good firms in order to get the bad firms. But we could institute situations like the CAMEL ratings so that the bad actors would be identified. The light of day would be shined on, and there would be an incentive within the industry itself to shine the light on the bad actors and get them out of the field.

I think we have to do something, because I had the thought when I heard the testimony in the Senate. There have got to be guys in New York that are going down to the Harvard Club or some other club and sitting there and saying, damn, look what I did today; I turned a million bucks, and we did this and this, and we were involved. And the guy sitting next to him says, gee, I only ripped off $100,000 today; I have to go back. And some honest guy is sitting there and saying, man, I must be a fool. I am living on just what I am getting paid on my salary and I am not ripping anybody off, and it is pervasive in the industry so I better get into it.

I think that is what has happened. We have allowed it to happen so long that when I hear 25 percent of an industry is engaging in illegal activity, we have to blow the whistle and we have to find a mechanism that protects the honest, protects those that act with integrity, protects the sound operator, and get at the bad actors. Sometimes the bad actors are not necessarily the funds themselves or the institutions themselves, but sometimes the employees and personnel. But we have to find some mechanism and regulation to get there.

Would you give any thought on that?

Mr. GALVIN. My thoughts are that, again, audits are very helpful. I think there has been a climate of accommodation. I think that is one of the problems, and this is pervasive throughout the securities industry. There has been a history when you come to regulation of accommodation that suggests, well, they don't admit they did anything wrong. They will pay a fine, but they will never admit and deny they did anything wrong. Well, that has to stop. We have to get findings. We are going to insist on findings in these cases in Massachusetts; admissions they did do things wrong. There is no question about it. That way, you can establish what the standards are and you can punish those who are guilty.

As far as an insurance fund, I think the problem with that that I perceive is that we are dealing with risk here. If you are talking about an insurance fund for fraud, that is one thing.

Mr. KANJORSKI. For fraud.

Mr. GALVIN. For fraud, because that might be worthy of some review, but I think it is risk. That is what makes it appealing, that people get in because they are going to get a higher return because there might be some there.

In terms of the way funds present themselves, very often funds present themselves talking about their past performance. I think probably the greatest lack of understanding of the way funds are presented, apart from the sales practices problems that I addressed and Ms. Schapiro addressed also, is the issue of they are talking about past performance. They are not talking clearly about fees. The fees that are being paid and the costs that are incurred, and the classifications of shares, those are the things that I think the average investor is not being given clear and digestible information.

The fact is that most people who go and look at mutual funds do so because they think it is a safe place to be. They either are unsophisticated or they prefer to be unsophisticated. They decide that somebody else will do the thinking for them. It is reasonable. That is kind of the service that mutual funds are marketing. They are saying there is safety in numbers. But unfortunately what we have uncovered is that everyone is not treated the same. That is the fundamental problem that some of these issues have presented.

Chairman BAKER. The gentleman's time has expired.

Mr. Castle?

Mr. CASTLE. Thank you, Mr. Chairman.

Mr. Chairman, it just occurs to me in all this we have been going through that with the changes in technology, when you get into the issues that are non-pure fraud, the market-timing issues and issues like that, there is just huge change that is rapidly happening, but in our enforcement and everything else, we need to keep that in mind. It reminds me of our currency. We are changing our bills now on a regular basis because of the ability to be able to copy them too easily. The same thing pertains here. A lot of this is computers. I do not think we can introduce legislation to eliminate computers, so we need to make sure that we are ready to deal with this.

I would like to start with Ms. Schapiro, if I can, because I am worried that we are missing the forest for the trees. This is probably a little beyond the subject of this hearing, candidly, but on page nine and also in your oral testimony, under investor education you talk about a number of things that the NASD has dealt with. I think that is important. But it seems to me that all these fees are significant. We obviously want to eliminate the fraud, and I am for doing all those things.

And maybe you just didn't do it because it is not part of this, but you do not mention talking about the tax consequences of mutual funds, which can be a huge problem to an individual investor, much greater than some of these fees issues. For example, 2 or 3 years ago, all these funds had made a lot of money over a long period of time. Then they had a lot of sales, so they had to sell a lot of their securities. Obviously, they had great capital gains and they have to pass them on. So you had the double hit of you paid big taxes if you were an individual, but your mutual fund values also had gone down.

Also, there is no discussion here of market risk, which is even a much bigger factor perhaps than anything else we have talked about. I assume that the NASD is very cognizant of these things and does some education in that area, and is not ignoring them. It is just not in your testimony. Maybe you would feel a little bit better about that.

Ms. SCHAPIRO. I would be more than happy to provide you with our investor alerts. You make excellent points. We of course talk about the tax consequences. I think we all personally felt the pain of paying taxes on declining-valued mutual funds over the last several years. We talk about the tax consequences there. We also talk about it in the context of changes to the tax law and what that has meant, for example, to variable annuities.

Mr. CASTLE. Not to cut you off, but you do focus on this. You just do not have it in your testimony.

Ms. SCHAPIRO. We focus on that, and we always focus on risk; that people have to understand the risks of all these different investment options that are before them. I would be happy to send out a package of the investor materials.

Mr. CASTLE. Okay, and perhaps the sheet funds which go riskless because they do not want to take any changes; a whole different issue.

Let me switch to Attorney General Galvin, if I can. I am very interested in what you said in your testimony, again on page eight, about the soft-dollar arrangements. The definition of "soft dollar" has always eluded me a little bit, which is part of my problem here. But I assume that the soft dollars pertain to the costs of a mutual fund in terms of their actual transactions and that kind of thing. So there are some real costs there. But are soft dollars just the amount above what the real costs would be? How can you just eliminate that? I am very intrigued with the idea of doing that, frankly, so I want to know how we can do it. I am not questioning that. I just want to know how to calculate it.

Mr. GALVIN. I think you have to understand that soft dollars came into play after a 1974 decision by the SEC that further restricted fees. Soft dollars cover research, but they also now have been abused. Clearly, research is necessary for any mutual fund to operate and that is a legitimate cost, but that can be an identifiable cost. There is no reason it should not be identifiable. Now what is happening is soft dollar costs include other things such as office overhead, such as costs of conferences, and other hidden ways that people can get compensation. It gets back to the relationships within the mutual fund sales practices and within the mutual fund itself.

I think one of the things the present bill, H.R. H.R. 2420, does a very good job of is starting to set up a model for how a mutual fund would operate, a directorship, if you will, explaining the audit committee, who the directors have to be. This issue of soft dollars flows in the same way.

Mr. CASTLE. Not to interrupt you, but you said at the end of this, by prohibiting soft dollar arrangements by mutual funds. Are you saying you prohibit certain abuses, but you include certain things which are allowable by defining them specifically in the legislation?

Mr. GALVIN. Defining it. The way you would have to do it would be to define them. If there is actual cost relating to research, you would have to put that into the cost assignable to the individual account. As opposed to saying, this is soft dollars; it is a fuzzy thing.

Mr. CASTLE. Right. It is too generic. It is too broad.

Mr. GALVIN. And it is abused. That is where some of the problems come in. The relationships here are often inherently engaged in conflict of interest and it creates more problems. When you have a receptacle that you can toss it into, it is a slush fund, if you will.

Mr. CASTLE. Thank you. I will not ask you any more on that, but I am interested in that language. I think we all are. If there is a sense that we can do that, I think it would be a major improvement.

Back to Ms. Schapiro, on the 12(b)(1) fees, which concern me a great deal, as I understand 12(b)(1) fees, they were basically introduced as a marketing-type of fee arrangement for mutual funds up to a certain percentage of something. I find now that mutual funds that have already closed still have 12(b)(1) fees. It seems to me that we have created multiple categories of fees; 12(b)(1) fees are ones that are disclosed. But my question is simply, should we eliminate 12(b)(1) fees? Or should we somehow redefine them so that in certain instances they cannot be charged? It seems to me it just gets more and more confusing. I would rather see one set of fees and not a series of three or four fees, and you add it all up and whatever it may be. I just think it is more confusing.

Ms. SCHAPIRO. I agree with you completely. I think the single most important thing the SEC and the Congress could do in this area would be to require clear, concise and simple disclosure of all of the costs of owning a mutual fund, front-end loads, contingent deferred sales charges, 12(b)(1) fees, administrative and management fees, directed brokerage, soft dollars.

It is virtually impossible for an investor to understand generically, let alone for their own personal account, what are the fees and expenses that they are paying. They have to look in multiple places in the prospective, in the statement of additional information, in the fee table, to try to find this information, put it together for themselves, and then to try to compare across funds is virtually impossible.

So I truly believe the single most important thing that could come out of all of this would be honest, complete, simple fee disclosure for investors that gives them comparability.

Mr. CASTLE. Thank you, Ms. Schapiro.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you. The gentleman's time has expired. Mr. Crowley?

Mr. CROWLEY. Thank you, Mr. Chairman.

Attorney General, I know you have relations in some regard with the work of Attorney General Spitzer in New York. Do you think that has been effective in terms of cracking down on the scandals, as limited as they may be, in the mutual fund industry? If so, would you support or oppose legislation that would strip Mr. Spitzer or any State official from investigating and prosecuting these criminal offenses?

Mr. GALVIN. I will start of by saying I am the Secretary of State in Massachusetts. I have the civil jurisdiction with regard to securities regulations. Criminal activity in Massachusetts would be handled by our Attorney General. We often refer matters when we see criminal conduct.

Mr. CROWLEY. Would Attorney General be a promotion or a demotion in your state?

Mr. GALVIN. It is hard to know.

[Laughter.]

Mr. CROWLEY. Okay.

Mr. GALVIN. In any case, we often refer matters when see criminal activity. Our focus, however, is on the civil side and it is primarily two things. One is to try to make the investor whole, and I am very pleased that we have a very good record. We have returned about $20 million to Massachusetts investors that they were defrauded of. The other is to police the industry. We do refer criminal matters when we see them. We refer them to the Attorney General of Massachusetts, to the United States Attorney General. When we were handling the CSFB matter, we were going through e-mails that we felt reflected criminal conduct. We referred that to Attorney General Spitzer and other New York prosecutors because we felt that was the appropriate place for jurisdiction.

I addressed earlier in my remarks the issue of preemption. I would be very concerned about any effort to preempt. I had an extended colloquy with the chairman relating to that. Obviously, there are legitimate concerns about making sure that one group of enforcement does not adversely affect the other, particularly in terms of national market policy. But I am not aware of any instance where that has occurred. The danger I think is much greater on the other side.

If you look at preemption at something that would stifle state enforcement activities, which as I pointed out in my earlier comments, these are often adversarial proceedings. The securities industry is very ably represented in these matters. They are certainly going to allege any opportunity they can or take any opportunity they can to allege lack of jurisdiction. So therefore I would be very concerned about any effort, however well meaning it might be, that might create a situation where State regulators would not be able to perform the task that we now do. I would perceive that as anti-investor.

Hopefully, these recent cases and these matters where we have worked fairly closely with any range of regulators, from the SROs as well as the SEC, demonstrate that I think we can work collectively together.

Mr. CROWLEY. Thank you, Mr. Secretary.

For both of you, in the hearing before the Senate last week, Chairman Baker sat side by side with Attorney General Spitzer at that hearing. Chairman Baker revived a proposal that would strip out of his bill, H.R. H.R. 2420, which would require an independent chair as head of a mutual fund. I have a few concerns about that. One, wouldn't this mean in essence that Charles Schwab, for instance, could not head his own company? And wouldn't that result in putting inexperienced people on board who do not necessarily know the business and can be more easily hoodwinked, than by veterans who know all the issues?

Secondly, I agree with the U.S. Chamber of Commerce, and it is not often that I say that, when they say, "to be an effective chairperson, a person must be intimately familiar with the operations of a company. Forcing a mutual fund to utilize a chairman not familiar with the operations of the company could severely impact its progress and success."

Thirdly, I fear a regulatory slippery slope as many of us as well as industry were told by the Republican staff of this committee, that Chairman Baker and the Republicans would like to extend the independent chair requirement to all of corporate America. I believe that, as well, would be wrong for American business and American investors.

I also understand that the SEC and the GAO told this committee that the inclusion of this independent chair requirement is unnecessary in assisting mutual fund shareholders.

What are your both of your thoughts on the independent chair issue?

Ms. SCHAPIRO. I think the goals of H.R. H.R. 2420 and the corporate governance movement generally to dramatically increase the independence of board members is very, very important, and particularly important in the mutual fund area, where as we have all discussed, so many people count on so few to do a good job. When those few don't, the consequences are pretty devastating and dramatic.

My experience in observing the corporate world is that the increased independence of corporate board members has had a very important and positive effect post-Sarbanes-Oxley on how corporate America conducts its business.

Mr. CROWLEY. What about the chair?

Ms. SCHAPIRO. I guess I do not have a strong feeling one way or the other. I think it is absolutely worth exploring. I do not think it will hurt. I think people will find good chairs of boards and good board members even if they have to be independent and not affiliated with the mutual fund or the adviser. So I do not see a downside. Whether there is a great up-side, I am not really in a position to judge.

Mr. CROWLEY. Secretary Galvin?

Mr. GALVIN. I would certainly endorse the idea of an independent board. Obviously, what we have seen in terms of governance up to now has been inadequate in terms of protecting the investors because there are inherent conflicts of interest. I think in the case of the chair, it comes down to this. I think it should be advanced as a hypothesis that we have an independent chair. If there are particular circumstances that arise where people of great expertise would be excluded for that, I think that case needs to be made during the course of debate.

I know you are anxious to get the bill out, but it seems to me it will not take too long to ascertain whether that becomes an onerous requirement. It would be a goal that would be worthy of pursuit. If it turns out that you are excluding people of great skill and talent, or unique skill and talent, then it might be something that would have to be reconsidered, which might be offset by having a sufficiently high number of independent directors on the board itself.

Mr. CROWLEY. My time has expired. I thank the Chair.

Chairman BAKER. I thank the gentleman.

Mr. Tiberi?

Mr. TIBERI. Thank you, Mr. Chairman.

Let me follow up on Mr. Crowley's last question. The current language in H.R. H.R. 2420 creates a two-thirds majority independent board. What I have argued in the past is that those independent directors if they choose, can choose an independent chair. If they choose not to, they can choose not to, but two-thirds of the board shall be independent. Mr. Galvin, what is wrong with that?

Mr. GALVIN. There is nothing wrong with it. I just endorsed it. I think it is an excellent idea, and I think that is the more important point. What I am saying with respect to an independent chair is that that would be a goal. In an ideal world, it would be wonderful. I do not know. I think the problem that Mr. Crowley pointed out is that you might be excluding people of unique skill. I am not making his argument. I am sure he is very capable of making it himself.

Mr. TIBERI. Let me interrupt you. I think we are in agreement here. If we have an independent requirement for two-thirds of the board, aren't those members in the best position to decide who the chair should be?

Mr. GALVIN. I think they are. I guess the question is, are there abuses out there, and maybe there are and maybe there aren't. This is an evolving situation that suggests the chair is a unique person in a unique position. One of the things that came out of the Senate hearing the other day is that there are a number of officers, and I won't name the company because I do not want to mis-name it, where in a given family of funds, individuals sat on the boards of 85 or 100 different funds. How much time could they possibly devote to their duties, and presumably they were being compensated in each and every case. How much time could they actually devote to their duties? So there is a danger here that you are simply stacking the deck with even so-called independent people

I think one of the other real problems, and it is a genuine one, and I don't know that we can solve it here this morning, is that we are asking independent chairs to step up to their fiduciary duty.

We are expecting to do a great deal. I can imagine independent individuals saying, what do I need that for? It is going to be hard to recruit the caliber of people we really want in the number of funds that are out there, but I think it is necessary. I think what we have seen makes it necessary.

To answer your question specifically, sure, if the board is truly independent and they can designate an independent chair, I think that will go a long way. I do not want to simply abandon the concept of an independent chair. I think it just needs to be explored. I can see legitimate arguments, particularly if it is a fund that requires particular expertise. Let's say it is a technology fund, and somebody who has a particular expertise in the market. There may be individuals out there that are uniquely qualified to be the chair.

Mr. TIBERI. But why should we mandate that? Why shouldn't we just let the two-thirds of the independent board do it?

Mr. GALVIN. I am not sure that we should.

Mr. TIBERI. Okay.

Mr. GALVIN. That is my answer to you. I am not sure. I am just saying I would not abandon it as a goal and say it is impossible. Let's explore it. Let those who would be excluded or those who would be concerned about their exclusion, come forward with specifics, as mentioned earlier. This whole subject matter is in some respect complex. This is another example of that. But it does not mean that we cannot get the answers. There are X number of funds out there. We can find out very rapidly where the problems are. The funds I am sure are very ably represented in this room right now. I am sure they can come up with the answers that you need for the discussion.

Mr. TIBERI. Ms. Schapiro?

Ms. SCHAPIRO. I don't disagree at all. I guess one thing that we could maybe even hope for is that it becomes a point of differentiation to have an independent chairman if those two-thirds elect an independent chair, and that that would be a distinguishing factor for a fund to demonstrate to the world it is taking its corporate governance issues very, very seriously.

Mr. TIBERI. Thank you. You both endorsed H.R. H.R. 2420 as a positive response. We passed it here at the end of July unanimously on a voice vote. Much has happened since then in the mutual fund industry. We may take H.R. H.R. 2420 to the floor next week or the following week. Much may happen in the next month and a half or 2 months. Do you both believe that in general some of the abuses that have occurred, number one, are illegal? And number two, people will go to trial?

Ms. SCHAPIRO. Clearly, the late-trading is illegal. I believe people will go to trial and suffer severe consequences from that. With respect to market timing, as we have talked about, it is a little bit more complicated. Nonetheless, for our jurisdiction which extends only to brokerage firms, not to funds, anywhere where we see that a broker-dealer has essentially colluded with a mutual fund to help a customer evade market timing restrictions that are contained in the fund's prospectus; anywhere we have seen an insurance company work to market-time variable annuity sub-accounts; or we have seen a broker-dealer set up multiple accounts for a customer in order to facilitate their market timing, we will move very, very aggressively, and those people will be subject to strong sanctions.

Mr. TIBERI. Mr. Secretary?

Mr. GALVIN. We believe that every case we brought will have the jurisdiction to complete action. We certainly think that, as I mentioned earlier, in the cases where fund managers funded in their own funds and where they used deceptive identities to trade or where they colluded, as Ms. Schapiro mentioned, we believe we have sufficient authority. I think the benefit of perhaps clearer and more definite language would be to send a message to other people out there in the funds. I go back to what was pointed out earlier. I think the statistics being offered by the SEC about the extent of market timing are indeed shocking. If that is the case, clearly there are many companies out there that need to be told clearly that this is illegal. So I certainly see no damage by doing something like that.

Mr. TIBERI. Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Miller?

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

I also want to ask about governance issues. We were here just a few months ago addressing specific practices that many regard as abusive. Now we are here discussing others that we did not know about then. I am very concerned that we will continue to chase specific abuses unless funds are managed in a way, governed in a way that takes into account the investors's interests and not the management's interest.

The concern that I have with independent directors is not whether we have enough of them, but whether they are independent enough. We tend to look at independence as being anyone who does not have certain prohibited employment relationships or certain prohibited family relationships. How can we make sure that we have directors who have the knowledge to exercise independent judgment and who will look closely and skeptically at what the fund is doing, with an eye toward the best interests of the investors? Can we define "independence" a little better?

Mr. Galvin?

Mr. GALVIN. I think you normally use the criteria that you just outlined. I think in terms of independence, beyond that, as Ms. Schapiro has noted, it might be a selling point for the companies to identify people of high caliber; people perhaps of either financial or academic accomplishment; people who perhaps have been in another aspect of the financial services industry or in some other corporate location that have demonstrated skill.

I do not know, given the number of mutual funds that we could possibly define it down to such a point that we could say, you have to have X amount of directors with this qualification, and X amount of directors with that. I think what maybe is needed, and again it is very hard to legislate ethics, but there may need to be some sort of a statement that clearly defines more clearly what a fiduciary duty is in the law. In that sense, what we really speak about when we talk about lack of independence among the directors, we are not so much worried about their lack of ability to read or understand. We are worried about the fact that there are conflicts of interest; that they are not putting the interests of the investors first; they are putting the interest of either the fund or the fund managers first, or other special individuals.

I think maybe some codification of duty by the directors may go further to identify true independence, because that is really what we are looking for. We are looking for their actions to be independent. We are not so much looking for what are their particular skills, what composition do they represent of the investor base, whatever it might be. We are looking really for their duties to be independent, to be thoughtful, to be in the best fiduciary interest of the investors.

Mr. MILLER OF NORTH CAROLINA. Ms. Schapiro?

Ms. SCHAPIRO. The only thing I would add to that is that we talk a lot about the fear that we will not find directors who are both expert and independent. I think we can find independent directors and I think we can train people to be expert. We dropped the ball, to some extent I think, on the issue of educating intelligent, hard-working people who are independent, about how funds work. They may well be in a position to ask some very basic questions that clearly need to be re-asked of this industry and how it operates. Is all this complexity necessary? Are we adequately disclosing our performance? Are we adequately disclosing our fees? Are we doing everything we can to keep the shareholders's interest paramount?

I think we can train people in the intricacies and give them the expertise they need, if they are in fact truly independent and if there is a will to do that. That is an expensive undertaking, but I think it is an important part of advancing the corporate governance here.

Mr. MILLER OF NORTH CAROLINA. Okay. Back in June, I asked about whether there should be some limit on the sheer number of boards that directors can serve on; that this is a little too sweet a deal for somebody serving on 80 or 90 boards, and presumably gets some substantial fee with respect to each board; that if you have that kind of financial stake in it, you are less likely to exercise independent judgment and ruffle management if you owe management that position.

I felt like I was kind of blown off then. I backed off of that proposal, and I saw in the press clips that Senator Collins raised the same issue this week on the Senate side. Is that something we should look at?

Ms. SCHAPIRO. I think it is worth looking at. I do not pretend to know what the right number is, but I will venture to say that there is no way you can serve on the boards of 40, 50, 60, 100 funds and do an adequate job. There are efficiencies and economies when you are looking at different funds within a fund family, and there are certain issues, the performance of the transfer agent and others, that may translate across all of the funds. But there are many issues about performance that do not. If you are paying careful attention as a board member to issues like performance, you cannot do it adequately serving on that many boards.

Mr. MILLER OF NORTH CAROLINA. Mr. Galvin?

Mr. GALVIN. I would certainly agree. I think whether you want to legislate a number, or you might find that difficult to do, or perhaps authorize the SEC by regulation to come up with some sort of a number or plan might be the better approach on that, but I am sure you are capable of coming up with something, but I definitely think it is something you might want to address.

Chairman BAKER. The gentleman's time has expired.

Ms. Kelly?

Mrs. KELLY. Thank you, Mr. Chairman.

Ms. Schapiro, in the Senate hearing on Monday, Eliot Spitzer stated several conditions that companies have to meet "to get a settlement with my office." They included things like a compliance program that would guarantee that no violations would occur again. He also included the full disgorgement of all fees that were earned related to any fund during the time that the illegal behavior occurred. Did you work with Eliot Spitzer on any of those conditions that he set forth?

Ms. SCHAPIRO. No.

Mrs. KELLY. I am sorry. Did you say no?

SCHAPIRO. No. To date, the cases that have been announced have largely involved the fund groups themselves. Again, we do not have jurisdiction over the funds, only over broker sales practices with respect to mutual fund distribution. We are working very closely with the State of Massachusetts, with the SEC, and with other regulators on a large number of investigations in the fund area, some of which do involve market timing and late trading, but they also involve inappropriate shares of B-classes, directed brokerage issues, sales contests and so forth.

I think regulators working together here is particularly critical. I see this most acutely from where I sit. As I said, we do not have jurisdiction over mutual funds. We do not have jurisdiction over hedge funds. So it is important for the regulators who do have different jurisdiction to work together so that we can try to bring together as comprehensive a resolution to these issues as possible.

Mrs. KELLY. Mr. Galvin, I would like to ask you a question. The SEC has actively lobbied states to return all fines and make restitution to the investors through the Fair fund. The chairman spoke about that. Do you think investors should be entitled to as much money as possible?

Mr. GALVIN. Yes. I regularly return it to them. I think the problem with the Fair fund which came up in the context of the so-called Global settlement is that no one seriously suggested that the cumulative amount of funds being paid to all entities under the settlement could ever even begin to compensate investors for what they lost. I recall a meeting on Wall Street discussing it. The point was made that we would not be returning cents on the dollar; we would be returning mils on the dollar. I had to remember what a mil was and realize how little it was.

We work actively to return monies to our investors. That is very important for us. The Fair fund is a good-faith effort at doing that, but it is not the most efficient way. For instance just last week in Massachusetts, we had a rather tragic case involving a family that had trusted a relative by marriage who was a broker, and had squandered and taken away the money and spent it, and the family was totally destitute. They had lost all of their money. We were able to get it back for them. If that family had to go through some sort of an administrative proceeding in a Fair fund, obviously I do not think they would be getting back that much money.

We oftentimes return money who are not represented by counsel, do not have lawyers, if we can get it back from them. That does not mean we are opposed to lawyers. I am a lawyer. I think lawyers are fine. We work with counsel. I think it is too simplistic to simply say there is going to be some Fair fund and all the money goes there.

The second point as far as the monies going to the States are concerned, oftentimes the monies going to the States in fact pay for additional investigations. The cost of conducting these investigations is great. In the case of, for instance, the CSFB case that Massachusetts handled, we were confronted with hundreds of thousands of e-mails. I had to go out and recruit students from law schools to read through these e-mails to find material because the cost and the necessity and the scope of these investigations is so great. I think an effort to take all of those funds away would be a mistake.

Mrs. KELLY. Mr. Galvin, you pointed out that without convictions or an admission of guilt, like we saw with the Global settlement, we have seen a lot of civil suits dismissed, as with the Global settlement. Don't you think this is another reason why we should require that all fines get returned to the investors, to maximize that amount of money? Just give me a yes or a no please.

Mr. GALVIN. All fines, no. I cannot give you a yes to that. There are costs involved. I think that the goal should be returning the money to investors, but you have to have the ability to continue prosecutions, and some of that cost has to be built into the settlement.

Mrs. KELLY. Have you set up conditions to set up settlements? Or are you going to take this stuff to trial?

Mr. GALVIN. On the pending cases?

Mrs. KELLY. On the pending cases.

Mr. GALVIN. No, we intend to take these cases to trial. We are certainly going to demand admissions. If there are settlements, it will be with admissions of wrongdoing. We are certainly not going to have cases where people are able to say, well, we did not do anything, but we will pay a fine. No, not at all.

Mrs. KELLY. Ms. Schapiro, the NASD rule 2830 that you talked about expressly prohibits the award of non-cash compensation, and it prohibits brokers from favoring the sale of any mutual fund on the basis of brokerage commissions that they receive. Isn't the practice of selling mutual funds off of preferred lists where brokers paid more to sell the funds off that list widely practiced? If so, and I just want a yes or a no answer, are there widespread abuses of the NASD rule 2830 that have gone unchecked?

Ms. SCHAPIRO. We have ongoing 12 investigations right now to determine whether funds have been inappropriately included on a broker-dealer's preferred list by virtue of having gotten directed brokerage, which is what 2830 goes to from that fund. We will be announcing a major case very shortly in the next several weeks. As I say, we have 12 major investigations going on.

Mrs. KELLY. Thank you.

My time is up. Thank you, Mr. Chairman.

Chairman BAKER. The gentlelady's time has expired.

Mr. Inslee?

Mr. INSLEE. Thank you.

I want to focus on the relative responsibilities and abilities of the federal and state regulators, if I can. I want to tell you that there is a perception out there on Main Street, at least the Main Street I walk down on my way to work, that the federal regulator has been grievously ineffective relative to the state regulators recently in this whole plethora of industry issues. I think there is some reason for that perception. I think it is not just a casual reading of the headlines. I think there is some actual reason to believe that, that there is some sort of systemic problem with our federal regulator in this regard that has not allowed them to be sufficiently aggressive or timely in these investigations or prosecutions.

Now, realizing your close working relationship with our Federal government, I am not going to ask you to do too much critical thinking about their lack, or at least perceived lack of aggressiveness on this. But perhaps you can give us some thoughts as a colleague of theirs, if you can, on how to promote at least more timely action from our federal regulator, and share some of the positive experiences of your operation and others that you think the Federal government needs to think about utilizing as well, in the most positive way that you can put your comments. I am looking forward to your advice.

Mr. GALVIN. I think we have to recognize, and I think Mr. Frank alluded to this in his opening statement, that the federal regulators are looking at a bigger picture. They are looking at issues such as liquidity in the market. They are looking at the complete market. All too often, their focus has not been on the impact on small investors in particular.

I think that that is in fact the advantage of the dual system that we now have, that the State regulators are more likely to see, it is a tired analogy by I will make it anyway, the cop on the beat, so to speak, and going to hear about something that has actually happened. In the case of Massachusetts, these issues arose in factual instances that occurred within the confines of the State of Massachusetts.

If I were to make a constructive suggestion to the SEC in terms of enforcement, it would probably be that recognizing that it is a large bureaucracy and probably going to, in the interest of enforcement, grow larger, they have to find streamlined ways of promoting information up the channels to bring actions, and perhaps devolve more authority to some of the regional offices to commence actions. I cannot say for a certainty that that is a problem.

I do sense, however, that like any bureaucracy, and I administer a bureaucracy as well, so I am well aware of its pitfalls, it is sometimes hard to get information up the chain, to let people know how to proceed. Oftentimes, especially in an industry that is so complex and so broad, and having so many individuals employed in it and so many individuals affected by it, there is such an overload of information it is hard to digest it all.

So I think if I were to make a constructive suggestion, recognizing that the SEC's role has continued to be interested in the overall financial market, in terms of individual instances, it would be best to have some kind of streamlined system of proceeding with information that I am not sure they have right now.

Mr. INSLEE. Ms. Schapiro?

Ms. SCHAPIRO. It is a hard question for me because I am overseen directly by the SEC, and I spent 6 years there as a commissioner. I guess I would say just a couple of things about it. I think it is important that they have a more intensive examination program, that in the fund area in particular the examiners that the SEC employs need to spend more time in the mutual funds and in the advisers, and all regulators have to recapture a sense of skepticism about everything they see. The presumption that everybody is honestly doing business, and most probably are honestly doing business, has to become checked at the door when you are a regulator. You have to walk in, and everybody knows entering trades after 4 p.m. is illegal. I do not think anybody thought that that could possibly be going on on a widescale basis, and yet it was.

So I think more examinations, more skepticism, and then more feeding of the results of examinations into the policymaking groups on a real-time basis so that where rules need to be written, they can be written and the enforcement program can move more aggressively and more quickly. I do believe the SEC's enforcement program, but that is the end of the chain, has worked quite aggressively over the last couple of years under Steve Cutler's leadership. I think some of the issues need to get to enforcement more quickly.

Mr. INSLEE. Do you think this legislation is a vehicle to look at some of these issues? Maybe that is outside your ken, but is there something unique enough about the mutual funds situation that in this legislation we ought to tackle some of those internal regulatory issues?

Ms. SCHAPIRO. I guess I am not really a good person to answer that question. I think the leadership of the SEC is very focused on tackling just those kinds of issues right now, and I have complete confidence that Chairman Donaldson will be able to do that. I think this legislation is very important for lots of other reasons, though, and Congress ought to move as quickly as possible to enact it.

Mr. INSLEE. Mr. Galvin had one more comment, I think.

Mr. GALVIN. My only comment was I think the audit part of the legislation or the discussions about audits would be very important. I would echo what Ms. Schapiro said, that I think that is a very important tool in the hands of enforcement people.

Mr. INSLEE. Thank you.

Chairman BAKER. The gentleman's time has expired.

Mr. Toomey?

Mr. TOOMEY. Thank you, Mr. Chairman.

I just wanted to focus a little bit on the market-timing issue. The late-trading seems to be pretty straightforward and a clear violation of any sensible set of rules regarding this. It is illegal. Market-timing, my understanding is, generally speaking, not illegal. My first question is, are there common practices of market timing that you think should be illegal? If so, why? That would be my first question.

Mr. GALVIN. I think market timing in general, unless it is a fund devoted to market timing, and I guess there are some entities like that, should be clearly illegal. I believe in the instances that we have uncovered, it was illegal. As we discussed earlier, in many instances it was made available by deception. It would certainly disadvantage the average investor.

Mr. TOOMEY. Could you explain, what is the economic cost to an investor who does not participate in market timing, and created by someone who does?

Mr. GALVIN. There are a number of consequences. First of all, as I mentioned earlier, it is our feeling, and I think so far the evidence has borne out, that the amount of money being flushed through the system in market timing is dramatic because it makes it worthwhile doing. So therefore, the returns are dramatic. For instance in our case against Putnam relating to market timing by Putnam customers, we had a group of people who were boilermakers affiliated with a 401(k) out of New York. The market timers who were taking advantage of the special rules for them in that case, in some instances were making up to $1 million simply on the market timing. That was coming out of the fund.

Secondly, there are tax consequences, as already has been averred by others this morning, because the fund oftentimes to meet the demands of paying out these people at some time makes sales of stock, keeping its portfolio balanced. So there are definite disadvantages. But beyond the technical disadvantages, and we could go further into what they are, it is fundamental fairness.

Mr. TOOMEY. There is a fairness issue that I think is one issue. But what I want to understand is, and I think if market timing is allowed, it should be available to everybody. If it imposes a cost on the fund, then the cost ought to be borne by the person engaging in the market timing. But what I want to understand is whether or not the fact that one party engages in market timing and even makes a profit from that, does that truly come at the expense of another investor who chooses not to? You mentioned there is a liquidity issue, and there may be transaction costs. Is that it?

Mr. GALVIN. We are not clear. You would have to analyze when the market timing was done, exactly to what extent it was done. As I mentioned, what we are looking at now are hedge funds doing it, large amounts of money passing through. There has to be an impact of that. It gets back to the inadequacy of some of the accounting that is presently done in these funds.

Beyond the fairness issue, to assess the damage that has been done by it, I think you have to get into deep detail as to when they did it and how they did it, and what the costs were. The general accepted theory is that it is costing investors money. It may not be a great deal of money to each individual investor at that particular time, but then you have to look at not only the cumulative effect on the fund as a whole, but also the interest of the investors who are holding over the long term. Over the long term, it is costing them a more substantial amount of money because it aggregates in that way also.

Mr. TOOMEY. Is it appropriate to deal with that by charging an appropriate fee to people who engage in market timing?

Mr. GALVIN. That is the so-called 2 percent solution. There is a proposal out there that would charge them a 2 percent redemption fee. The problem with those types of things, in my view, is that once you say, well, it is okay if, how do we enforce the "if"? One of the biggest problems with this whole discussion is it gets extremely complex. We have so many mutual funds out there. We have so many people out there. If we are going to say, you can do it if you adhere to these rules, we have rules. They are in the prospectus. They did not adhere to them. In fact, they worked around them and the companies in many instances helped them work around it.

Mr. TOOMEY. But that essentially is an enforcement problem, not necessarily a problem with the rule itself.

Mr. GALVIN. But it is the same problem. You cannot separate the rule from enforcement, in my opinion, because the rule without enforcement is meaningless.

Mr. TOOMEY. I am not disputing that, but I still think that there is a separate issue here.

I would like to hear what your thoughts are, Ms. Schapiro.

Ms. SCHAPIRO. What I would add to that is that if a fund wants to advertise in its prospectus that it allows marketing timing and it will impose a 2 percent redemption fee, and it uniformly and always imposes that fee on every customer, good customers do not get a special deal and pay only 1 percent or nothing, I have less trouble with that than I do with what seems to be the prevalent problem here, which is a prospectus that states, we discourage market timing and we will take steps against people who market-time our funds, and then look the other way while the best customers market-time the funds.

To me, the disparity of how people have been treated, that there are special investors and not-so-special investors is really very offensive.

Mr. TOOMEY. Right. It sounds to me what you are saying is that the misrepresentation of what is allowed or tolerated or condoned by the fund is more objectionable than the activity itself.

Ms. SCHAPIRO. The activity can be objectionable, because I think in addition to saying we are going to impose a redemption fee and we are going to impose it consistently, is I think you have to explain to investors what does it mean if you choose to be in this fund, even if you are not going to market time. What is it market-timers are taking out of the fund? What additional cost is their activity imposing on you? I guess it goes back to the earlier conversation that people have to understand the performance. This affects the performance of the fund. If they are going to allow market timing, even with a high redemption fee, everybody else needs to understand what the impact of the activity is on their fund value.

Mr. TOOMEY. I agree with you.

Thank you, Mr. Chairman.

Chairman BAKER. The gentleman's time has expired.

Mr. Emanuel?

Mr. EMANUEL. I want to thank the chair for holding this hearing, as well as the one on Tuesday.

I would like to follow up a little on what the Chairman asked as it related to hedge funds and mutual funds. As we look forward to drafting bipartisan legislation or going forward with some type of legislation, your thoughts in the area of mutual funds being able to have inside the shell hedge funds in the coordination. This is the second case brought today as it relates to a hedge fund and mutual fund, and the type of special treatment for special accounts. We are going to deal with market timing and we are going to deal with late trading, independent boards, and greater transparency.

My worry here is intermingling of two worlds that have never come together in the past, one marketing to a different clientele than the other. Again, we have a culture that says "heads I win, tails you lose," that we are going to take care of a special client at the expense of all the average investors getting the short end of the stick constantly. I suppose it is not really a question that I just made, and I apologize for that, but your thoughts as we start to think about drafting legislation that affects these two worlds now starting to bounce into each other, or blend and become one.

Mr. GALVIN. I think it is something we have to think about. That is why I mentioned it earlier, and I am glad the Chairman mentioned it as well. You are right. The perception on the part of the average investor is they are investing in this safe fund that they share risk and opportunity. They could not define a hedge fund for you, and hedge funds are largely unregulated, so they are these powerful entities. The fact that we are seeing them surface in the market timing thing suggests that they are the type of entities that get special treatment. They are not the only ones. There may be large pension funds or 401(k) groups, so they are not exclusively the bad people in this situation. But I think the question is, if we are going to acknowledge that mutual funds are such an important part of our financial savings system, as I mentioned earlier, the substitute bank for many people, is it wise to have hedge funds participating on an unrestricted basis?

I do not have an answer for you this morning, because I do not know whether eliminating them would cause a great problem in the marketplace. I am concerned that their action, though, interacting with mutual funds, is potentially problematic, and I certainly think there should be some disclosure. I actually think hedge funds should be a lot more regulated. I also mentioned in my earlier testimony as well the issue of these unregulated entities, holding companies that hold perhaps a hedge fund and also interest in a mutual fund at the same time. Those are things that I think at least ought to be focused upon by the SEC at the very minimum.

Ms. SCHAPIRO. If I could address the structural issue about hedge funds and mutual funds being potentially harmed by the same manager or in the same family. My personal view is that it is an untenable conflict of interest to have a manager have to select where their best transactions are going to reside, in the hedge fund which may be paying higher fees and in which the manager may in fact even have an interest; or the mutual fund which is dispersed among a lot of people and has less effective voice to it in the whole process. I do not understand how you can have a situation where the same person manages both the hedge fund and the mutual fund.

Mr. EMANUEL. Thank you. Again, it is a structural issue, but it again deals with the conflicts of interest, higher fees, a different clientele, at the expense, my biggest worry, is that it is at the expense of the average mom-and-pop investors who have college savings. This is also the one area, unlike the others, and those are important for setting the rules of the road, that look forward in some sense, although what you are dealing with today is today's problems, but more sense about where the industry is going.

Rather than kind of review this every 2 years, someone gets a clear line of direction that blending or coming together of the mutual fund and the hedge fund industry. My greatest concern here is that what we are trying to do is restore the Good Housekeeping seal to the mutual fund industry that has been tarnished in the last 3 months, so to say, that these cases have been brought, and really are about actions that have been taken over the last 3 or 4 years, because they are so essential to the democratization of the financial and capital markets that we have.

One other area of inquiry, and then I will give up my time. Do I have time for one more question, Mr. Chairman? I asked Attorney General Spitzer and others on the panel the other day about the area of the IPOs and the hot market that existed in the late 1990s. Given that the industry somewhat lost focus on its fiduciary responsibility to its investors and had a culture of heads-I-win and tales-you-lose kind of dominate. Have any of your investigations to date or inquiries to date taken you into the area of how the hot IPO market, and where certain classes of the friends and family got distributed?

Ms. SCHAPIRO. We jointly chaired with the New York Stock Exchange, at the request of the SEC earlier this year, a blue ribbon advisory committee to look at the IPO market after the market meltdown. We do not actually have a hot IPO market again yet, but it looks to be heating up. That report generated a number of recommendations, including with respect to friends and family programs and limitations on those programs, and a number of other recommendations that are generally geared toward trying to make the initial public offering market a bit more public, and a bit less geared toward the insiders that have traditionally been able to get access to IPOs.

That report resulted in for us a series of rule proposals that will go to our board next week and then be filed after that with the SEC. We would like to encourage Dutch auction activity in the IPO market; much more transparency about who gets IPO shares; much more involvement, quite honestly, of the issuer in the process of setting the price so that it is not just done by the investment bank to generate enormous first-day bounces.

Mr. EMANUEL. But my question is, to date either in that investigation or any of the ones that you have had up in the commonwealth of Massachusetts, have you seen any of the special offerings in the mutual fund industry to personal accounts, rather than to the accounts for the rest of the investors anywhere in that area, or to the management, or to a special investor?

Ms. SCHAPIRO. As you say, we have certainly seen it in the IPO market generally over the last several years and brought a number of cases related to that. We have not seen it, to my knowledge, in the mutual fund area.

Mr. GALVIN. We have not seen it as such. What we have seen, as I mentioned earlier, is fund managers market timing. We have not seen them try to take advantage of their IPOs.

Chairman BAKER. The gentleman's time has expired.

Mr. EMANUEL. Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Ms. Hooley?

Ms. HOOLEY OF OREGON. Thank you, Mr. Chairman, and thank you for holding this meeting.

I have first a question for Mr. Galvin. Strong Financial founder and chairman Richard Strong is under investigation for market timing. The Strong Financial Company manages accounts for 529 college savings plans, including those in my home State of Oregon. State and federal law holds that Strong must place investors's interests ahead of his own, yet by engaging in market-timing trades for himself, his friends and his large clients, it appears that Mr. Strong was looking out after his own financial interest ahead of those who had college savings plans. Of course, the losers are the parents and the students that they were going to send to school.

So I have three questions. How do we ensure that mutual fund companies put their investors's interests ahead of their own? Two, is there a comprehensive investor restitution system that is in place to get these college savings back? And three, should this Congress look to create a comprehensive investor restitution program?

Mr. GALVIN. First of all, clearly, let me start off by saying that the Strong case was not one that I have brought, but I am familiar with it, but the principles and the issues in the Strong case are the same as in some of these other cases, which as you say, is the people running the mutual fund putting their interest ahead of their investors.

Clearly, one of the things that we are going to be looking for is restitution to the fund for whatever has been lost by market-timing practices or any other breach of fiduciary duty. I think that will be an essential for any resolve of these cases. In terms of preventing it in the future, I think the bill that is under consideration goes a long way towards that. It starts to speak of independence. I think the discussion we have had here this morning regarding audits is very important. I would like to echo what Ms. Schapiro said about a skeptical eye being turned on some of these matters.

I also think in the case of, as you describe, college education funds, usually they are coordinated by some state authority of some kind, making them available to the general public. I frankly think that while we have talked a lot about states's rights here to enforce law, I think we have to talk about state responsibility, too. I think it is important that the state authorities that placed these funds take on that fiduciary duty just as they might in a pension fund to make sure that the fund is policed properly; to make sure that the fund is answering the right questions. I do not think we can absolve the customer in this sense. It is the state that is organizing, and not the individual parent that is trying to plan for their children's future, from responsibility. I think this bill would go a long way toward helping that.

Ms. HOOLEY OF OREGON. Need to look at an investor restitution program?

Mr. GALVIN. I think the program should be built into any violations that are uncovered. I think the cleanest way of getting restitution is to make sure that it is done by those who have actually perpetrated it. Mr. Kanjorski earlier asked about the creation of some kind of an insurance fund. My response to him at that time was if we are talking about fraud, maybe that might be worthwhile; if a fund was completely fraudulent or there was no investment, perhaps. I think in most instances here we are not talking about fraud.

I think this might be an opportunity to restate something I have been saying a lot, and I want to make sure people understand this. Many average people get very nervous when they hear about these investigations. They think about, is the fund going to fail? Am I going to lose all my money? They might make rash decisions, and that would be a mistake. What is different in the fund situation from, for instance, a run on a bank, is that there are assets in these funds. They have invested their portfolios. It is unlikely, while the fund might be weakened by a lot of withdrawals, and that would be a cause of concern, unless there has been out-and-out fraud, it is quite unlikely it is going to go bankrupt. For an investor who is committed to long-term investment, to make a rash decision based on these representations that we have seen, even if they are true, might be a mistake.

I think that argues all the more for prompt state and federal action, both in terms of enforcement and in terms of changes in the law. I do think it should be a cornerstone of any actions that are brought and resolved, however they might be resolved, through adjudication or by settlement, full restitution to those who have lost money because of inappropriate behavior by fund managers.

I have a quick question for Ms. Schapiro. Obviously, mutual funds are what a lot of people have invested in as a low-risk way to enter the stock market. Three quick questions. You see these mutual fund scandals. They are on top of, now, all of the other corporate scandals. Do you see these scandals affecting the market as a whole? And how do these scandals affect the mutual fund industry and Americans's participation in it? And should we be prepared for more scandals?

Ms. SCHAPIRO. Thank you. I do think they affect the market as a whole, because they affect investor confidence. We need the capital and the contribution of investors to our economy to keep it growing. So I think to the extent that people are scared away by, first, the series of scandals with respect to investment banking and research analyst conflicts of interest, inappropriate allocation of initial public offerings, and now something that everybody thought was safe and sound and fair, mutual fund investing, I think investors are weary and scared, and may well decide that stuffing their money into a pillow and putting it under the bed is a better place to put it. I think that would be a real tragedy, because the fact is that mutual funds really were designed to be wonderful investment opportunities for diversification and professional management for people who could not otherwise afford it.

So I think the mutual fund industry has a lot of work to do to restore confidence in their credibility and in the integrity of the investment vehicles that they offer. I am not sure if that answered all your questions. Or, what other scandals might we see?

Ms. HOOLEY OF OREGON. Should we be prepared for more? Yes or no?

Ms. SCHAPIRO. Maybe.

[Laughter.]

We are very, very focused, as I know the SEC is, in trying to look around the corners and see what else might be out there. We are doing a much more effective job, I think, than ever before of mining regulatory data; of understanding what the potentials are for problems out there; where all the conflicts of interests lie in this business; and combining conflicts of interest with opacity and complexity, and knowing that that may well be the next area for us to be looking at. We are trying to understand what all of those are and get out ahead of them.

Chairman BAKER. The gentlelady's time has expired.

Ms. HOOLEY OF OREGON. Thank you, Mr. Chairman.

Chairman BAKER. Mr. Lynch?

Mr. LYNCH. Thank you, Mr. Chairman.

I, as well, want to thank both of the witnesses today for coming forward to help the committee with its work. I wish I agreed with our ranking member, Mr. Kanjorski, that this might be the result of the actions of a few bad individuals. It seems, though, that based on the reports that we have read, that this is rather endemic to the industry and that it is not just some renegade firms that are guilty of this conduct, but some fairly reputable firms.

I would just say that if you look at the harm that has been done here and if you look at the measure of trust that has been lost by the industry, there is a real concern here because of the nature of the wrong being done to the investor. The whole system, the whole industry is built on trust, and it appears that the need for these firms to compete in this way, and I am talking specific toward late trading, is to get an advantage for the investor, this small group of investors.

So they are choosing to compete with other firms by giving an advantage to a select group of investors. That is competition. It is illegal competition in many, many cases, and I know there are some borderline descriptions that you have rendered where it perhaps did not amount to fraud, but because what is driving this is competition among advisers and fund managers, not necessarily the fund itself, it would appear to me that the consequences and penalties for late trading and for market timing need to be a fairly serious consequence.

I just want to ask you both, and maybe I will start with you, Mr. Secretary. What do you see as the best long term, and bear in mind I am not just out to get the bad guy so to speak. What is the best thing for the investor? What is the best thing for the industry and for the long-term success of the mutual fund industry, but getting rid of this practice or this series of practices that have so shaken the trust of the American investor in the mutual fund industry?

Mr. GALVIN. I would respond by thinking, first, that we have to proceed with the prosecutions we have already brought. Secondly, I think we have to make it clear that if there is any ambiguity in the law, while I do not believe there is, I think it can be put to rest by this committee and by this Congress right now that these practices should be clearly illegal. I think establishing a clear responsibility in the area of mutual funds of a fiduciary duty by those who administer and manage them and direct them, also enshrining that in law, would be a great way to guarantee that in the future.

Then I think you have to have vigilant enforcement, not just by the States, but by the Federal government. I think an essential part of that is the audits and accounting that we have spoken about before. I think that we also then have to try to educate those who are participating in mutual funds. We do not expect them to get into the depth of detail of corporate management, how their fund is managed, as much as to be looking out for how their fund selections are made, what the fees they are charged actually represent, in digestible language, understanding not just fees, but also procedures and how the funds operate. I think those are important things that we have to do.

Clearly, to build credibility or restore credibility in an industry like this, it takes an effort not only by the government to come up with clear lines, and bright lines at that, but it takes an effort by the industry itself. I think they have been shaken by this. I think it is in a sense a good thing because they shared in this. They hid it for a long time. It is in our interest to restore their reputation if they are worthy of it. I know you share with me the concern, coming from Massachusetts as you do, that we are the home to many of the financial services companies that employ people in Massachusetts. It is a big part of our economy. It is certainly not something we want to see destroyed.

By the same token, we do not want to see it stay in business in a way that defrauds not only our own citizens, but the citizens throughout the country. So it is very important to all of us to get this cleaned up. I think that the contribution that Congress can make right now is to make it very clear what the duties of mutual funds are; to bring mutual fund regulation up to the level that it should be, given the responsibility that it has in our financial system.

Mr. LYNCH. Thank you.

Ms. Schapiro?

Ms. SCHAPIRO. Thank you. I am not sure my answer is very different at all. I think we have to pursue these enforcement cases with a tremendous amount of vigor, with very meaningful sanctions against the funds's brokers, to the extent they are involved, and management individuals. People have to be held responsible for direct participation in these schemes or fostering a culture within the organization that permitted them to go on either undetected or, if detected, unaddressed.

I think the second piece of it is rigorous, ongoing examination of fund practices and operations by the SEC on a continuing basis, a tremendous focus there, so that we are looking under the rocks all the time and finding the problems before they blow up.

The third is fund governance. Again, to really echo what Bill has said, the shareholders's interests have got to be paramount here and it is up to the boards and the management of funds to ensure that that is happening.

The fourth, I guess I have said about four times today, I believe we must have clear, more concise and consolidated disclosure of all the expenses and fees associated with buying a mutual fund, and then the impact of all of those on performance, so investors understand exactly what they are getting, exactly what they are paying, and how to compare those across different funds.

Chairman BAKER. The gentleman's time has expired.

Mr. LYNCH. May I?

Chairman BAKER. Do you want a follow up?

Mr. LYNCH. Please.

Chairman BAKER. Yes, sir.

Mr. LYNCH. Thank you, Mr. Chairman.

I just want to say in closing, and I know that Mr. Crowley had the wish to get 30 seconds himself, but just on the issue of disclosure that I repeatedly hear here. I just hope you realize the body of information that is coming to the average investor, and the complexity of it. I am a recovering attorney as well, and sometimes I just hold my head when I read just an average prospectus from an average fund. I actually have an unwritten rule. When someone tells me they need more disclosure, they ought to come up with an idea of a few of those disclosures that we are providing now that are just pure gobbledygook that are costing the investors, costing these funds. I think a lot of it is a waste of money because it is not coming in an effective way to the investor. It is a waste of printing. It is a waste of money.

Ms. SCHAPIRO. I absolutely agree.

Mr. LYNCH. I want good, effective, valuable disclosures made to the investor. I do not want muddled, legal mumbo-jumbo. I want people to have usable information as a result of these disclosures.

Ms. SCHAPIRO. I think you are completely right. I think what they have right now is mumbo-jumbo, and you have to look in four or five different places to get disclosure about the fees and expenses associated with a fund. It needs to be clear. It needs to be concise. It can fit on one page. It can be done with pictures. There are ways to do it far more effectively than I think it has been done, and in a way that will benefit investors. We do not want to burden them with any more to read. They are already not reading what they are getting. There is a better way to do it, and I think it is really incumbent upon all of us to find that way.

Mr. LYNCH. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. The gentleman's time has expired.

Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman.

I also want to thank you, Mr. Galvin and Ms. Schapiro, for coming before our committee this morning.

Each day, it seems, we are learning more and more about these mutual fund scandals than we did the day before. In today's Washington Post and Wall Street Journal, for example, there are two more revelations of two more companies coming under scrutiny. Investor confidence is just going down. I came across today, according to Reuters, a new poll was released by a wealth management firm, the United States Trust Company, and they found that these scandals are having an extraordinarily profound impact on investor confidence.

Sixty percent of Americans are now losing confidence in investments; 79 percent of those polled questioned the reliability of corporate financial statements and do not trust stock analysts; 67 percent do not trust corporate management; and 65 percent do not trust independent auditors of mutual funds, and that is even despite the recent very significant up tick in the stock market. And now today we find out from a story in The Washington Post of investment banks getting into the act as well. It seems like, as we are trying to handle this, it is like trying to put your hands around a bowl of Jell-O. You kind of squeeze it and another part oozes out.

I want to ask just a couple of questions, going back to the article in this morning's Washington Post. It says that industry sources are quoted as saying that investment banks either played favorites among mutual funds when doling out shares in hot IPOs, or they placed poor-selling IPOs in their own mutual funds. Do you have any idea about how involved investment banks are in manipulating mutual funds? And if so, what do you recommend that we do to protect against this unsavory practice?

Ms. SCHAPIRO. We are investigating that very activity. I do not have a good answer for you at this point about how pervasive the problem is or how serious it is, but we will pursue our investigations. We will undoubtedly bring enforcement cases in that area. If necessary, we will write rules that will make it easier to enforce in the future.

On your general issue, I think we will not make you happy, probably, by telling you there will be many more headlines. There will be many more discouraged investors, because there are many more cases to come just on this issue of late trading and market timing, from both the state regulators, the SEC and the NASD. So it will be awhile before I think we see light at the end of this tunnel.

Mr. SCOTT. Mr. Galvin, on investment banks?

Mr. GALVIN. I think the investment bank issue, much like the hedge fund issue, raises the question, are these appropriate partners to be under the same tent? I think it goes back to the issue of independent boards of directors and making sure that they truly do not have conflicts of interest. In essence what you are suggesting, the scenario you are suggesting, is a conflict of interest, an investment bank looking to park fully performing IPOs or whatever shares in some other entity to the benefit of the fact that they took the business to promote or produce this IPO, or whatever it might be.

It gets back to how do you ensure independence. I think that is why setting a fiduciary duty in statute, creating a requirement for independent directors that is based upon that, is probably the most effective thing you can do.

I share your concern about investor confidence. As I mentioned to the gentlelady earlier, I am concerned that people are going to rush in now and say, I will take my money out. That is not the right thing for them to do right now. It is going to hurt them more. We do not want to see them hurt any more than they have already been hurt. So it does mean that moving on this legislation and moving on these prosecutorial efforts has to go forward as rapidly as possible.

I think it is fair to say that it is now clear, or it should be clear to the industry at every level that is involved with mutual funds, that they need to come clean, too. Don't wait for them to catch us. Don't wait for them to see the law change so they have to adhere to it. Why not, if they are knowing of some issues that they have, I think it is much better for them to come clean to their investors right now over the next few weeks land address these issues, than waiting for you to change the law or us to enforce it.

Mr. SCOTT. I had a gentleman and former Securities and Exchange Commission chairman who wrote an excellent book with a take on the street, and he said the deadliest sin that he felt was fees. I want to ask you this question as well. The cost of buying and selling mutual funds is often disguised as high fees charged by the providers. Some funds are able to get away with overly high fees because investors do not understand how fees can reduce their returns. What do you recommend to clearly explain the potential costs of fees to investors up front?

Mr. GALVIN. Again, we have talked a lot about disclosure. Mr. Lynch mentioned making it digestible. I think we have perhaps a model when people purchase homes in this country now, they have the benefit of when they sign up for a mortgage, they are presented with a document. It is usually not a single page any more, but not too many pages, anyway, that lays out the numbers. I think that is really the type of disclosure you need, something that lays out the numbers in understandable form. What does this actually cost you?

I think we have to also think about, as this bill seeks to address or at least raises the topic of soft-dollar costs and how those fees are set. I think that is an important part of any fix in this whole area.

Lastly, we have spoken, I know the NASD has and I have, and the Morgan Stanley case illustrates it, relating to contests and extra compensation for selling certain funds. I think that is important, too. I think it is important for brokers and those who sell funds to tell the customer if they are getting extra money to push a certain fund. If someone is getting extra money, that needs to be on the table. That is a material fact that the person is making a decision to purchase needs to know.

Mr. SCOTT. Thank you. I am going to ask one more follow-up question.

Mr. GALVIN. Sure.

Mr. SCOTT. One of my major efforts and concerns on this committee is financial literacy and financial education. I quite firmly believe that, as the old prophet Isaiah said, people without vision will surely perish. If we in this country cannot collectively come up with a strong vision of America as being literate financially, we are going to have more of these rows. I see some downturn to that. We are grappling with that and putting forward some legislative initiatives on financial literacy and investor education.

I am concerned that many investors, and this is especially true for minority investors which are trying to encourage more in the minority community, to get involved in investing. Of course, with these scandals coming up, it is making it more difficult. But I am concerned that we are not fully educated about the risk of investing. What do you recommend that we can do to ensure that investor education is an effective tool, and not just throwing money at the problem?

Mr. GALVIN. I think you have to put it in simple terms. People have got to understand, you are going to give me this amount of money, that it has to be clearly stated when there is a risk. We have had cases in Massachusetts, which come up all too often, when people to into federally insured banks where they have money in the bank, and there is another table, same color, same logo, off to the side, and they are selling mutual funds or some other kind of risk investment.

Now, there are requirements of disclosure, but you sometimes need a magnifying glass to see that down there. To the unsuspecting or unsophisticated investor, it looks like an employee of the bank. I think we have to make sure that is a clear demarcation line. You do hear oftentimes on the tail-end of commercial and presentations for reputable risk investment, you may lose all of your principal. We have to get that point across, not to scare people, but to have them understand there is a fundamental difference.

I also think, and I know this is your ultimate purpose, in fact, to encourage people to invest.

Mr. SCOTT. Absolutely.

Mr. GALVIN. So that being the case, it is important that we do not scare people away. One of the greatest concerns I have as I have brought these enforcement efforts is that I do not want to see people scared away from the financial services industry or investment, because investment in general is a very good thing. This has been a bad thing for the industry and the industry has done bad things to people, but it is time for us to make sure they do better things and to put in place the protections that people who do not have a lot of time, who are simply looking for a reasonable place, people of modest means looking for a reasonable place to park their savings, are treated fairly.

That is why, I know we have talked back and forth about definitions, but it comes down to honesty and fairness. That is really what we are talking about. We cannot legislate, you cannot legislate and I cannot enforce something that says you are going to make money, because you may not. You may lose money. But we can insist that people be treated fairly and honestly. That I think we have an obligation to do.

Mr. SCOTT. Thank you very much.

Chairman BAKER. The gentleman's time has expired.

I want to address one thing that was brought to the committee's attention by Mr. Crowley a little earlier, referencing a Republican staff comment and quotes attributable to me relative to the assertion that I would be proposing independent chairmen for public operating companies. It kind of threw me back a bit. So I went back to the prior explanation in the committee markup of the bill and just will read this, because I am surprised I made sense. I went back and looked at it to make sure.

The content of the independent chair proposition comes to this bill in recognition that an operating company, a company traded on the New York or American Exchange, is inherently different in structure from that of a mutual fund. A CEO and a CFO for a publicly traded corporation that is an operating company has one clear set of responsibilities, and that is to its shareholders. There are not conflicting sets of shareholders. Mutual funds are managed by corporations, corporations that have a different set of shareholders. Take company X which has been awarded the management contract for mutual fund 101. Company X has its own set of shareholders. Company X may manage 100 different mutual funds. They do that work for the benefit of company X's shareholders.

If the person running the mutual fund is also the person running the management corporation, he has a conflicted set of shareholders. On the one hand, if fees are increased for the mutual fund management company, that decreases returns for the mutual fund. If he keeps fees low for the mutual fund participant, that decreases the revenue to the mutual fund management company. So the mutual fund director is in a distinctly different and unique position from the CFO or the CEO of an operating company, hence the reason for suggesting the chair should be independent.

If the management company is not performing appropriately, charging excessive fees, or is just not doing its job in the proper rate of return for the mutual fund shareholders, do we really believe the chairman of the board of the mutual fund is going to suggest to his board dismissal of his own corporation as manager?

That was the statement made, and I do not know from where Mr. Crowley reached his conclusion, but just on the record, I have no intent, and have not to my knowledge ever suggested that anyone other than a mutual fund structure should have an independent chair, but it did bring to light what I think are good policy reasons. The growth of the industry over the decade has been enormous, with now over 8,000 funds with trillions of dollars under management. One fund, one management company has 277 different funds.

I do not know where the maximum management time begins to diminish. I am not suggesting a fund and a board. There are efficiencies that occur from multiple funds being managed by the same board. Clearly, the industry growth I think exacerbates this managerial question, and hence my belief that inclusion of the independent chair in this proposal ultimately is in the best interest of the market as it is currently constituted. I will yield to the other gentleman since this is basically a second round on my part, if you choose to make any comment.

Mr. MILLER OF NORTH CAROLINA. Mr. Chairman, I would like to take advantage of that, particularly since I did honor the red light earlier in my questioning.

I have one more question along the lines of what the chair was just asking, and also consistent with my earlier set of questions about governance. One alternative to an independent chair, and I think both of you thought there might be some circumstances in which it might be better not to have an independent chair, as we have defined "independence."

The mutual fund industry itself has suggested that their best corporate governance practices should require that there be not just a set of independent directors, all of whom are supposed to be independent, all of whom are supposed to exercise independent judgment, but that there be a lead independent director who is supposed to be the point of contact between management and the independent directors; that that be the person they consult with, and that there be focused responsibility for skepticism, for independent judgment, and that that director have the authority to place items on the agenda, to call meetings, to obtain outside advice on behalf of all the independent directors.

Do you know if that is being widely used in the industry? Has that been an effective method of assuring greater independence by the board? Is there a reason why that should not be part of what we require if we do not in fact require that the chair be independent?

Ms. SCHAPIRO. I cannot speak to the mutual fund industry. I know generally in corporate America, lead independent directors are being very widely used and I think to good success.

As I said earlier, I am confident there is no harm in requiring an independent chairman, but I am not really in a position to judge whether that is a necessity. I think it is a good idea. If there is not going to be an independent chairman, then I think at a minimum you must have a lead director who is independent.

Mr. GALVIN. I think it is an excellent idea. It is an approach. I think it comes back to having a process internally within the mutual fund that guarantees it is steering the right course. I think that is what it comes back to. It really addresses the fact that there are all these mutual funds out there, and how possibly, even with the best-armed enforcement effort, are you going to police every single aspect of it. I think you have to enshrine some sort of fiduciary duty, but having a point person in the structure of the management who would have the responsibility of making sure it is adhering to the principles of fiduciary duty I think would make a lot of sense.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

Chairman BAKER. Mr. Scott, anything further?

Mr. SCOTT. Yes. I would like to just ask one point to each of you, if you could get to a response to this. We have talked about hedge funds a little earlier. We do know an increasing number of mutual fund companies now have begun to offer hedge funds in recent years. We have found in the articles this morning and beyond that Alliance Capital's managers ran both mutual and hedge funds. How common is it for these managers to run both funds? And shouldn't there be regulations to prevent what appears to me to be an outright conflict of interest?

Ms. SCHAPIRO. We do not have authority to prohibit a mutual fund from also operating a hedge fund, since we do not regulate them directly. My view is that it is an untenable conflict of interest for a manager to operate a hedge fund and a mutual fund at the same time. It should not be permitted.

Mr. SCOTT. Do you see that that might be an area for our legislation to address, too?

Ms. SCHAPIRO. Perhaps, yes. The SEC obviously needs to look carefully at the issue, but it may well be an issue that should be addressed legislatively.

Mr. SCOTT. Thank you.

Mr. Galvin?

Mr. GALVIN. I definitely think that hedge funds need to be looked at. I think they are a potential problem. They should not be under the same tent as mutual funds. I think we have to also acknowledge their affect on the overall financial system. I think for a long time they have been kind of a stealth player in that system. I think what these mutual funds reveal, the scandals have revealed, is that they have been involved in mutual funds as well. They have been the beneficiary of some of these market-timing instances.

I think the regulation of mutual funds should be put in a pristine situation, and therefore it should not be put under the same circumstances as hedge funds. I mentioned earlier some of these other entities, financial holding companies that hold both. I think there has to be a demarcation line drawn. The whole concept of mutual funds by the way it has been sold to the investing public, is totally distinct from hedge funds, which by definition are designed for people of very high income who can sustain great risk.

Mr. SCOTT. Thank you very much, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Scott.

That is one of the elements that I outlined at the hearing on Tuesday, that we hope to have included in a manager's amendment. The slight distinction that we are contemplating is rather than prohibition against mutual funds and hedge funds being operated by the same company, just being managed by the same individual so that it would be permissible for a company to have a mutual and hedge fund operation, but to have distinctly different managers in charge of each activity. But it is one of the elements which we hope to reach consensus on, Mr. Scott, and include in some sort of amendment to the underlying H.R. H.R. 2420. I thank the gentleman.

And let me express to each of you our appreciation, not only for your appearance here today, but for your good work over the past months. We look forward to continuing to work with you in the days ahead. Thank you very much.

I will ask our participants on our second panel to come on up. Let me welcome each of you to our second panel this morning. As I am sure you are now painfully aware, we have debated at quite a length the need for additional regulation of our mutual fund industry. I look forward to your testimony. Your prepared remarks will be made part of the record. To the extent practical, attempt to limit your comment to 5 minutes, and we will certainly engage in questions at the conclusion of your testimony.

It is my pleasure to first introduce Mr. Charles Leven, Vice President, Secretary and Treasury of the American Association of Retired Persons. Welcome, Mr. Leven.

## STATEMENT OF CHARLES LEVEN, VICE PRESIDENT, SECRETARY AND TREASURER, AMERICAN ASSOCIATION OF RETIRED PERSONS

Mr. LEVEN. Thank you very much. I guess it is now good afternoon, so I will change my statement a little bit.

Chairman Baker, Ranking Member Kanjorski and members of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, my name is Charles Leven. I am a Vice President of AARP's board of directors. I appreciate this opportunity to testify on behalf of the AARP's over 35 million members on a matter of great importance to the financial security of all Americans. That is the savings that they have invested in and entrusted to the mutual fund industry.

Mutual funds control 21 percent of U.S. corporate equity, representing an estimated $19 trillion in assets. More than 95 million Americans are invested in mutual funds, representing more than half of all American households. Mutual funds are the investment of choice for millions of our members and for mid-life and older Americans in general. The consequence of lost or diminished investment savings can, and for far too many, may have been immediate, profound and lasting.

AARP supports the efforts of this subcommittee under your leadership, Chairman Baker, to improve investor awareness of mutual fund costs, and to improve the independent oversight and governance functions of fund boards of directors. The legislation you introduced and which is now pending before the House, the Mutual Fund Integrity and Transparency Act of 2003, H.R. H.R. 2420, would put into effect an overdue upgrade in investor protection for the ordinary saver-investor. These reforms were already warranted by the continuing evolution in market practices and the growth in market choices.

Real damage has already been done to the economic security and financial well-being of many Americans in or near retirement. This has been in part due to the market's natural cycles that has tracked the general economy downward over the last couple of years. But some of the damage was caused by corporate financial reporting, accounting transgressions and market manipulations. Apart from corporate reporting and accounting scandals, mounting allegations of illegal or, at best, unethical practices by mutual fund management companies, executives and brokers highlights the need for prompt remedial action.

Startling results reported just this week from an SEC survey revealed the apparent prevalence with which mutual fund companies and brokerage firms had arrangements that allowed favored customers, including themselves, to exercise after-hours trading privileges and market-timing options, as well as to participate in other abusive practices. These apparent violations of the fiduciary duty owed to investors has caused real harm, both in confidence and in lost dollars. These allegations come on top of other more recent examples of conflicts of interest in the industry.

We must do more to protect the individual investor. With regard to initiatives designed to increase fund transparency, we strongly support H.R. H.R. 2420's provisions to require, among other new obligations, that fees be disclosed using dollar-amount examples; fee disclosures be enhanced so they can encapsulate all fees, including portfolio transaction costs and the structure of compensation paid to portfolio managers and retail brokers be disclosed, to include the holdings in the funds managed; disclosure of breakpoint discounts to investors be improved; and directed revenue sharing, brokerage and soft-dollar arrangements be made to conform to the fiduciary duties to the funds and their investors.

We are increasingly concerned that lay investor confidence in the mutual fund industry not be allowed to deteriorate further, specifically in its ability to reliably provide fairly priced benefits of investment diversification and expert management. While greater transparency is essential to fair competition among funds for investors, we believe it does not provide a sufficient check on the cost of fund governance. Most funds are not established by investors, but rather are incorporated by advisory firms, who then contractually provide research, trading, money management and customer support services, and who also have some representation on the fund's board. But the advisory firms have their own corporate charters and are accountable to their own boards of directors, posing as we see a range of potential conflicts of interest in the cost of services provided to the fund.

We see these failures of mutual fund governance not simply as a lack of statutory or regulatory authority, but as a failure of compliance and enforcement. We support the provisions in H.R. H.R. 2420 designed to strengthen the role and independence of boards of directors, and further target directors's energies where potential conflicts of interest between the fund adviser and fund shareholders are greatest.

Specifically, we strongly recommend the final measures include provisions requiring that a super-majority, somewhere between two-thirds and three-fourths of fund board members, should be independent. The board chairman should be selected from among the independent members, and the independent directors be responsible for establishing and disclosing the qualification standards of independence, and for nominating and selecting all subsequent independent board members.

In summary, the importance of the mutual fund market as a critical component of the economic security of all Americans, especially older persons, should not be underestimated. We urge prompt, bipartisan passage of H.R. H.R. 2420 by the House. Full disclosure of expenses and requirements for stronger fund governance will help hold fund advisers accountable for their trading practices, which should reduce costs to investors.

We believe these changes will introduce more vigorous price competition in the mutual fund marketplace. We look forward to working with you, Chairman Baker and Ranking Member Kanjorski, and with the other members of this subcommittee, in further perfecting and working to enact this important piece of investor protection legislation.

I would be happy to take any questions you may have.

[The prepared statement of Charles Leven can be found on page 264 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Leven.

Our next witness is Dr. Eric Zitzewitz, Assistant Professor of Economics at Stanford University Graduate School of Business. Welcome, sir.

**STATEMENT OF ERIC ZITEWITZ, ASSISTANT PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY, GRADUATE SCHOOL OF BUSINESS**

Mr. ZITZEWITZ. Thank you.

Chairman Baker, Ranking Member Kanjorski, members of the subcommittee, thank you for the opportunity to discuss the issues of late trading and stale-price arbitrage, as I am going to refer to what is otherwise known as market timing in mutual funds.

My name is Eric Zitzewitz. I am an Assistant Professor of Economics at Stanford's Graduate School of Business. I am the author of three studies related to the issues being examined by the subcommittee. I have also worked with the industry on the issues of fair value pricing and estimating the extent and cost of stale-price arbitrage trading. I will draw on my research and experience, as well as the work of other academics in the course of my testimony.

Let me begin by summarizing some of the main conclusions of my research. My analysis of daily flows for a sample of funds reveals flows consistent with stale-price arbitrage in the international funds of over 90 percent of fund companies, and consistent with late trading in 30 percent. In 2001, a shareholder in the average international fund in my sample lost 1.1 percent of their assets to stale-price arbitrage trading and another .05 or five basis points of their assets to late trading. Losses are smaller, but still statistically significant in funds holding small cap equities or liquid bonds such as municipals, convertibles, and high-yields.

The source of these losses is arbitrageurs buying funds for less than their current value and selling funds for more than their current value. The source of that opportunity is the way we calculate our net asset values. We are calculating them using historical prices that in some cases are 12 to 14 hours old for international funds. We need to fix that problem. This is the source of the arbitrage problem. This is the most serious component of the market timing that people are talking about.

Dilution rates have declined since the beginning of 2003, but not to zero. Even for September 2003, after the announcement of the investigation by state and federal regulators, international fund shareholders were still diluted at an annual rate of 0.3 percent. In April 2001, the SEC sent a letter to the fund industry remind it of its obligation to use fair value pricing to eliminate stale prices, especially in their international funds. Despite this, my statistical analysis of fund net asset values reveals that in 2003, over 50 percent of fund families removed less than 10 percent of the staleness from the net asset values of their international funds. This implies that they are fair valuing extremely rarely, if at all. The average fund is removing just over 20 percent of the staleness in their net asset values.

Short-term trading fees and monitoring by the fund family alone are imperfect solutions to the problem. I find that dilution due to stale-price arbitrage is only 50 percent lower in funds with fees. This is because arbitrage can wait out the fees, because the fees cannot be applied in all channels and because the collection of fees is not always enforced. The SEC survey by Mr. Cutler reports that almost all fund families monitor for stale-price arbitrage, and yet dilution is still substantial in at least some of those funds.

One important point to make, though, is that industry averages mask substantial heterogeneity. Just under 10 percent of fund families are fair-valuing their funds, frequently enough to remove over 70 percent of the staleness. Another 10 to 15 percent are removing about 50 percent. Although almost every international fund has been diluted by stale-price arbitrage, about 75 percent of dilution is concentrated in the 25 most affected international funds. I have found that fund families with more independent directors and lower expense ratios experience less dilution, were more likely to use fair value pricing, and short-term trading fees to limit arbitrage activity.

Policymakers and regulators face two challenges. Number one, ensuring that affected investors are fairly compensated, and number two, ensuring that these and similar problems cease and do not reoccur. The first is a non-trivial issue. Simply relying on the reimbursement calculations of the affected firms may be insufficient, since affected firms will certainly be tempted to apply a narrow definition of damages, which could lead to an under-compensation of investors. Policymakers obviously may choose to provide some guidance here.

I will devote my attention for now to the second issue. I believe that a complete solution to the market-timing and late-trading issues needs to involve three components. Number one, a pricing solution. The most direct method of eliminating stale-price arbitrage is to eliminate the staleness in NAVs via fair value pricing. It is already standard practice to use fair value pricing for corporate and treasury bonds, except we do not call it fair value pricing. We call it evaluated or matrix pricing, but it is basically the same thing. Fair value needs to be extended to international and perhaps small cap equities, and evaluated bond pricing should be extended to currently excluded asset classes such as convertibles and high yields.

The SEC allows for fair value pricing, but as I noted, it has been underutilized by the industry. A cynical view might be that funds have dragged their feet on fair value to preserve the ability to allow favored customers to arbitrate their funds. This may be true in some cases, but adoption of fair value has also been limited by the vagueness of the SEC's April 2001 letter. In particular, the SEC reminds funds of their obligation to fair value after a significant event, but does not define the term. Some funds have used such a narrow definition of a "significant event," such as an earthquake or a 3 percent move in the value of international securities, that they end up fair-valuing extremely rarely. In some cases, this may be due to the perceived legal risk of fair valuing more frequently. In some cases, the perceived legal risk may be used as an excuse.

In his testimony on October 9, 2003, SEC Chairman Donaldson listed as one response to these issues, emphasizing the obligation of funds to fair value under certain circumstances. It is vital that the SEC define, perhaps not exhaustively, what these circumstances are. In order for fair value to be effective, this definition will need to be broader than it is currently.

Allowing fair value pricing to be done using an ad hoc process is dangerous, since it invites manipulation. A better approach is to use a model that updates the most recent market price for recent changes in market indicators, and I list some in the written testimony, on a security-by-security basis. The model could be calibrated using historical calculations and should be subjected to rigorous testing both before implementation and on an ongoing basis.

I should emphasize that short-term trading fees or restrictions are not substitutes for fair value pricing. The greatest danger I see in the current debate is that this will not be recognized. Fees have not been fully effective historically for the reasons I mention. Even if the investment company institutes a proposed 2 percent fee for trades within 5 days is perfectly enforced in every channel, which is far from certain, arbitrageurs could simply wait until day six to sell. A quick simulation I ran revealed that a mandatory 5-day hold, which is stronger than a 5-day trading fee, reduced arbitrage excess returns from only 48 percent to 24 percent per year, hardly enough to be a serious deterrent. Even a complete ban on selling within 90 days would only reduce arbitrage excess returns to 5 percent per year. These are still going to be attractive excess returns to hedge funds. My guess is that average investors would not appreciate such a ban. Fees may be a good idea, but they are not a substitute for eliminating stale prices.

A related danger I see in the current debate is that the SEC might allow funds to use solutions that allow them to deny arbitrage opportunities to some investors, but allow them to others. Fair value pricing removes arbitrage opportunities equally to all investors. Other solutions such as short-term trading fees, monitoring by the fund company, and allowing funds the option, and I stress option, to either delay exchanges or return gains from short-term trades, can be applied or not applied as funds see fit. The limitation of many of the current popular solutions, this limitation of them, has clearly contributed to the recent scandal.

The second component is a third-party monitoring solution. Fair value pricing addresses stale prices, price arbitrage, but there is no pricing solution for late trading. Furthermore, no fair value pricing formula will be perfect. Therefore we need to provide tools for boards, regulators and even shareholders to monitor trading activity in funds.

One possibility would be to require funds to publicly disclose daily in-flows and out-flows, perhaps with a 2-month lag to alleviate any front-running concerns. This would allow anyone, including data and advisory firms, to use the formula for my and other academic studies to estimate dilution. An alternative would be to require the disclosure of this information to regulators, boards and a limited number of third-party firms who would disclose only the most egregious cases. My guess is that either way, this idea will meet with significant resistance from some in the industry. But you should ask yourselves, is there any good reason why these disclosures should not be made?

Third, I believe part of the solution is governance. What I have to say here is not terribly unique, except to add that I support these proposals to make boards more effective.

With that, I will conclude and I welcome your questions.

[The prepared statement of Eric Zitewitz can be found on page 281 in the appendix.]

Chairman BAKER. Thank you, Doctor.

Let me start. You suggest that there should be a model developed that would accurately determine fair value pricing that could be adaptable to market conditions. Do you have from your work such a conceptual model developed? Or is that something that would have to start from scratch, that we would ask the SEC to engage in over some period of time?

Mr. ZITZEWITZ. Actually, I have helped a firm develop a model, so I should mention that in the interest of full disclosure. There is also a competing model. Those models are being used by some fund families. Those fund families I mentioned that are removing a lot of the staleness from their fair value prices, in large part that is how they are doing it. Some of them have their own proprietary models as well.

Chairman BAKER. So simply having the SEC develop a rule at our request, that would initiate utilization of modeling for the purposes of establishing fair value pricing, in your opinion, would not be premature.

Mr. ZITZEWITZ. No, I think that would be feasible. In fact, I think you might even want to go further and mandate a performance standard. You should be removing X percent where X is something like 80 or something like that, I think that would be feasible, of the staleness from your fair value prices, because I think there is a danger that you mandate the use of a model, but if you do not specify how frequently it is used, some funds will not remove the staleness.

Chairman BAKER. Sure. If there any interim definition of "significant event" that could be offered to help a more frequent updating to eliminate staleness? Or is that not worth the effort?

Mr. ZITZEWITZ. No, I think we may want to get specific here. Using an S&P basis for a definition for a significant event is imperfect, but if we were to use one, something like a 75 basis point movement in the S&P, if that were a significant event, of course there could be others like earthquakes and so forth.

Chairman BAKER. I was being a little more maybe politically creative there. If you define "significant event" as a triggering mechanism in the appropriate way, but offer as an alternative an appropriate modeling standard, the industry would probably pursue modeling with some degree of enthusiasm if the significant triggering event was drafted properly. Am I communicating?

Mr. ZITZEWITZ. I see. I understand and agree.

Chairman BAKER. Okay, great.

Mr. Leven, I appreciate the testimony given, and it is highly supportive of H.R. H.R. 2420. Contentious discussion tends to still focus on the necessity or desirability of the independent chair. You and the AARP have taken the position that the chair of the board should be selected from the independent members, and therefore support the concept of an independent chair.

Mr. LEVEN. That is correct.

Chairman BAKER. I do believe that shareholder investors in mutual funds perhaps do not understand today adequately enough the authority and influence of the chair, particularly in light of board members not being able to give the necessary attention, perhaps, to each individual fund for which they are assigned managerial responsibilities. As I indicated to the earlier panel, I am aware of one management company that has 277 separate funds. I do not know how they do the work.

Does this rise to a level of concern for AARP, where if H.R. H.R. 2420 were to be considered and a manager's amendment were to be constructed, that the AARP would contact membership relative to the importance of the adoption of that amendment?

Mr. LEVEN. Obviously, I cannot speak for the total board. Certainly, I will take it back to the board and to our executive committee for their point of view. I suspect strongly that I would support that. Whether the board will remains to be seen, of course.

Chairman BAKER. You have an independent board, I take it. That is a joke. I am just kidding.

[Laughter.]

Mr. LEVEN. Oh, very independent. I am the chair of the audit committee, which is even more independent. I would suggest to you that an independent chairman obviously is not going to be an expert in all areas of what he is going to do. What he is going to do is what any intelligent person would do. You would either call in experts from outside or hire experts from outside. An independent board clearly has full authority to do that.

Chairman BAKER. Removing one's own personal financial interests from the considerations you make is a key principle of independence, I think, and in making sure that you are not disenfranchising the interests of one set of shareholders to enrich another. That point has not been sufficiently made, apparently, in the course of our debate, but any help we can get from any interested party is certainly appreciated.

Mr. LEVEN. We do support it. We will do our best to examine it and see whether appropriate support is required or necessary as we go forward.

Chairman BAKER. Let me read through the list that is being contemplated now for additions to H.R. H.R. 2420, and ask either of you to make comment about any one or group of the recommendations: reinstatement of the independent chair you have already commented on; require that all funds not only have a chief compliance officer, which is required by the bill, but that the compliance officer report only to the independent chair and the other board members; further refine the definition of "independent" so it precludes individuals with relationships with the management that would compromise their independence, for example a family member of the manager.

Disclose the compensation of fund executives and portfolio managers, as they are disclosed for public operating companies, not to set a new standard, but simply extend the standard now required for public operating companies to the mutual fund managing company; disclose all purchases, sales and aggregate holdings of fund shares and portfolio securities of management and directors, as they are disclosed for public operating companies in specific section 16 reports under the 1934 Act; disclose on the fund Web site fund codes of ethics and reported violations of the code of ethics; prohibit short-term trading by portfolio managers and fund executives for their own account.

Prohibit joint portfolio management of mutual funds and hedge funds by the same manager, not necessarily the same fund company; increase enforcement penalties applied to mutual fund violators; allow funds to choose whether they are going to permit market timing, but make the policy determination defined as "fundamental," which means they will have to then make the policy clearly disclosable in the prospectus and unchangeable without shareholder consent; require the board of directors to certify the valuation procedures; permit funds to charge more than the current limit of 2 percent for short-term redemptions, but not mandate statutorily such a charge. This gives the funds the choice to permit investors to decide whether they wish to invest in a fund that is going to have a more restrictive short-term trading limit or not. And finally, a strengthening of the fiduciary duty that directors have to fund shareholders.

Anything we are missing? That is on top of H.R. H.R. 2420.

Mr. LEVEN. I did not hear independent audits, but I am sure it is in there.

Chairman BAKER. If it is not, we will make sure that that is on the list.

Any comment, doctor?

Mr. ZITZEWITZ. I already mentioned a couple of things that I might add to that, right? I think disclosure of daily flow data could be very valuable and I think you could allay any concerns about front-running with a delay and that disclosure. I think absent that, investors have no way of knowing whether their fund is being diluted. The range in which their funds have been diluted in the past, at least, it is bigger than the expense ratio range. So we spend all this effort educating them on expense ratios, and they have no way of knowing whether their fund is being diluted or not. I think that is something important to fix.

Then we also talked about perhaps needing to go a bit further in terms of requiring fair value pricing.

Chairman BAKER. Yes. Although it was not on the pre-printed list, the fair value pricing is certainly something that rises to our attention.

I want to express my appreciation to both of you for your patience in waiting through the long hearing today. Your recommendations are certainly important to the committee's work, and we look forward to working from this point forward into what we hope will be a prompt, but more importantly, an appropriate review and final passage of legislation to assure shareholders that they are being fairly and equitably treated, all appropriate disclosures are made, and that all the rules apply equally to all participants.

I thank you very much. If you have no further comments, our meeting stands adjourned. Thank you.

[Whereupon, at 12:50 p.m., the subcommittee was adjourned.]

# APPENDIX

November 4, 2003

**Opening Statement**

# Chairman Michael G. Oxley

## Financial Services Committee

**Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises**

**"Mutual Funds: Who's Looking Out For Investors?"**

**November 4, 2003**

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Thank you, Chairman Baker, for holding this timely hearing.

It is often said that we have become – in the past two decades – a nation of investors. While unquestionably true, I believe that it would be more precise to say that we are now a nation of *mutual fund* investors. By an overwhelming margin, these pooled investment products have become the preferred way for ninety-five million Americans to access the stock markets.

So, we had better make sure these investors are protected.

It appears that we are now in the early innings of what already is the biggest scandal in the history of the 80-year-old mutual fund industry. We don't know everything yet, but what we do know is deeply troubling. Many commentators, some from industry itself, have called the revelations shocking. Large institutional investors have been given preferential treatment, to the detriment of individual investors and in violation of law and the funds' own stated policies. According to the firms themselves, some fund managers and executives have essentially been stealing from their own customers. At one large fund company, portfolio managers found to be market timing their own funds as far back as 1998 were not terminated, in fact not even disciplined, until a September subpoena brought this information to the public's attention.

Perhaps the most troubling aspect of all this illegal conduct is that it appears to be so widespread. We cannot say that a few bad apples have violated the fiduciary duty owed to shareholders. We cannot say that only a handful of mutual fund firms have mistreated their customers, the mom and pop investors who are supposed to be the industry's "bread and butter." And we cannot pretend that all of the fund companies were unaware of this conduct.

This Committee was concerned about mutual fund investor protection issues long before these recent revelations. It has been my view, and certainly one shared by Congressman Baker and other members, that a review of fund regulation and industry practices was inevitable given the Committee's work over the past few years. We have examined almost every other segment of the securities industry, including Wall Street's analyst conflicts and IPO allocation abuses, the accounting profession, corporate boards, the stock exchanges, credit rating agencies, and hedge funds.

In this post-Sarbanes-Oxley world, the investing public demands full disclosure of all relevant information---and rightfully so.

The Committee's year-long review of mutual funds makes clear that more transparency is needed with respect to fund fees, costs, expenses, and operations. There should be more useful disclosures regarding fund distribution arrangements so that investors are aware of any financial incentives that may influence the advice they receive. There should be stronger leadership by fund directors. And clearly, fund investors deserve better oversight of the industry by the SEC.

Congressman Baker's legislation, which passed this Committee by voice vote in July, addresses these issues in a responsible and measured way. In light of the recent scandals, I think few would disagree that it would be appropriate to consider strengthening the bill.

I yield back.

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MICHAEL N. CASTLE
DELAWARE, AT-LARGE

COMMITTEES:
FINANCIAL SERVICES
EDUCATION AND THE WORKFORCE
CHAIRMAN,
SUBCOMMITTEE ON EDUCATION REFORM

**Congress of the United States**
**House of Representatives**
**Washington, DC 20515–0801**

1233 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, DC 20515–0801
(202) 225–4165

DISTRICT OFFICES

201 N. WALNUT STREET
SUITE 107
WILMINGTON, DE 19801–3970
(302) 428–1902

300 S. NEW STREET
SUITE 2005
DOVER, DE 19904
(302) 736–1666 (KENT)
(302) 856–3334 (SUSSEX)

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***Statement of Congressman Michael N. Castle***

***Capital Markets Subcommittee Hearing on***
***"Mutual Funds: Who's Looking Out for Investors?"***

***November 4, 2003***

Thank you Chairman Baker and Ranking Member Kanjorski for holding this hearing before the Capital Markets Subcommittee today. These hearings are essential and the industry must take note of the concerns that are being raised. Behavior will change but we must put the tools in place to ensure this will not happen again five to ten years from now. I hope each one of us remembers what we are saying here today and the importance of addressing this issue. When we begin to formulate regulations and legislation, we must approach it with the same vigor we are addressing this issue with today and not let it get watered down in politics. Protecting investors is our end goal, but we must fully evaluate this situation to ensure we make the proper changes the first time, we can not afford to be wrong.

The average American family choose to invest in mutual funds. Two decades ago, only 6 percent of American households had mutual fund shares valued at $134 billion. Today, half of all American families have $7 trillion at stake, more than a 500 percent increase in the last twenty years. Mutual funds represent about 10 percent of the total financial assets of the U.S. population. The number of funds have grown from less than 500 mutual funds in 1980 to approximately 8,000 mutual funds today.

This committee, and specifically Chairman Baker, has shown leadership in reforming mutual funds and addressing abuses. In July, the Financial Services Committee approved H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act," which seeks to improve transparency for investors and strengthen funds' corporate governance standards. This is a good start, but obviously more remains to be done.

In evaluating and improving the mutual fund industry a number of key issues must be addressed, in short order, to protect the small investor. Issues that must be scrutinized include late trading, market timing, as well as oversight and regulation. Favoritism to big investors and violating ethical and legal codes rob the average investor who depends on their investments for costs such as education and retirement.

First, late trading is not only an improper advantage for large fund investors, it is illegal. Late trading has allowed some big fund investors to take advantage of the current day's price on orders to buy or sell shares placed after the close of the New York markets, when proper procedure would be to carry out the orders at the following day's price. Some have likened this practice to "'betting today on yesterday's horse race' -- knowing ahead of time what the outcome would be." I understand the Securities and Exchange Commission (SEC) is reviewing a proposal to require that funds, not brokers, receive orders by the close of the market. This would be a good first step in addressing this problem and we must have accountability in our mutual funds.

Second, market timing, which involves short-term trading of mutual fund shares and exploits the time differential between foreign and U.S. markets. Although this practice is not inherently illegal, nearly all mutual funds ban it in their prospectuses. Fund directors are required to represent the interests of their shareholders, and only their interests. In reality, as the recent scandals have demonstrated, fund directors are not fulfilling their fiduciary duties to their shareholders. Funds should have more independent directors, fund management must not be spread too thin, to ensure proper oversight. If a mutual fund prospectus states a fund will not participate in market timing and then the fund proceeds to do so, that policy is not only disingenuous but it should be fraudulent. This level of investor fraud can not be accepted and the SEC must eliminate future abuses.

Finally, it concerns me that these practices may be the tip of the iceberg and have been camouflaged by the bull market. Mutual funds are a $7 trillion industry and with more than 50% of the American public invested in mutual funds there is the potential for investors to be hurt more so by these recent revelations than even the World Com and Enron scandals. I am not downplaying the problems that were in play there but I feel this issue is further reaching and could impact a greater number of investors in the long run. Some in the industry have stated market timing was an open practice, furthermore, some funds have even stated they participated in market timing on a limited level with clients to allow controversial trading as a way to control the improper practice. This bothers me.

I look forward to hearing from Mr. Spitzer and Mr. Cutler as well as all of our panelist today. There are a number of questions I hope we will be able to address in this hearing, specifically:

-Why has the SEC not been in the forefront of stopping abuses in the securities market;
-How long have these illegal practices been occuring and why have we not stopped them before now;
-Would a higher redemption fee help address market timing;
-Are mutual funds engaging in false marketing by allowing market timing practices when their prospectus ban it;
-What are the steps we must take to correct this problem?

Statement of the Honorable Rahm Emanuel
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises
November 4, 2003

*"Mutual Funds: Who's Looking Out For Investors?"*

- Mr. Chairman, thank you for holding this important hearing. I appreciate that our witnesses, including New York Attorney General Eliot Spitzer, SEC Enforcement Director Stephen Cutler, and former SEC Chairman Arthur Levitt, have taken the time to be here today.

- It's important to emphasize that by and large, mutual funds remain a safe and good place for middle class investors to put their money. There are many highly skilled, honest fund managers who put their clients' interests first every time.

- But for too long, some mutual funds have pursued a "Heads I Win, Tails You Lose" strategy, favoring a few top clients and lining their own pockets at the expense of millions of "mom and pop" investors.

- If this scandal isn't an argument against privatizing Social Security, I don't know what is. These scandals have shown it's not worth exposing our seniors' Social Security benefits to the risk of misconduct or mismanagement. Dozens of pension funds have pulled their money out of mutual funds to protect their retirees, and it would be wrong to subject social security benefits to the vagaries of the capital markets.

- The problems with mutual funds have become systemic and endemic. As a result, the mutual fund industry has forfeited the right to self-regulation. We need legislation and SEC rule-making to clean up the system and restore the core principle of making investors the highest priority.

- These abuses go to the heart of mutual funds' fiduciary duties. Unlike in the instance of the corporate scandals that led to Sarbanes-Oxley, *in these cases*, some mutual funds have literally stolen directly from the pockets of middle class investors.

- In too many fund companies, managers have violated their most important fiduciary duties. Basic principles of honesty and fair dealing have been replaced by a "Managers Win, Investors Lose" mentality.

- 50% of all U.S. households invest in mutual funds---families saving for college tuition and retirement, students opening their first investment accounts, senior citizens relying on income to provide for their living needs. For the $90 billon in fees and overhead that middle class mutual fund investors pay every year, they certainly deserve better.

- Our number one priority is to restore the highest standards of integrity to this industry—the core principles that are part of every statute, every prospectus and every piece of marketing material these firms send out.

- Because the industry has shown it's incapable of effectively policing itself, Congress needs to pass tough new rules to eliminate abuses and to protect investors. These remedies must address corporate governance, trading, and disclosure of information issues.

- I look forward to working with the SEC and with my colleagues in Congress to pass legislation that will ensure mutual funds protect the interests of investors and shareholders, not those of company insiders and "special" clients.

*Thank you, Mr. Chairman. I yield back.*

November 4, 2003

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Hearing entitled, "Mutual Funds: Who's Looking Out for Investors?"

Thank you, Mr. Chairman, for calling this important hearing and for your continued leadership on this issue. I am pleased to have joined our Chairman as an original cosponsor of his overall mutual funds reform legislation, the Mutual Funds Integrity and Fee Transparency Act (HR 2420) considered and approved by this Committee last July.

Little did we know last summer, that we would be revisiting this topic in Committee hearings this week made necessary by recent revelations of widespread improper trading arrangements, late trading, and market timing trading practices across the mutual funds industry.

Over the past two decades, the percentage of households in the United States invested in the stock market has grown from 32.5 to 49.5 percent, according to a survey published by the Investment Company Institute and the Securities Industry Association. In Ohio alone, there are 3,916,000 shareholders with $295.4 billion invested. Many of these Americans and families in the Fifth District of Ohio, which I am privileged to represent, are invested through mutual funds and often they depend on the safety of their funds to enjoy a secure retirement. The revelation of abuses within the mutual fund industry affects average Americans across our nation and clearly calls into question the effectiveness of its current regulatory structure.

I look forward to our witness' testimony today and Thursday as we explore the details of recent trading abuses and discuss how such activities continued without immediate scrutiny by the Securities and Exchange Commission (SEC), let alone the fund managers who are directly tasked with protecting the interests of mutual fund investors.

Thank you again, Mr. Chairman, for providing us with this opportunity to address these remaining issues and I look forward to an informative session.

**OPENING REMARKS OF THE HONORABLE RUBÉN HINOJOSA**
**HOUSE FINANCIAL SERVICES COMMITTEE**
**SUBCOMMITTEE ON CAPITAL MARKETS**
**"MUTUAL FUNDS: WHO'S LOOKING OUT FOR INVESTORS?"**
**NOVEMBER 4, 2003**

Chairman Baker and Ranking Member Kanjorski,

I want to thank you for holding this third hearing on mutual funds this year, and for the additional hearing the Subcommittee will hold this Thursday on the same subject.

Mr. Chairman, I believe that this is going to be a very interesting hearing based on all the news reports I have read on the developments in the mutual fund industry, the SEC's involvement and the role New York State Attorney General Elliott Spitzer has played in the investigations of malfeasance at certain mutual funds.

I was very alarmed to read in yesterday's Congress Daily PM that Senate Governmental Affairs Chairwoman Susan Collins stated yesterday at a hearing before her Committee that "clearly, much more must be done to protect mutual fund investors, whether it is through legislation, tougher enforcement actions, new and stronger regulations, or all three."

Governmental Affairs Financial Management Subcommittee Chairman Peter Fitzgerald, R-Ill., inferred at that same hearing that federal law not only allows but "codifies" an "incestuous relationship" between mutual fund boards of directors and their investment advisers and managers.

If they are correct, then the mutual fund industry is in dire need of reform. However, what I would truly like to learn today is if this series of events in the mutual fund industry is merely limited to particular funds or if these recent scandals represent a more serious, systemic problem within the mutual fund industry that might require Congress to enact legislation to correct the situation. Many believe that adequate laws and regulations exist to police late trading and market timing issues raised in the suits against the mutual funds in question. I am not certain that I want the current allegations of abuse to cause an overreaction of legislation or regulations to sweep-up legal late processing with the illegal allegations.

Like most of my colleagues here behind the dais, I would like to learn more about market timing and late trading. I look forward to the witnesses' testimony and to their views on whether adequate laws and regulations exist to police late trading and market timing issues.

For these reasons and more, this hearing is both timely and helpful

Thank you Mr. Chairman and Ranking Member Kanjorski.

I yield back the balance of my time.

# Opening Statement
## Rep. Ed Royce (CA-40)
## "Mutual Funds: Who's Looking Out for Investors?"
## 4 November 2003

Chairman Baker, thank you for holding this timely hearing on oversight of the mutual fund industry. I would also like to thank our distinguished witnesses for appearing today -- and I look forward to their testimony.

Since this summer, officials from New York, Massachusetts, and the SEC have unearthed a number of alarming "market timing" activities within the fund industry. I encourage investigators and prosecutors to vigorously pursue those who have betrayed investors. I also sincerely believe we should use these revelations as an opportunity to improve the fund industry going forward. I hope all parties involved will work together in a way that punishes the wrongdoers, corrects inadequacies in regulations, and results in a better climate for America's investing public.

To this end, I am encouraged to see that there are a number of proposals being put forward by both interested and disinterested parties. In particular, I am pleased to see that both the SEC and the Investment Company Institute ("ICI") are looking at specific actions that can be taken such as (1) requiring all trading orders to be received by 4:00; (2) devising a mandatory redemption fee for "IN and OUT" investors; (3) exploring fair-value pricing mechanisms; and (4) improving compliance procedures at fund companies. In my view, the largest burden must fall on the fund industry itself to create better, more effective compliance policies.

Once again, I thank Chairman Baker for having this hearing today. It is of great importance that this committee remains vigilant in ensuring that the investor marketplace is fair and transparent. I look forward to working with my colleagues on this issue. I yield back.

Testimony of Mercer E. Bullard

President and Founder

Fund Democracy, Inc.

and

Assistant Professor of Law

University of Mississippi School of Law

before the

Subcommittee on Capital Markets, Insurance,

and Government Sponsored Enterprises

Committee on Financial Services

United States House of Representatives

November 4, 2003

Chairman Baker, Ranking Member Kanjorski, members of the Subcommittee, thank you for the opportunity to appear before you today to discuss alleged trading abuses in the mutual fund industry and actions needed to mitigate such practices in the future. It is an honor and a privilege to appear before the Subcommittee today.

I am the Founder and President of Fund Democracy, a nonprofit advocacy group for mutual fund shareholders, and an Assistant Professor of Law at the University of Mississippi School of Law. I founded Fund Democracy in January 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments. Toward this end, Fund Democracy has filed petitions for hearings, submitted comment letters on rulemaking proposals, testified on legislation, published articles on regulatory issues, educated the financial press, and created and maintained an Internet web site.

Before addressing the topic of today's hearing, I would like to express my appreciation for Chairman Baker's and Chairman Oxley's leadership on the issue of mutual fund reform. The last two months of revelations regarding significant problems in mutual compliance have made regulatory reform the issue *de jour*, but you provided critical leadership before these latest allegations surfaced, and in doing so gave us, in the form of H.R. 2420, a strong foundation on which to build. You deserve the thanks of America's 95 million mutual fund investors for your leadership during this crisis. I look forward to working with you to restore Americans' faith in the mutual fund industry.

## I. Introduction

Last June, I introduced my testimony before this subcommittee with the following statements:

> More than 95 million Americans are shareholders of mutual funds, making mutual funds America's investment vehicle of choice. These shareholders have made the right decision. For the overwhelming majority of Americans, mutual funds offer the best available investment alternative.[1]

More than 95 million Americans still own mutual funds today, but they are no longer certain that they made the right decision, or that mutual funds offer the best available investment alternative.

Recent allegations of fraud have fundamentally altered Americans' perception of mutual funds. These allegations do not involve isolated instances of individual wrongdoing by low-level employees – the proverbially "few bad apples." These allegations appear to involve the majority of mutual fund complexes, and wrongdoing by a large number of employees, including, in some cases, the executives at the highest levels of management.

The usual ways in which we respond to such crises do not apply here. When frauds occur that could not reasonably have been anticipated, perhaps because of some previously unidentified legal loopholes, we can close the loopholes and forgive the stewards of the industry. Structural reform generally is not needed.

The alleged frauds in this case, however, were open and notorious and violated express legal requirements. Fund stewards were on notice and failed to take action. There are no significant legal loopholes to close or grounds to excuse a fundamental

[1] Testimony of Mercer Bullard, Fund Democracy, Inc., before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, at p. 2 (June 18, 2003) at http://financialservices.house.gov/media/pdf/061803mb.pdf.

failure of compliance. These systemic frauds have exposed a compliance system that is not working and is in dire need of structural reform.

In this testimony, I have described the recently alleged frauds – stale pricing, late trading, market timing, and commission overcharges – in Section II. Section III discusses the systemic nature of these frauds and explains why structural reform in the way mutual funds are regulated is necessary. Section IV describes specific actions that I believe are necessary to protect investors and restore Americans' confidence in the mutual fund industry. Section V discusses certain proposals made by the fund industry.

## II. Description of the Alleged Frauds

### A. Stale pricing

Stale pricing refers to the practice of pricing a fund's shares based on prices of portfolio securities that no longer reflect their market value. For example, consider a Hong Kong fund that holds securities traded on the Hong Kong Exchange. The Exchange closes at 3:00 am EST, but the fund prices its portfolio securities at 4:00 pm EST, at the close of the U.S. markets. If the fund manager prices the fund using closing prices on the Hong Kong Exchange, and nothing has affected the value of the securities during the 13 hours since the Exchange closed, then the fund's price reflects current market value. If events have occurred that affect the value of those securities, however, then the price will not reflect current market value.[2]

[2] Stale pricing also can occur in domestic funds that hold illiquid or infrequently-traded securities whose most recent trading price may be hours or days old.

A number of academic studies have shown that such events often occur after the close of foreign exchanges, and that the effect of these events is very predictable.[3] The effect is so predictable, in fact, that professional and retail investors alike routinely purchase shares of foreign funds in the knowledge that the funds are undervalued and that their share prices will rise the next day when the higher value of the securities is reflected in closing prices on foreign exchanges.[4]

This is precisely what occurred, for example, in October 1997, when a sharp drop in Asian markets was followed by a rebound in the U.S. market. According to the Securities and Exchange Commission ("SEC"), "fairly large numbers of investors attempted . . . to take advantage [of stale prices] which promised potential gains in double digits."[5] The SEC has not disclosed the results of its investigation of the effect of stale pricing on this occasion, but Fund Democracy has estimated, applying the methodology used by the SEC, that some funds lost in excess of 2% of net assets.[6] This means that a

[3] See, e.g., Conrad Ciccotello, Roger Edelen, Jason Greene & Charles Hodges, Trading at Stale Prices with Modern Technology: Policy Options for Mutual Funds in the Internet Age, 7 Va. J.L. & Tech. 6 (Fall 2002); Jacob Boudoukh, Matthew Richardson, Marti Subrahmanyam & Robert Whitelaw, Stale Prices and Strategies for Trading Mutual Funds, 58 Financial Analysts Journal (July/August 2002) at http://www.aimrpubs.org/faj/issues/v58n4/full/f0580053a.html; Eric Zitzewitz, Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds (October 2002) at http://faculty-gsb.stanford.edu/zitzewitz/Research/arbitrage1002.pdf; and William Goetzmann, Zoran Ivkovich & Geert Rouwenhorst, Day Trading International Mutual Funds (October 2000) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=217168.

[4] Although prices that are too high can also be exploited by selling fund shares and then buying them back the next day, this is less frequent because traders typically prefer to have cash available to exploit trading opportunities as they arise, and therefore prefer not to have cash tied up in a single fund that can be used to exploit trading opportunities only in that fund.

[5] Address by Barry Barbash, Director, Division of Investment Management, Securities and Exchange Commission, before the ICI Securities Law Procedures Conference, Washington, D.C. (Dec. 4, 1997).

[6] Mercer Bullard, Your International Fund May Have the Arbs Welcome Sign Out, TheStreet.com (June 10, 2000); see also Mercer Bullard, International Funds Still Sitting Ducks for Arbs, TheStreet.com (July 1, 2000).

shareholder with a $100,000 account would have lost more than $2,000 to traders ***in a single day***.

Stale pricing is a violation of the Investment Company Act. The Act expressly requires that when market quotations are not readily available, funds' portfolio securities must be fair valued "in good faith by the board of directors."[7] Market quotations are not readily available, for example, when events occurring after the close of a foreign exchange have affected the value of the securities.[8] In that event, funds must update the value of the affected securities. Some fund firms routinely update their portfolio securities' prices, but as evidenced by the pervasive exploiting of stale prices uncovered by recent investigations, many do not.

**B. Late Trading**

Late trading refers to purchase and sales that occur after the fund has been priced, which is typically at 4:00 pm EST. It is similar in effect to exploiting stale prices. After a fund has been priced, that price may quickly become stale as events occur that affect the value of the fund's portfolio. For example, companies often announce their quarterly results after the close of the U.S. markets at 4:00 pm EST. If the announcements are positive and they involve companies held in a fund's portfolio, the 4:00 pm EST price will then be lower than the actual value of the portfolio after the announcements are made.

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[7] Investment Company Act Section 2(a)(41)(B); see Investment Company Rule 2a-4(a)(1).

[8] See Investment Company Institute, SEC No-Action Letter (Apr. 30, 2001) ("If the fund determines that a significant event has occurred since the closing of the foreign exchange or market, but before the fund's NAV calculation, then the closing price for that security would not be considered a 'readily available' market quotation, and the fund must value the security pursuant to a fair value pricing methodology.").

The Investment Company Act prevents traders from exploiting post-4:00 pm EST information by requiring that all purchases of fund shares be executed at their next calculated net asset value.[9] An order received by a fund at 3:59 must receive that day's 4:00 price. An order received by a fund at 4:01 must receive the next day's price.

The SEC has permitted orders to be received after 4:00 pm EST in certain situations. As a practical matter, brokers, pension administrators and other intermediaries often receive orders before 4:00 pm EST but are unable to transmit the orders to the fund until after 4:00 pm EST. In these cases, the fund receives the order after legal deadline.[10] Of course, the SEC has permitted such "backward pricing" on the condition that orders received by the fund after 4:00 were received by the intermediary before that time.[11]

Further, the SEC position assumes that orders received before 4:00 cannot be cancelled after 4:00. Otherwise, a trader could exploit positive information released after 4:00 by placing an order every day and then canceling the order each day that there was no post-4:00 information affecting the value of the portfolio or the post-4:00 information was negative.

Recent investigations have found that traders, in direct contravention of existing rules and SEC positions, have routinely submitted orders and/or cancelled fund orders after the time the fund was priced.

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[9] Investment Company Act Rule 22c-1.

[10] According to a complaint filed by the New York Attorney General, some funds have given the same day price to orders received as late as 9:00 pm EST, State of New York v. Canary Capital Partners, LLC (Sep. 3, 2003), and some press reports suggest that some funds do so for orders received in the early morning hours.

[11] Charles Schwab & Co., Inc., SEC No-Action Letter (July 7, 1997).

**C. Market Timing.**

Market timing is a term of art that, with respect to mutual funds, refers to frequent purchases and redemptions based on the trader's views about the relative short term performance of certain market sectors, asset classes or other broad categories of investments.[12] For example, there are market timing newsletters that make recommendations regarding which categories are expected to outperform in the short-term, and there are mutual fund families that cater specifically to market timers.[13]

Traders who exploit stale prices and engage in late trading also are market timers, but there is no necessary connection between market timing and the two frauds. Such traders are market timers, that is, frequent traders, because trading in and out of the fund promises them the greatest profit for the least risk. Their goal is to remain invested in a fund only as long as necessary to collect their risk-free profits and to minimize their exposure to fluctuations in the value of a fund's portfolio.

Permitting market timing is, by itself, legal. Permitting market timing in contravention of a fund's stated trading policies, however, violates the federal securities laws. Some fund prospectuses state, for example, that the fund does not permit frequent trading in fund shares.[14] The purpose of these policies is to hold down fund costs; they

[12] Recent news reports have used the term "market timing" to describe frequent trading conducted for the purpose of exploiting stale prices. This use of the term is inaccurate and risks confusing and thereby improperly limiting the ultimate responsibility of fund managers for using stale prices. For example, some fund managers have stated that they intend to compensate funds for any harm resulting from "market timing" but have said nothing about compensating funds for dilution resulting from stale pricing. See, e.g., Letter from Richard M. DeMartini to Nations Fund Shareholders (Sep. 19, 2003) (promising restitution for harm caused by "discretionary market-timing agreements") at http://www.bankofamerica.com/nationsfunds/pdf/press_release.20030919.pdf.

[13] Two examples are the ProFunds and Rydex fund complexes.

[14] See, e.g., Prospectus for the Vanguard U.S. Stock Index Funds at 52 (July 3, 2003) (limiting round trips to two per 12-month period and requiring 30 days between round trips).

are not required by law. Market timers can increase fund costs because a fund must spend more on processing transactions in fund shares and investing fund assets. Market timing also can adversely affect a fund's investment performance by disrupting the management of its portfolio. Another benefit of market timing restrictions is that they limit the ability of traders to exploit stale prices or engage in late trading, although the best protection against these frauds is, of course, to accurately price the fund and to reject trades that were placed after the fund was priced.

Recent allegations have revealed that many fund complexes, perhaps even a majority, have permitted market timing and have even entered into market timing arrangements with selected traders. These arrangements can violate the securities and general antifraud laws to the extent that they are not consistent with the fund's stated policies. They also can be illegal if the special treatment afforded to the traders violates the fund manager's or another participant's fiduciary duty to the fund.[15]

### D. Commission Overcharges

Another fraud that was uncovered prior to the current mutual fund scandal is the systematic withholding of discounts on commissions from qualified investors. Mutual funds frequently offer discounts on sales commissions that are based on volume, which are known as "breakpoints." For example, a $10,000 purchase might incur a full 4% sales commission, whereas a $100,000 purchase might be charged only 2%. A $1,000,000 purchase typically would not be charged any commission.

[15] There is not, however, a general duty to treat all shareholders equally. Fund shareholders are routinely treated differently based on, for example, the size of their accounts, the size of their initial investments, and, as indicated by market timing policies, the frequency of their trading.

Funds often permit purchases by different accounts, by different family members, and in different funds in the same fund complex to be aggregated for purposes of calculating the breakpoint. Some funds also permit purchases made over time to be aggregated for breakpoint purposes. Other, more complex circumstances in which shareholders are entitled to breakpoints are summarized in a joint SEC/NASD/NYSE report released earlier this year.[16] The calculation of breakpoints can thus require fairly complex monitoring systems in order to ensure that investors actually receive the breakpoints to which they are entitled.

Between November 2002 and January 2003, the SEC, NYSE and NASD conducted a joint inspection of 43 broker-dealers to determine whether shareholders had received the breakpoints to which they were entitled. The regulators found that shareholders were systematically overcharged by the broker-dealers. They found that shareholders were overcharged with respect to 32% of transactions that were eligible for discounts. Of the 43 firms, only two were found not to have overcharged any shareholders. Three broker-dealers were found to have overcharged shareholders in every single instance in which discounts should have been applied. The average amount by which shareholders were overcharged was $364.

## III. A Systemic Compliance Failure

The frauds described in the immediately preceding section represent a systemic compliance failure in the fund industry. Each of these frauds reflects a failure to ensure that there are compliance procedures in place that are reasonably designed to protect

[16] Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds (March 2003) at http://www.sec.gov/news/studies/breakpointrep.htm.

shareholders, and that steps are taken to ensure that the procedures are working. None of these frauds is surprising in the sense that the fraud reflects an unknown vulnerability in the operation or regulation of mutual funds. Each of these frauds was predictable and could and should have been prevented simply by enforcing minimal compliance standards.

**A. Stale Pricing**

The use of stale prices is so widely known that many retail investors routinely exploit international and other funds by buying shares after upswings in U.S. markets. In one case, 28 members of the Boilermakers Local Lodge No. 5 of New York each executed 150 to 500 trades in Putnam funds over a three-year period.[17] They realized profits ranging from $100,000 to $1,000,000 by exploiting stale prices. These profits came directly out of the pockets of the other 916 members of their union who were invested in the funds and other fund shareholders.

The opportunities offered by stale prices have been discussed in Internet bulletin boards and personal finance magazines.[18] A stream of academic studies have demonstrated that U.S. mutual funds lose hundreds of millions, if not billions, of dollars each year as a result of stale prices.[19] In 2000, I published two articles describing the

[17] In the Matter of Putnam Investment Management, LLC, Docket No. E-2003-061. The ICI has stated that "knowing when and how to fair value foreign securities in these types of circumstances is not an exact science, as there is no way to know for sure at what price those securities would be traded as of 4:00 p.m. Eastern time." Mutual Funds: Trading Practices and Abuses That Harm Investors, Testimony of Matthew Fink, President, Investment Company Institute, before the Subcommittee on Financial Management, the Budget, and International Security, Committee on Governmental Affairs, U.S. Senate at p. 11 (Nov. 3, 2003). This statement is belied by the frequency with which professional and retail investors alike have successfully exploited stale prices, apparently in the belief that they could, in fact, "know for sure" the true value of a fund's securities at 4:00.

[18] See, e.g., Jill Andresky Fraser, Short Term, Long Enough, Bloomberg Personal Finance at 95 (Sep. 2000) (describing how to exploit stale prices).

[19] See supra note 3.

stale pricing problem in which I estimated that stale prices could cost a fund in excess of 2% of its assets in a single day.[20] In 1997, the SEC examined a number of funds that had used stale prices and found that "fairly large numbers of investors attempted . . . to take advantage [of stale prices] which promised potential gains in double digits."[21]

The problem of stale pricing has been successfully addressed by some fund firms. Vanguard, Fidelity and other fund complexes regularly fair value their portfolios when events occurring after the close of foreign markets affect the accuracy of closing prices on foreign exchanges. For some years, independent pricing firms have offered services to funds that enable them to update their prices to reflect such events. The SEC staff has on two occasions described the tools that funds can use to ensure that their portfolios are accurately valued.[22]

Despite the fact that the problem of stale pricing has been widely recognized and, by some fund complexes, successfully addressed, it is clear based on recent revelations that traders have routinely exploited stale prices to the detriment of shareholders of a large number of funds. These funds' managers have been aware that their funds' prices were stale, as further evidenced by aggressive market timing by some fund shareholders. In some cases, fund management allegedly colluded with traders to take advantage of stale prices and even loaned traders the money they used to cheat the fund's shareholders. In at least one case, the portfolio managers themselves alleged exploited stale prices of

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[20] See supra note 6.

[21] Barbash, supra note 5.

[22] Investment Company Institute, SEC No-Action Letters (Dec. 8, 1999 & Apr. 30, 2001).

the very funds that they managed.[23] In another case, the chief executive officer of the fund manager allegedly exploited the stale prices of funds of which he was the chairman.[24]

Further, these funds' directors failed to satisfy minimum standards of compliance oversight. These directors should, at a minimum, have regularly reviewed funds' pricing policies to ensure that they were designed to prevent stale pricing and required periodic spot checks to determine whether the procedures were working. These spot checks would include, for example, comparing prices of the complex's international funds to prices of similar funds in other complexes or prices calculated by outside pricing services, and monitoring fund inflows and outflows to determine whether market timers were exploiting stale prices. Although fund directors cannot reasonably be expected to detect individual instances of fraud, their primary responsibility is to detect and prevent the kind of widespread abuses uncovered in recent investigations.

**B. Late Trading.**

The potential problems of late trading were even more obvious than stale pricing. For years, funds have routinely received orders after 4:00 pm EST. There is no basis for claiming, nor have any fund managers attempted to claim, that they were unaware that orders were received after 4:00 pm EST. Fund managers expressly authorized this practice.

In view of fund managers' and directors uncontradicted knowledge of the receipt of orders after 4:00 pm EST, it was incumbent upon them to ensure that there were

[23] See supra note 17.

[24] Tom Lauricella, Probe Hits Strong's Chairman: Investigators Say Firm's Founder Engaged in Improper Trading, Wall Street Journal (Oct. 30, 2003).

procedures in place that were reasonably designed to detect and prevent orders from being placed or cancelled after 4:00 and to take steps to ensure that these procedures were working. It is self-evident that, given the opportunity, some traders will attempt to take advantage of opportunities to profit from late trading (as evidenced by ongoing investigations).

Some fund executives have suggested that protecting fund shareholders against late traders is not the fund manager's or director's responsibility when trades are executed through omnibus accounts.[25] In this situation, an intermediary is responsible for processing fund transactions, and the only trade with the fund is a single order that nets all of the trades of persons who invest through the omnibus account.[26] Although the presence of an omnibus account may create an additional layer of compliance for a fund manager and fund board, it in no way relieves them of their fundamental responsibility to protect fund shareholders.

Fund managers and fund boards must take steps to ensure post-4:00 pm EST trades are placed before 4:00 and cannot be arbitrarily cancelled. The SEC has permitted funds to receive orders after 4:00 pm EST on the condition that the fund's directors ensure that the orders originate before 4:00. In a letter to Charles Schwab & Co., Inc., in which the SEC authorized Schwab to submit orders after 4:00, the SEC stated that the fund's "board of directors should consider whether Schwab has adopted and implemented

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[25] The ICI has stated that, with respect to omnibus accounts, "[o]ften in those cases, the fund cannot monitor trading activity by individual investors in these accounts." See Fink Testimony supra note 17 at p. 13. In fact, funds ***can*** monitor such activity, only they affirmatively choose not to require access to trading records when they permit omnibus accounts to invest in their funds.

[26] Such omnibus accounts would include employee benefit plans, such as 401k plans, accounts held in street name by a broker-dealer, and accounts held by fund supermarkets, such as Schwab's Mutual Fund OneSource service.

internal controls reasonably designed to prevent customer orders received after the Fund's Pricing Time from being aggregated with the orders received before the Fund's Pricing Time."[27] The SEC also stated that the fund directors also should consider whether third parties designated by Schwab to receive orders have internal controls designed to ensure that late trades originated before the fund is priced.

**C. Market Timing.**

The problem of market timing is so notorious that many funds have adopted trading policies that are designed to combat market timing and have disclosed these policies in their prospectuses. It cannot have been a surprise to fund managers or directors that many investors would seek to trade in and out of their funds.

Nor can fund managers or directors have been ignorant of the prevalence of frequent trading in their funds. Funds have direct knowledge of daily cash flows in and out of their funds, and it is difficult to imagine, in light of the high profile of the market timing problem, how such cash flows could not have been the subject of constant and careful analysis by fund managers and directors. At a minimum, fund managers and directors must ensure that there are procedures in place that are reasonably designed to protect shareholders against inappropriate market timing and to conduct regular checks to ensure that these procedures are working. Reports that half of the 80 fund complexes subpoenaed in connection with ongoing investigations may have market timing arrangements with some investors and that half of those complexes have anti-market timing policies is evidence that the most fundamental elements of effective compliance -- standardized procedures and periodic verification -- were routinely ignored.

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[27] See supra note 11.

Some have suggested, as similarly suggested with respect to late trading, that fund managers and directors should not be held accountable for frequent trading conducted through omnibus accounts. For the same reasons discussed above, these arguments are incorrect. Further, omnibus accounts are permitted to invest in funds only with the funds' permission, and such investments should not be permitted on the condition that the beneficiaries be allowed to trade in and out of the fund to the detriment of other shareholders.

Further, patterns of frequent trading in omnibus accounts are, in fact, detectable. For example, Putnam was able to detect frequent trading by a deferred compensation plan for which a third party acted as the administrator. As indicated in exhibits to the Mass. Secretary of State's complaint, the deferred compensation plan resisted Putnam's request to eliminate frequent trading, thereby illustrating that ultimate responsibility for protecting fund shareholders does and must lie with fund managers and directors.

**D. Commission Overcharges.**

It is fundamental to a fund manager's or director's duty to protect fund shareholders that he take steps to ensure that shareholders are not overcharged. Nowhere is the potential for fraud or embezzlement greater than when persons are able to collect their fees or commissions directly from the amount of a purchase or a shareholder's account. This is especially true in the context of mutual fund purchases, where, unlike virtually every other type of securities transaction, the SEC has exempted brokers from disclosing to shareholders they amount that the broker was paid in connection with the transaction.[28]

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[28] SEC Report at 80.

It is incumbent upon fund managers and directors to establish procedures that are reasonably designed to ensure that investors are not overcharged, and to require periodic checks to ensure that the procedures are working. The procedures might include regular, independent audits of fees charged to shareholders and occasional sampling to determine whether the audits were effective. It is precisely this kind of sampling that was conducted by regulators and revealed an extraordinary record of overcharges.[29] Regulators cannot police every fund and every broker; effective compliance must begin at individual firms.

**E. A Systemic Compliance Failure**

The frauds discussed above demonstrate a systemic breakdown in compliance systems in the mutual fund industry. This is not intended to suggest that fund managers and directors should be expected to catch every fraud, to detect every frequent trader, to price every foreign security perfectly, day in and day out.[30] This is not the standard to which fund managers and directors are or should be held. Indeed, when brokers process millions of fund transactions, it is to be expected that shareholders will occasionally be overcharged, and in some cases they may be overcharged intentionally. But the extraordinary incidence of overcharges found by regulators exceeds the inevitable glitches that any complex system will produce. For example, investors entitled to breakpoints would almost have had a better chance of not being overcharged if they had flipped a coin. In some cases, such investors had a 100% chance of being overcharged.

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[29] See supra discussion at pp. 9 -- 10.

[30] The ICI has correctly stated that "[d]irectors cannot be expected to unearth every instance of wrongdoing." Fink Testimony supra note 17, at p. 19. The ICI misunderstands, however, that the alleged frauds do not reflect isolated instances of wrongdoing, but a pervasive pattern of compliance failures that demonstrate significant failings on the part of fund directors.

The overcharges, along with the failure to detect and protect the other alleged frauds, demonstrate a systemic failure of compliance.

The frauds described above have been shown not to be isolated incidents. They reflect widespread abuses occurring at a large number of fund complexes that in a number of cases involve upper level management. Fund managers and directors knew or should have known that their funds were using stale prices, and some even assisted investors in exploiting these prices. They knew or should have known that late trading was occurring, and some even helped late traders process their transactions. They knew or should have known that traders were market timing their funds, and some even negotiated deals to facilitate this practice. They created a system of awarding breakpoints that was complex and plainly susceptible to abuse, yet in some cases investors had a 0% chance of receiving the breakpoints to which they were entitled.

## IV. Mutual Fund Reform

These frauds necessitate prompt and forceful action by Congress. In this section, I propose certain measures that are needed to strengthen the independence and authority of fund directors. Strengthening measures, however, are not sufficient. These frauds reflect a systemic compliance failure in the sense that the current structure of fund oversight is not resulting in fund shareholders receiving the most fundamental and obvious forms of protection from actual and potential abuses that have been known to regulators and the fund industry for years. If shareholders are not being protected from the most obvious frauds, they cannot have any confidence that they are being protected from frauds that we have yet to or may never discover. I therefore strongly recommend that Congress create a Mutual Fund Oversight Board, as also described in Section IV below.

Finally, Congress should adopt long overdue reforms to ensure that fund fees and expenses are fully disclosed. These reforms, which already have been passed by the House Financial Services Committee, are critical to restoring investors' confidence and promoting competition in the mutual fund industry. Mutual funds have historically maintained a higher standard of ethics and professionalism than any other financial services provider. This high standard is attributable, in part, to the relative transparency of their fees and the strict regulatory regime under which they operate. The current scandal, however, has severely damaged their reputation, perhaps irreparably. Congress should take immediate steps to restore Americans' trust in this once proud industry.

**A. Independent Fund Directors**

As discussed above, recent frauds demonstrate systemic weaknesses in mutual fund compliance. These systemic weaknesses require immediate steps to strengthen the independence and authority of independent mutual fund directors, and the creation of a regulatory structure designed to ensure that fund boards of directors fulfill their responsibility to protect shareholders.

As this subcommittee is aware, virtually all mutual funds are essentially a board of directors that oversees a nexus of contracts with different service providers. Recent frauds have implicated a variety of different legal requirements applicable to these service providers, but all of the frauds share a common element: the failure of mutual fund boards to satisfy fundamental standards of compliance oversight. I strongly recommend that Congress adopt the following requirements to restore Americans' confidence in mutual funds and ensure that the industry never again engages in frauds of the kind and scope that have recently been brought to light.

**1. Independent Chairman**

Congress should require that the chairman of a fund's board of directors be independent. As often noted by the Commission, a mutual fund is effectively dominated by its adviser,[31] and this fact necessarily compromises the control normally exercised under state law by a board of directors. To compensate for this imbalance, it follows that additional requirements, beyond those provided under state law, are necessary for the board to effectively police the adviser's conflicts of interest and protect shareholders.

[31] See, e.g., Role of Independent Directors of Investment Companies, Investment Company Act Rel. No. 24082, at Part I (Oct. 15, 1999) ("investment advisers typically dominate the funds they advise").

These additional requirements have become especially important in light of recently alleged frauds perpetrated, in part, by fund managers and, in one case, the chairman of the fund's board. It is self-evident that, where such frauds may be perpetrated by a service providers to a fund, an executive of that service provider cannot provide objective leadership to the fund's board. There is an inherent conflict between the board's duty to evaluate the adviser's conflicts of interest on the one hand, and the appointment of an employee of the adviser as the board's chairman on the other. Requiring that the chairman be independent will remove this conflict and ensure that the fund's independent directors have complete control over the board.

The Commission staff has suggested that an independent chairman is unnecessary because the independent directors already can "influence the agenda and the flow of information to the board."[32] It is not enough, however, that the independent directors "influence" the information they receive; nor is the staff's position consistent with the principle underlying directors' affirmative statutory duty to "request and evaluate" the information necessary to evaluate the advisory contracts.[33] Indeed, the staff's suggestion that fund boards designate a "lead independent director" acknowledges the need for independent directors to exercise authority beyond that afforded by their numerical superiority. Formally appointing an independent director as chairman would better fill that need.[34] There can be no better demonstration of this fact than recent allegations that

[32] Memorandum from Paul Roye, Director, Division of Investment Management, to William Donaldson, Chairman, Securities and Exchange Commission, at 50 (June 9, 2003) ("SEC Report").

[33] See Investment Company Act Section 15(c).

[34] For further discussion of the reasons that an independent board chairman is necessary, see Letter from Mercer Bullard, Fund Democracy, Inc., to the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Enterprises, U.S. House of Representatives, at pp. 8 -- 11 (July 9, 2003).

the chairman of the board of the Strong fund complex, who is also the chief executive officer of the fund manager, personally engaged in market timing the funds whose boards he commanded for the purposes of exploiting stale prices.

The Commission's position also contradicts current trends in corporate governance. Recent corporate scandals have caused leaders in corporate law and practices to reconsider common assumptions about corporate governance. In June 2002, for example, The Conference Board convened the Commission on Public Trust and Private Enterprise to "address the causes of declining public and investor trust in companies, their leaders and America's capital markets."[35] In its report, the Commission on Public Trust specifically recommended that the position of board chairman not be held by a member of management.[36]

If we are to learn anything from alleged frauds in the fund industry, it is that accepted standards of conduct for funds' boards of directors need to be reexamined. I recognize that requiring that a chairman be independent in law will not guarantee that he or she will be independent in fact, but it is beyond dispute that -- all things being equal -- a legally independent chairman is more likely to be truly independent than a person with ties to management.

[35] Findings and Recommendations, The Conference Board Commission on Public Trust and Private Enterprise (Jan. 9, 2003).

[36] Id. at 21.

### 2. Authority and Representation of Independent Directors

Congress also should take steps to ensure that independent directors have the authority and representation necessary to counter the domination of the fund's manager. As discussed immediately above, mutual funds have a uniquely conflicted structure that necessitates an especially strong and independent board. Congress should take five steps to improve the effectiveness and independence of independent fund directors

The first two steps are related. First, Congress should increase the minimum percentage of independent directors on a fund board from 40% to 75%.[37] Second, Congress should prohibit any fund from requiring that board action necessitate the approval of a non-independent board member. This second step is necessary to prevent the circumvention of the independent directors' 75% control, for example, by adopting a provision that requires the approval of 80% of the board for any board action. These measures, in tandem, will ensure that independent fund boards have the authority to act when necessary to address conflicts of interest and detect and prevent fraud.

Third, Congress should ensure that fund directors actually "represent" fund shareholders in a meaningful way. Many current fund directors have never been approved by shareholders. Mutual funds normally do not have annual shareholders meetings, and fund directors typically are appointed for an indefinite term. Congress should prohibit any person from counting as an independent director unless that person has been approved by shareholders at least once every five years.

[37] As a practical matter, SEC rules virtually require that all funds have a majority of independent directors. See Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001). This is not, however, a statutory minimum.

Fourth, Congress should require that independent directors be found annually by a majority of the other independent directors, after reasonable inquiry, not to have any material business or familial relationship with the fund or any significant service provider to the fund that is likely to impair the independence of the director.[38]

Finally, Congress should require that independent directors form a committee of their peers that shall have responsibility for selecting and nominating independent directors.[39] This committee should be required, at a minimum, to adopt qualification standards for the selection of nominees that are disclosed in the fund's registration statement.[40]

### 3. Definition of Independent Director

Without an adequate definition of independence, no law can ensure that independent directors will be effective advocates for fund shareholders. In many respects, the current definition of independence permits persons with significant conflicts of interest to serve as independent directors.[41]

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[38] See Amendment No. 2 to the NYSE's Corporate Governance Proposals (Oct. 8, 2003) at http://www.nyse.com/pdfs/amend2-10-08-03.pdf (recommending that corporate boards be required to find that independent directors have no material relationship with the company and to disclose these determinations).

[39] Id. (recommending that corporate boards be required to nominating committee that identifies director qualification criteria).

[40] Id.

[41] SEC Report at 47 – 48 (describing independent fund director relationships "that suggest a lack of independence from fund management").

Congress should amend the standard for independent directors to disqualify the following persons:

- any natural person who has served as an officer or director, or as an employee within the preceding ten years, of an investment adviser or principal underwriter to the fund, or of any entity in a control group with the adviser or underwriter; and
- any natural person who has served as an officer or director, or as an employee within the preceding 10 years, of any entity that has within the five preceding years acted as a significant service provider to the fund, or of any entity in a control group with the service provider.[42]

Furthermore, Congress should authorize the SEC to prohibit any class of persons from serving as independent directors who the SEC determines are unlikely to exercise an appropriate degree of independence.

#### 4. Mutual Fund Oversight Board

Although the proposals discussed above will strengthen fund boards, they will not be adequate to ensure that the kinds of frauds discussed above do not reoccur. These frauds reflect a failure by independent fund directors that cannot be explained solely by a lack of independence or authority. These frauds reflect systemic compliance failures that require structural changes in the way that fund boards are regulated.

Recent frauds demonstrate that the Commission staff has too many responsibilities and not enough resources to provide adequate oversight of fund boards by itself. I strongly recommend that Congress create a Mutual Fund Oversight Board that would have examination and enforcement authority over mutual fund boards. The Board

[42] See SEC Report at 47 (noting that a former fund management executive can serve as an independent director two years after retiring from his position); Report of the Advisory Group on Best Practices for Fund Directors, Investment Company Institute, at 12 – 14 (June 24, 1999) (recommending that former officers and directors of a fund's investment adviser or principal underwriter not serve as independent directors).

would supplement, and not in any way supplant, the SEC's authority over mutual funds. In the event of any disagreement between the SEC and the Board, the SEC would have final decisionmaking authority. The Board would be charged with identifying potential problems in the fund industry and ensuring that fund boards are actively addressing these problems before they spread. For example, the Board would promulgate guidance regarding current regulatory issues and best practices regarding how to deal with them, and examine boards to ensure that they are taking necessary steps to protect shareholders.

The Board would be financed from assessments on mutual fund assets to provide an adequate and reliable source of funding. Board members would be persons with specific expertise in the fund industry and would be appointed for five year terms by the Commission to ensure their independence. This model, which ideally combines the strengths of independent, expert oversight with the advantages of a reliable and adequate funding source, would do more to restore confidence in the fund industry and protect fund shareholders than any changes in the makeup, qualifications or authority of fund boards.

**B. Fees and Expenses**

Congress also should act promptly to eliminate two major gaps in mutual fund fee disclosure: portfolio transaction costs and compensation paid to brokers for selling fund shares. As discussed below, current SEC rules and positions provide investors with a misleading picture of the costs of fund ownership and the incentives of brokers from whom they buy fund shares. With America's investors experiencing a crisis in confidence in the mutual funds, fee disclosure reform is more important than ever.

### 1. Portfolio Transaction Costs

As stated by the Commission, "fund trading costs incurred in a typical year can be substantial."[43] The Commission cites studies that estimate that brokerage commissions alone cost about 0.30% of equity funds' net assets.[44] Other studies estimate that market spread, or the amount by which the price of a security is marked up or marked down, costs about 0.50% of equity funds' net assets, and that "opportunity costs may amount to 0.20% of value."[45]

Another study found that the mean brokerage and market spread costs for a sample of equity funds was 0.75% of assets, or almost three-quarters of the mean expense ratio of 1.09%.[46] The brokerage and spread costs constituted an even larger percentage of the total costs of funds with the highest trading costs, with mean brokerage and spread costs equaling 1.54% of assets and the mean expense ratio equaling only 1.24%.[47] Thus, portfolio transaction costs can be the single largest fund expense, exceeding all other fund expenses combined. These costs are not, however, included in fee information provided in the prospectus. Transaction costs vary greatly among funds, and full disclosure of these expenses will help hold fund advisers accountable for their trading practices.

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[43] SEC Report at 19.

[44] Id. at 22.

[45] Id.

[46] Chalmers, Edelen & Kadlee, Fund Returns and Trading Expenses: Evidence on the Value of Active Fund Management (Dec. 29, 2001).

[47] Id.

Fuller disclosure of portfolio transaction costs also will provide a collateral benefit in connection with funds' soft dollar practices. In short, transaction cost disclosure will subject fund expenditures on soft dollar services to market forces, and thereby provide a practical solution to the problem of regulating soft dollar practices.[48] For some transaction costs, fashioning disclosure rules will be a relatively easy task. Fund brokerage commissions already are disclosed in the Statement of Additional Information as a dollar amount. Converting this dollar amount to a percentage of assets and including it with other expenses in the expense ratio in the fee table would be simple and inexpensive.[49]

Providing disclosure regarding other types of transaction costs will be more difficult, but no less necessary. There are no standardized methods for calculating spread costs, market impact or opportunity costs. Nor are these concepts, unlike fund brokerage, generally understood by the investing public. Nonetheless, the Commission has been able to develop effective, standardized, quantitative disclosure tools in other contexts, such as funds' investment performance and expense ratios. There are a number of private companies that already provide fund advisers with quantitative assessments of their funds' transaction costs for self-evaluative and board review purposes.[50] The SEC's inspection staff routinely considers these quantitative assessments when evaluating a fund adviser's obligation to obtain best execution of fund transactions. It should not be difficult, over time, to develop quantitative tools to measure fund transaction costs and

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[48] For further discussion of this benefit, see Bullard Testimony, supra note 1 at pp. 10 – 13.

[49] Accord, SEC Report at 28.

[50] Id. at 21-22

disclosure formats that will provide this information in a way that helps investors understand these costs.

The Commission has objected to the disclosure of fund portfolio transaction costs on the grounds that the disclosure of brokerage commissions, while easily comparable and verifiable, would be incomplete, and the disclosure of other components of transaction costs, while completing the transaction cost picture, would not lack comparability.[51]

This objection misunderstands the purpose of fee disclosure rules. The purpose of fee disclosure rules is to ensure that investors have the information they need to make informed investment decisions. Thus, the issue is not whether the disclosure is theoretically perfect or complete, but rather whether it provides information that facilitates better investment decisions.

For example, Commission-mandated standardized investment performance is imperfect and incomplete in a number of ways. It is calculated net of fees, notwithstanding that this does not accurately portray a fund adviser's pure stock picking ability before expenses. It arbitrarily measures performance at 1-, 5-, and 10-year intervals, and not periods in between. It is based on only one of a number of different methods of calculating an internal rate of return. In advertisements, it is permitted to show the returns of a single class, even though the performance of other classes may have been different.

Similar observations could be made about imperfections in the fee table. Indeed, one drawback of the expense ratio is that it is incomplete, and including commissions

[51] Id. at 20-22 & 28-35.

would make it a more complete measure of the cost of fund investing. Both standardized performance and the fee table have provided an undisputed net benefit to shareholders, notwithstanding their theoretical inadequacies.[52]

The fact that there is more than one way to calculate the different components of fund transaction costs is not a reason to deprive shareholders of useful information about these costs. The Commission has suggested enhanced disclosure of funds' turnover ratios as an alternative to disclosure of actual transaction costs. Using the turnover ratio as a proxy for transaction costs, itself an imperfect measure, would be an inferior and inadequate substitute for disclosure of actual transaction costs.[53]

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[52] Indeed, the same observations could be made about the SEC's preference for turnover rates as a proxy for portfolio transactions costs. Chalmers, supra note 46 (demonstrating that fund turnover is not a reliable proxy for fund trading expenses). If an imperfect, indirect measure of transaction costs such as portfolio turnover is to be used, it is unclear why a direct measure, such as commissions, spread costs, market impact or opportunity costs would not be preferable.

[53] Id.

### 2. Brokers' Compensation

The purpose of prospectus disclosure is to inform investors about the cost of investing in a fund. In contrast, the purpose of disclosure made at the point-of-sale is to inform investors about the economic motives of the person (referred to herein as the "broker") recommending the fund. Rule 10b-10 under the Securities Exchange Act accordingly requires that brokers disclose, to purchasers of securities, "the source and amount of . . . remuneration received or to be received by the broker in connection with the transaction." This disclosure is known as the "trade confirmation" or "confirm." The Commission has, ill-advisedly, taken the position that Rule 10b-10 does not apply to sales of mutual fund shares.[54]

The prospectus does not disclose all of the compensation that may be paid to brokers for selling fund shares.[55] Even the compensation that is disclosed has no necessary relationship to the amount paid to a broker in a particular transaction. For example, the prospectus for two different mutual funds may show that an investor will pay the same front-end load of $500 on a $10,000 investment, but the broker selling the funds may be paid more for selling one fund over another.[56] The broker payout for both of these funds may be lower than for a fund with a 1.00% 12b-1 fee, for which brokers often receive a flat, upfront payment substantially in excess of the amount of 12b-1 fees that the shareholder will pay in the course of a single year. The broker also may receive

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[54] SEC Report at 80.

[55] For further discussion of the disclosure of disclosure of compensation paid to brokers in the registration statement, see Bullard Testimony, supra note 1 at pp. 13 – 15.

[56] See Lauricella, Investment Firm's Portfolios Get Priority Despite Rules: 'The Home Field Advantage,' Wall Street Journal (May 22, 2003).

payments directly from the fund adviser or compensation in the form of fund portfolio brokerage commissions.

If an investor buys shares of IBM or Dell, his broker must send a confirm that shows how much the broker was paid in connection with the transaction. In contrast, if an investor buys shares in a mutual fund, the confirm is not required to provide this information. For a number of years, the Commission has stated that it recognizes this problem and is studying possible solutions.[57] It is time for Congress to overrule the SEC's position that Rule 10b-10 does not apply to sales of fund shares and require that all compensation received by brokers in connection with sales of fund shares be disclosed on fund confirmations, as well as any information necessary to direct investors' attention to incentives that a broker may have to prefer the sale of one fund over another. Further, in light of regulators' discovery that brokers routinely fail to credit investors with commission breakpoints, see supra p. 16, Congress it should consider whether fund confirms should include a separate box that shows the breakpoint schedule and how it was applied to the purchase.

[57] In February 2000, the Commission conceded that current rules fail to require disclosure of payments received by brokers for recommending fund shares and stated that it had directed its staff to make recommendations on how to fix this problem. See Brief of the Securities and Exchange Commission, Amicus Curiae, in Donald Press v. Quick & Reilly, Inc. (2d Cir.)(Feb. 2000). Almost four years later, the Commission has taken no action to remedy this gap in fund disclosure. In a report issued by the Commission on June 9, 2003, the staff restated that it had been "directed . . . to make recommendations" but provided no indication that it was any closer to making recommendations than it was in early 2000. SEC Report at 80.

**C. Portfolio Manager Compensation**

Congress should require that the amount and structure of portfolio managers' compensation be disclosed ("portfolio manager" hereinafter includes the portfolio management team). In many cases, the frauds described above have involved the portfolio managers of the affected funds. No one stands in a stronger fiduciary relationship with a fund than the person responsible for the actual management of the fund's portfolio. Portfolio managers often have conflicts of interest, however, and these conflicts of interest may be specifically related to their compensation.

The SEC staff has noted that whether a portfolio manager's compensation turns on short-term or long-term, or pre-tax or after-tax performance may indicate whether the manager's and the shareholder's interests are aligned.[58] Whether a portfolio manager is compensated for services provided to other mutual funds or other fund or non-fund clients, or for providing other outside services generally, also is highly relevant to shareholders who wish to evaluate the manager's commitment to a fund and the presence of conflicts of interest that the manager may have as a result of outside duties.[59] Disclosure of portfolio managers' compensation will cause fund managers to minimize such conflicts and enable shareholders to judge for themselves whether portfolio managers' are aligned with their interests.

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[58] SEC Report at 43.

[59] See Remarks by Paul Roye, Director, Division of Investment Management, before the ALI/ABA Investment Company Regulation and Compliance Conference (June 14, 2001)("As many mutual fund managers look to generate revenues by expanding into other areas of the investment management business such as offering private accounts or sponsoring and advising hedge funds and other alternative investment vehicles, they should be mindful that certain of these new opportunities raise conflict of interest issues and the potential for abuse.").

Requiring disclosure of portfolio manager compensation is not a novel concept. Indeed, for years publicly held companies have been required to disclose the compensation of their highest paid executives. Many mutual fund managers have been exempt from this requirement because the managers' executives work for a separate entity from the fund that is not publicly held. Nonetheless, the policies favoring disclosure of executive compensation by operating companies apply equally to mutual funds.

Executive compensation rules need to be adapted, however, to reflect the particular structure of mutual funds. Mutual funds typically do not pay their executives, as these executives are employed and compensated by funds' managers. In addition, the manager's highest paid executives usually are not the personnel who have the greatest impact on the fund's performance. Thus, the executive compensation most relevant to mutual fund shareholders is that compensation received by the fund's portfolio manager or portfolio management team.

## V. Fund Industry Proposals

On October 30, 2003, the Investment Company Institute released three proposals to combat alleged trading abuses in the fund industry.[60] These proposals are as follows:

- Impose a 4:00 deadline for all mutual fund trades to be reported to mutual fund companies;
- Impose a mandatory 2% redemption fee on redemptions made within five days following a purchase for virtually all mutual funds (excepting money market funds); and

[60] Mutual Fund Leaders Call For Fundamental Reforms to Address Trading Abuses, Investment Company Institute (Oct. 30, 2003).

- Recommend to mutual fund companies that their Codes of Ethics include oversight of all trading activity in mutual funds offered or sponsored by the company.

The ICI has indicated that these proposals are only a first step. It stated:

> "ICI Chairman Haaga said mutual funds would continue to work with the SEC and other government officials to seek additional possible responses to the issues uncovered by ongoing investigations. 'Our commitment to righting the wrongs that arise from these investigations comes with no caveats, limitations or qualifications. We said "everything is on the table to protect fund shareholders," and we mean it. We said we would embrace whatever it takes to rebuild investor confidence and we mean that too. Our decisions today are important steps in an ongoing process.'"

I agree with the ICI regarding the importance of developing additional responses to the alleged frauds. As described above, I believe that the responses to the alleged frauds will only be adequate to the extent that they, as suggested by New York Attorney General Spitzer, involve extensive reform.[61] The three ICI proposals listed above, however, fail to meet this standard. The ICI's proposals regarding the 4:00 deadline and redemption fees are discussed below.

**A. Mandatory 4:00 Deadline**

The proposal to require that all mutual fund orders be reported to fund companies by 4:00 is well-intentioned and may provide marginal additional protection against late trading abuses. (I assume that the cut-off would not be 4:00 for all funds, but rather the time at which a fund prices its portfolio, which in most cases is, in fact, 4:00 pm EST.[62]) It is not clear, however, that the benefits of this proposal will outweigh the costs. Further, the proposal risks distracting Congress from the real issue raised by the alleged frauds,

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[61] Riva Atlas, Spitzer Vows Action Against Funds for Improper Trading, New York Times (Oct. 30, 2003).

[62] It is my understanding that the ICI does not intend that all funds be required to price their portfolios at 4:00 pm EST. In fact, pricing earlier than 4:00 can be an effective way to address the most harmful of the alleged frauds, stale pricing. For example, the Guinness Atkinson China & Hong Kong Fund imposes a 9:30 am EST purchase deadline in order to reduce the likelihood that its price will become stale.

which is: Why have rules regarding the timing of fund purchases been so widely disregarded?

The potential benefit of the 4:00 deadline is that it probably would be more difficult for traders to engage in late trading. A trade that has been received by 4:00 has, by definition, been placed prior to the pricing of the fund, and, assuming compliance with the rule, traders could not buy shares at an old price. The ICI should clarify, however, that by the phrase "reported to mutual fund companies" it means received by mutual fund companies, and does not mean that the actual receipt of the order by the mutual fund company can occur sometime after 4:00.

The potential problem with the 4:00 deadline is that it may impose additional costs on fund investors, especially employee benefit plans, fund supermarkets and other types of omnibus accounts. The SEC has permitted trades to be received after 4:00 from such omnibus accounts for good reason. Administrators of omnibus accounts often receive orders late enough in the day that it is difficult to transmit an order to the fund company by 4:00.[63] Provided that there are procedures in place to ensure that trades received after 4:00 originated before 4:00 and that such orders cannot be cancelled, the receipt of orders after 4:00, as previously determined by the SEC, should not necessarily present a significant risk of late trading.[64]

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[63] See Schwab supra at note 11.

[64] As a matter of prudent investing, it should not matter to a long-term investor whether he or she must wait to receive the next day's price. It is a fact, however, that many fund investors value the ability to get the same day's price, and this attitude may be better addressed through education than by a 4:00 deadline. Further, there are fund complexes, such as Rydex and ProFunds, that are specifically designed to cater to market timers and accordingly may need to be able to accept orders as late as possible in order to service their shareholders.

The Subcommittee should consider the impact of a 4:00 deadline on these administrators before adopting such a deadline. Funds currently have the ability to require that orders be received by 4:00; it is not clear that a one-size-fits-all solution is appropriate or necessary. Nonetheless, the ICI's proposal, provided that the burdens on omnibus accounts are not material, may reduce the likelihood of late trading.

As an alternative to the ICI's proposal, Congress should consider requiring that all persons responsible for receiving fund orders keep records of the time the each order was received in a non-erasable, non-editable format that shall be available to fund companies upon request. This would facilitate the monitoring of the times when orders are actually received

The most significant problem with the ICI's proposal is that it suggests a misunderstanding of the alleged frauds. The ICI has stated that "the most effective solution to protect against the possibility of late trading would be to require that all purchase and redemption orders be received by a fund (or its transfer agent) before the time the fund prices its shares."[65] I disagree. The "most effective solution" would be to take steps to ensure that the rules governing the timing of fund trades, whatever they may be, are actually followed.

The ICI fundamentally misunderstands that, as discussed above, late trading has occurred primarily because fund management and boards failed to ensure that trades received after the fund was priced originated before that time and could not be cancelled.[66] This reflects a failure of fundamental compliance, not a problem with

[65] See Fink Testimony supra note 17 at Executive Summary and p. 5.

[66] See supra discussion at pp. 14 – 15.

existing legal requirements. Late trading should not be painted as a failure of the rules, rather than a failure of compliance and oversight; nor should we allow the fund industry to address late trading simply by placing additional burdens on shareholders[67] when the primary responsibility for this scandal rests with the fund industry itself.

Changing the rules, as suggested by the ICI, would emphatically not be the "most effective solution" to late trading. The problem is not that current law is unclear or unreasonably difficult to enforce.[68] Fund directors and managers needed only to apply compliance systems that were reasonably designed to ensure that orders originated before 4:00, and to conduct spot checks to ensure that the procedures were working. While a 4:00 deadline would, as a logistical matter, probably make it marginally more difficult to engage in late trading, there is no reason why the alleged late trading practices would not continue.

There is no reason to believe, based on the facts underlying recent revelations, that some telephone agents, transaction processing personnel, fund executives, or even fund board chairmen would not agree to backdate an order received after 4:00 if they were adequately compensated for participating in such a scam. Merely changing the rules does not make it more likely that people will comply with them. The ultimate measure of compliance with rules, whatever those rules may be, is a proactive, independent compliance structure. Without reforms that are designed to create such a structure, we should expect a 4:00 deadline to be gamed just as existing rules have been.

[67] See Fink Testimony supra at note 17 at n. 6 (conceding that "[i]n many cases, investors may no longer have the ability to obtain same-day prices.")

[68] Id.

**B. Mandatory 2% Redemption Fee**

The ICI proposes to require that virtually all non-money market funds impose a 2% redemption on shares purchased within the preceding five days. The purpose of this proposal is laudable in that it will deter market timing and reduce the ability of traders to exploit stale prices. These goals will be accomplished because most market timers will find that they cannot hope to profit if they have to pay 2% of their assets each time they sell shares. Opportunities to exploit stale prices will be reduced because in most instances stale prices represent less than 2% of a fund's net asset value, and the redemption fee therefore would eliminate the ability to profit on stale prices in most situations.[69]

The redemption fee proposal, however, even more than the 4:00 deadline proposal discussed above, suggests a fundamental misunderstanding of the alleged frauds.[70] First, the most significant problem with market timing was not the mere fact of frequent trading. Canary Capital and the Putnam managers sued by the Massachusetts Attorney General did not allegedly profit by driving up the costs of funds for other investors. Their profits were made by exploiting funds' stale prices. A redemption fee does not solve this problem, but rather continues to permit shareholders to buy and sell fund shares at inaccurate prices, and traders to exploit stale pricing opportunities that exceed 2% or that are still relatively risk free even if the shares are held for more than five days. As noted above, the SEC found in connection with stale pricing that occurred in October

[69] One might argue that the redemption fee might impose an undue burden on investors who, for emergency reasons, need to redeem fund shares immediately after buying them. As a practical matter, I do not believe that the possibility that an investor would be harmed by having to wait five days to redeem fund shares is a material disadvantage of the proposal.

[70] See also supra note 12.

1997 that "fairly large numbers of investors attempted . . . to take advantage [of stale prices] which promised potential gains in ***double digits***."[71] To the extent that a fund's price is undervalued by more than 2%, not to mention "double digits," a redemption fee will simply reduce traders' profits. It will not deter traders from exploiting stale prices.

Second, as discussed above, the alleged frauds do not reflect gaps in the rules as much as a systemic failure to enforce such rules. There is no assurance that redemption fees, whether or not statutorily required, will be collected. In light of recent allegations, one could easily imagine fund personnel agreeing to waive redemption fees in return for an agreement by traders to park their assets in an affiliated money market fund at times when the assets were not invested in the target international fund. The problem is that fund managers and directors ignored widespread violations of existing laws.

[71] See Barbash supra at note 5 (emphasis added).

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

**CONCERNING**
**RECENT COMMISSION ACTIVITY TO COMBAT**
**MISCONDUCT RELATING TO MUTUAL FUNDS**

**BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS,**
**INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES**

**COMMITTEE ON FINANCIAL SERVICES**

**U.S. HOUSE OF REPRESENTATIVES**

**NOVEMBER 4, 2003**

**U.S. Securities and Exchange Commission**
**450 Fifth Street, N.W.**
**Washington, D.C. 20549**

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

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

**Before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services**

**November 4, 2003**

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

## I. Introduction

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

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

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

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

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

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

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

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

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

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

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

## II. <u>SEC Response to Misconduct Relating to Mutual Funds</u>

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

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

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

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

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

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

**A. Recent Enforcement Efforts Relating to Mutual Fund Trading**

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

On September 16, the Commission filed a civil action against Theodore Sihpol, a salesperson at Bank of America Securities ("BOA"), who was Canary Capital's primary contact at Bank of America. Specifically, the Commission issued an administrative order instituting proceedings in which the Division of Enforcement (the "Division") alleges that Sihpol played a key role in enabling certain hedge fund customers of BOA to engage in late trading in shares of mutual funds offered by Bank of America, including the Nations Funds family of funds and other mutual funds. Based on the conduct alleged in the Commission's Order, the Division alleges that Sihpol violated, and aided and abetted and caused violations of, the antifraud, mutual fund pricing and broker-dealer record-keeping provisions of the federal securities laws. In its action, the Division is seeking civil penalties, disgorgement and other relief, which may include permanently barring Sihpol from the securities industry.[2] Simultaneous with the issuance of the Commission's order, Sihpol surrendered in connection with Attorney General Spitzer's filing of a two-count complaint charging him with larceny and securities fraud.

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

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

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

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

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

In its administrative order, the SEC found that Connelly approved agreements that permitted select investors to "time" certain mutual funds managed by Alger, a practice that violates an adviser's fiduciary duties and adversely affects the value of the fund being timed. In this case, the timing arrangements were also inconsistent with Alger's public disclosures in prospectuses and Statements of Additional Information filed with the SEC. According to the Commission's order, Connelly was involved in timing arrangements at Alger from the mid-1990s until 2003. By early 2003, Connelly was requiring that investors seeking timing capacity agree to maintain at least 20% of their investment at Alger in buy-and-hold positions, sometimes referred to as "sticky assets."

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

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

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

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

**B. The Commission's Use of Examination Authority**

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

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

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

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

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

1. Preliminary Results Involving Late Trading

*a. Conduct of Broker-Dealers*

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

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

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

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

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

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

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

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

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

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

*b. Conduct of Mutual Funds*

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

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

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

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

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

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

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

2. <u>Preliminary Results Involving Market Timing</u>

*a. Conduct of Broker-Dealers*

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

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

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

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

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

*b. Conduct of Mutual Funds*

- **Almost all funds have some kind of anti-market timing policy:** More than 90% of responding funds with long-term investment objectives have policies aimed at identifying and deterring the disruptive effects excessive short- term trading in fund shares could have on such funds' performance and expenses. (Money market funds usually do not have market timing policies and prohibitions and do not restrict the purchase and redemption activities of shareholders. Money fund NAVs cannot be arbitraged because their NAVs are a constant $1 per share.)

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

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

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

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

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

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

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

3. Preliminary Results Involving Disclosure of Portfolio Holdings

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

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

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

## III. Conclusion

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

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

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

STATEMENT OF PAUL G. HAAGA, JR.

EXECUTIVE VICE PRESIDENT

CAPITAL RESEARCH AND MANAGEMENT COMPANY

AND

CHAIRMAN

INVESTMENT COMPANY INSTITUTE

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

ON

"MUTUAL FUNDS: WHO'S LOOKING OUT FOR INVESTORS?"

NOVEMBER 4, 2003

## EXECUTIVE SUMMARY

- The bedrock principle of the mutual fund industry is that the interests of investors always come first. Consequently, the industry has reacted with shock and outrage to recent allegations of abusive mutual fund trading practices.

- Forceful steps must be taken immediately to restore and reinforce investor confidence. SEC Chairman Donaldson has laid out a blueprint for regulatory reform. The Institute has formed task forces to identify possible options to address the alleged abusive mutual fund trading practices, and has developed recommendations based on the task forces' findings.

- ***Late Trading.*** The Institute believes that the most effective solution to protect against the possibility of late trading would be to require that all purchase and redemption orders be received by a fund (or its transfer agent) before the time the fund prices its shares (*e.g.*, 4:00 p.m. Eastern time). This approach would significantly limit opportunities for late trading and enhance compliance oversight by funds and regulators.

- ***Market Timing.*** Market timing is not inherently illegal or improper, but because frequent trading can be disruptive to portfolio management and can increase trading and administrative costs, funds often employ methods to deter such activity. It has been alleged that some funds were not applying their market timing policies fairly and consistently, and even worse, that some fund insiders may have engaged in market timing, reaping personal benefits at the expense of other shareholders.

    - The SEC is considering various regulatory measures in this area, including (1) requiring funds to have more formalized market timing policies and procedures and to explicitly disclose those policies and procedures, (2) emphasizing the obligation funds have to fair value their securities under certain circumstances and (3) reinforcing board oversight of market timing policies and procedures. The industry supports all of these measures.

    - With respect to personal trading activities of senior fund personnel, the Institute is urging its members to clarify or amend their codes of ethics to require oversight of trades by such persons in any mutual funds offered or sponsored by the company.

    - Funds and their shareholders also would benefit if funds had additional "tools" to combat harmful market timing activity. These could include redemption fees higher than the 2% limit currently imposed by the SEC staff and measures that would enable funds to better enforce their market timing restrictions on short-term trading activity within omnibus accounts, such as a mandatory minimum 2% redemption fee on fund shares redeemed within a minimum of 5 days of their purchase.

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## I. INTRODUCTION

My name is Paul G. Haaga, Jr. I am Executive Vice President and Chairman of the Executive Committee of Capital Research and Management Company, the investment adviser to the 29 funds in The American Funds Group, with more than $450 billion in assets under management. The American Funds Group is the third largest mutual fund group in the United States and the largest group distributed exclusively through unaffiliated financial intermediaries. Before I joined the American Funds in 1985, I was a securities attorney in private practice in Washington, D.C. and, prior to that, was on the staff of the Securities and Exchange Commission. I also serve as the Chairman of the Board of Governors of the Investment Company Institute, the national association of the American investment company industry. My testimony today is offered on behalf of the Institute and its members.[1]

I appreciate the opportunity to appear before the Subcommittee today to discuss the issues of late trading and market timing of mutual funds, and the industry's commitment to take whatever steps are necessary to make sure that the interests of fund shareholders are fully protected.

The bedrock principle of the mutual fund industry is that the interests of mutual fund investors always come first. Consequently, the industry has reacted with shock and outrage to the allegations of late trading and market timing in the New York Attorney General's complaint

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,664 open-end investment companies ("mutual funds"), 601 closed-end investment companies, 106 exchange-traded funds and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.967 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders.

in the Canary case[2] and other recent allegations of abusive mutual fund trading practices. There can be no excuse for knowingly permitting the buying and selling of fund shares at old prices after the market has closed. And while restricting market timing may be easier said than done, silently selling to a select few the right to trade fund shares is deeply troubling. Even more abhorrent is the notion that, in some instances, fund insiders themselves may have engaged in market timing to reap personal benefits at the expense of other fund shareholders. The industry commends the New York Attorney General's office and the Securities and Exchange Commission for their investigative efforts and forceful responses to these alleged practices. It is imperative that the ongoing investigations by the SEC and others of these allegations are thorough and successful in rooting out trading activities that have compromised or harmed the interests of individual mutual fund shareholders.

We cannot wait until those investigations are complete, however, to take the steps necessary to restore and reinforce investor confidence in mutual funds. Investor confidence is every mutual fund's most precious asset. The industry earned the confidence of millions of Americans by serving their interests above all other considerations. The business practices that have been alleged are inconsistent with this principle and are intolerable if mutual funds are to serve individual investors as effectively in the future as they have in the past. Forceful action will be the key to restoring and reinforcing investor confidence. The broad elements of what must be done to reassure investors are as follows:

[2] *State of New York v. Canary Capital Partners, LLC, Canary Investment Management, LLC, Canary Capital Partners, Ltd., and Edward J. Stern* (NY S. Ct. filed Sept. 3, 2003) (undocketed complaint) ("Canary Complaint").

- First, government officials must identify everyone who violated the law. Forceful and unambiguous sanctions must be delivered swiftly wherever punishment is warranted.
- Second, if shareholders were harmed because of illegal or deceptive business arrangements, these wrongs must be made right.
- Third, any gaps in the otherwise strict system of mutual fund regulation must be identified and effectively addressed.

With respect to the last point, SEC Chairman Donaldson has announced plans to propose tough new regulatory requirements addressing the late trading and abusive short-term trading of mutual fund shares.[3] The SEC also will consider whether additional requirements are necessary to address the issue of selective disclosure of portfolio holdings information. The industry pledges its full support of the SEC in whatever course of action will best protect mutual fund shareholders.

To help advance this objective, the ICI's Board of Governors established two separate task forces to identify specific options to address the issues of late trading and abusive short-term trading involving mutual fund shares. Based on the findings of the task forces, the Institute has developed several recommendations, which are outlined below.

Mutual funds themselves also have acted swiftly to determine whether wrongdoing occurred in their firms. They have conducted internal investigations, in some cases aided by independent outside experts to investigate and judge the findings, and communicated their findings and responses to their boards. Some fund boards have retained their own independent third parties to conduct investigations. As a result of these investigations, several funds have

[3] *See* SEC Chairman Donaldson Releases Statement Regarding Initiatives to Combat Late Trading and Market Timing of Mutual Funds, SEC Press Release No. 2003-136 (Oct. 9, 2003) ("Donaldson Statement").

terminated senior executives. Many funds have committed to taking remedial actions, including compensating fund shareholders for any detrimental impact that improper or illegal transactions may have had on their investments. These actions reinforce that funds take very seriously their obligations under the federal securities laws and the fulfillment of their responsibility to make sure that investors' interests always come first.

The remainder of my testimony will focus on the issues of late trading and abusive short-term trading of mutual fund shares. I also will discuss the practice of selectively disclosing information about fund portfolio holdings to shareholders, and oversight of hedge funds. Finally, I will discuss other initiatives to reinforce the protection and confidence of mutual fund investors.

## II. LATE TRADING

A basic tenet of mutual fund investing is the concept of "forward pricing." Mutual funds are required to price their shares at least once each day, at a time or times designated by the fund's board of directors and disclosed in the fund's prospectus. Most funds price their shares as of 4:00 p.m. Eastern time, the close of regular trading on the New York Stock Exchange. All purchase and redemption orders received by a fund or its agents before 4:00 p.m. must receive that day's price. All orders received after 4:00 p.m. must receive the next day's price. The requirement that a purchase or redemption order be priced based on the fund's net asset value (NAV) next computed after receipt of the order is known as the "forward pricing" rule. The SEC adopted this rule in 1968 because it recognized that "backward pricing" (purchases and sales of fund shares at a previously determined NAV) could lead to dilution of the value of fund shares and could be susceptible to abuse in that it could allow speculators to take advantage of fluctuations in the prices of the fund's portfolio securities that occurred after the fund calculated its NAV.[4]

Under current SEC rules and staff interpretations, funds may treat the time of receipt of an investor's order by an intermediary designated by the fund as the relevant time for determining which price the order will receive.[5] Thus, it is common industry practice for intermediaries such as broker-dealers, banks and retirement plan administrators to transmit their clients' purchase and redemption orders that were accepted before 4:00 p.m. to a fund for processing after 4:00 p.m. at that day's price.

Given the alleged abuses that recently have come to light, the Institute believes that existing regulations should be tightened to better protect against the possibility of late trading. The most effective solution to this problem would be to require that all purchase and redemption orders be received by a fund (or its transfer agent) before the time of pricing (*e.g.*, 4:00 p.m. Eastern time).[6] While such a requirement could have a significant impact on the many investors who own mutual funds through financial intermediaries,[7] the recent abuses indicate

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[4] *See* Investment Company Act Release No. 5519 (October 16, 1968).

[5] *See, e.g.*, Investment Company Act Release No. 5569 (December 27, 1968).

[6] As noted above, most funds price their shares as of 4:00 p.m. Eastern time. Thus, for simplicity, the discussion below assumes that this is the case. A fund that prices its shares as of a different time should be required to cut off orders at that time.

[7] Institute data show that the vast majority (approximately 85-90 percent) of mutual fund purchases are made through such intermediaries, including both financial advisers and employer-sponsored retirement plans. *See* Investment Company Institute, 2003 Mutual Fund Fact Book, at 38. A 4:00 p.m. cut-off time at the fund will require intermediaries to apply an earlier cut-off time to the mutual fund orders they receive. This, in turn, will compress the time period during which investors conducting fund transactions through intermediaries could receive same-day prices. The precise impact likely will vary among different types of intermediaries, and among individual firms. In many cases, investors may no longer have the ability to obtain same-day prices.

that the strongest possible measures are necessary to ensure investor protection. Such a cut-off would significantly limit opportunities for late trading by narrowing the universe of entities responsible for applying a 4:00 p.m. cut-off time to include only the funds and their transfer agents. In addition to limiting the number of entities involved, it would restrict them to SEC-regulated entities. This would simplify both funds' compliance oversight responsibilities and regulators' examination and enforcement efforts with respect to potential late trading. In doing so, it should provide greater assurance of compliance.

We urge the SEC to proceed expeditiously to adopt this approach, and note that Chairman Donaldson has specifically asked the SEC staff to examine the feasibility of such a requirement.[8]

## III. MARKET TIMING

The ongoing investigations by the SEC and other governmental officials also involve issues relating to "market timing" of mutual funds. It is important to note that "market timing" is not a precisely defined term. Generally speaking, the term refers to a trading strategy involving frequent purchases and sales of mutual funds in an effort to anticipate changes in market prices. There is nothing inherently illegal or improper about such activity.

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[8] Donaldson Statement, *supra* note 3. We note that a reasonable period of time will be needed to allow all affected entities to make the necessary systems changes to implement new cut-off requirements. In the future, advances in technology may make it possible to devise systems (e.g., a system for "time stamping" mutual fund orders in a way that cannot be altered) that provide a high level of assurance regarding the time of receipt of an order by an intermediary. Nothing would prevent the SEC from revisiting this issue in that event.

At some level, however, frequent trading activity can be disruptive to the management of a fund's portfolio. For example, frequent trading may compel portfolio managers either to hold excess cash or to sell holdings at inopportune times in order to meet redemptions. This can adversely impact a fund's performance, and increase trading and administrative costs.[9] For this reason, many fund groups have sought to employ a number of methods designed to limit frequent trading, such as imposing redemption fees, restricting exchange privileges, and limiting the number of trades within a specified period. Many funds disclose in their prospectus that they do not permit short-term trading or that they may take steps to discourage it.

Different types of funds are affected differently by short-term trading, and higher turnover of smaller accounts has little effect on portfolio management. Funds also may seek to serve different types of investors; some funds are designed specifically to accommodate short-term trading. Thus, there is no "one size fits all" solution with respect to market timing generally.

The specific concerns that have been raised about market timing are not that funds did, or did not, have certain policies in place. Rather, it has been alleged that some funds were not applying their market timing policies fairly and consistently. A number of different steps can be taken to address these concerns, which are discussed below.

[9] In addition, as discussed in Section III.B below, abusive short-term trading activity sometimes can dilute the interests of other shareholders.

A. Written Policies and Procedures

SEC Chairman Donaldson has outlined various regulatory measures that the SEC sta considering to address the alleged practice of certain funds allowing a few investors to engag in market timing activities in a manner inconsistent with their policies.[10] These measures include new rules and form amendments to (1) require explicit disclosure in fund offering documents of market timing policies and procedures and (2) require funds to have procedur to comply with representations regarding market timing policies and procedures. The indus fully supports these measures.

While many funds already have these policies and procedures in place, requiring fun to adopt formal and detailed policies and procedures in this area will ensure that all funds ha systems in place to address abusive activity. Such a requirement should also provide a more effective mechanism for boards and regulators to police compliance because more formal policies likely would limit discretion in dealing with short-term traders. Further, mandatory adoption by funds of more formal policies should result in increased cooperation by intermediaries in their application.

Another element of Chairman Donaldson's regulatory action plan is to reinforce the obligation of fund directors to consider the adequacy and effectiveness of fund policies and procedures.[11] For example, fund boards could be required to receive regular reports on how

[10] Donaldson Statement, *supra* note 3.

[11] *Id.*

these programs have been implemented. We strongly support reinforcing board oversight in this area.

Fund shareholders also will benefit from additional prospectus disclosure about a fund's policies on short-term trading by gaining an understanding of how the fund will protect their interests from abusive activity. Requiring that such disclosure be in a fund's prospectus could serve to enhance compliance with the policies. The disclosure also could have a deterrent effect by alerting potential abusers to the fund's policies.

Additional steps are needed to address alleged abusive short-term trading by fund insiders. As noted above, this conduct, if true, is especially reprehensible. Thus, with respect to personal trading in fund shares by portfolio managers or senior executives, the Institute is urging all mutual funds to clarify or amend their codes of ethics to require oversight of personal trading activity by these persons in any funds offered or sponsored by the company.

B. Fair Valuation

An issue related to market timing is the obligation of funds to determine the fair value of their portfolio securities under certain circumstances. Much short-term trading activity appears to be motivated by a desire to take advantage of fund share prices that are based on closing market prices established some time before a fund's net asset value is set. It has been suggested that one way to address this concern is to require funds to fair value their portfolio securities more often. As part of Chairman Donaldson's regulatory action plan, the SEC staff is considering rules that would "emphasize the obligation of funds to fair value their securities under certain circumstances to minimize market timing arbitrage opportunities."[12]

The Investment Company Act establishes standards for how mutual funds must value their holdings. Funds are required to use market prices when they are available. This relies on the fact that market prices generally are objective and accurate reflections of a security's value. When market prices are not available, funds must establish a "fair value" for the securities they hold. The Investment Company Act places primary responsibility for fair valuation on a fund's board of directors. There is no definition of "fair value" provided in the Act, nor an established or required uniform method for fair value pricing inasmuch as it necessarily calls for professional judgment and flexibility.

In 2001, the SEC staff issued guidance that, among other things, discussed situations in which funds might need to utilize fair value pricing of foreign securities, even where those securities had closing prices in their home markets. In particular, the SEC staff said that, in certain circumstances, a significant fluctuation in the U.S. market (or a foreign market) may require a fund to fair value those securities.[13]

The rationale underlying the SEC staff's position is the same as that underlying the forward pricing rule discussed earlier in my testimony. To the extent that prices of foreign

[12] *Id.*

[13] Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission, dated April 30, 2001 ("2001 Valuation Letter").

securities are correlated with changes in the U.S. market, a significant change in the U.S. market that occurs after the time that a foreign market closes can indicate that the closing prices on the foreign market are no longer an accurate measure of the value of those foreign securities at the time the U.S. market closes (*i.e.*, 4:00 p.m., Eastern time). Certain investors may attempt to exploit this situation by engaging in short-term trading activity. For example, someone might purchase shares of an international fund on days when the U.S. market is up significantly, and redeem shares of such a fund on days when the U.S. market is down significantly. Like late trading activity, this can hurt other shareholders in the fund by diluting their interests.

Unfortunately, knowing when and how to fair value foreign securities in these types of circumstances is not an exact science, as there is no way to know for sure at what price those securities would have traded as of 4:00 p.m. Eastern time. Consequently, funds must exercise their best judgment in valuing these securities. In designing procedures to determine fair value, funds must take care not to introduce too much subjectivity into the valuation process. On the other hand, if fair value procedures do not provide for sufficient (and frequent enough) adjustments, then they run the risk of losing their effectiveness in protecting fund shareholders from losses due to activity of the type described above.[14]

Balancing these concerns, funds must have in place rigorous, board-approved policies and procedures concerning fair valuation. Some fund groups have developed detailed fair value pricing methodologies in-house; others are utilizing third-party service providers to assist them in valuing foreign and other securities. Either way, fair value policies and procedures should be updated as needed; as the 2001 SEC staff letter states, "funds should regularly

[14] The potential for these losses can be mitigated by imposing restrictions on market timing.

evaluate whether their pricing methodologies continue to result in values that they might reasonably expect to receive upon a current sale."[15] The ICI has published two compliance papers for its members on valuation issues, which are intended to assist them in meeting their regulatory responsibilities and in ensuring that fund share prices are fair to purchasing, redeeming and existing shareholders.[16]

It is important to note that, while fair valuation can reduce the impact of harmful trading activity, it cannot by itself entirely eliminate such trading. Accordingly, as mentioned above and discussed further below, funds often employ additional methods to deter market timing activity.

C. Tools to Deter Market Timing

The investigations referred to above involved situations where funds allegedly granted exceptions from, or did not enforce, policies against market timing. It is important to note that many funds that are susceptible to market timing have devoted significant resources to efforts to combat such activity. Frequently, however, the various means that funds have employed to deter harmful market timing activity have not proved fully effective. Funds and their shareholders would benefit if funds had additional "tools" to restrict trading activity that they determine to be harmful to their shareholders. Last year, the SEC staff responded favorably to an Institute request to permit funds to delay exchange transactions, in an effort to deter some

[15] 2001 Valuation Letter, *supra* note 13, at 7.

[16] *See* Investment Company Institute, *Valuation and Liquidity Issues for Mutual Funds* (February 1997) and Investment Company Institute, *Valuation and Liquidity Issues for Mutual Funds, 2002 Supplement* (March 2002).

market timing activity.[17] There are additional methods for combating market timers that the SEC staff should consider permitting funds to employ. One such method would be to permit funds to impose a redemption fee (which is a fee paid directly to the fund to offset the costs resulting from short-term trading) greater than the 2% limit currently imposed by the staff.

A particular challenge that funds face in effectively implementing restrictions on short-term trading is that many fund investments are held in omnibus accounts maintained by an intermediary (*e.g.*, a broker-dealer or a retirement plan recordkeeper). Often in those cases, the fund cannot monitor trading activity by individual investors in these accounts. The Canary Complaint describes this practice as follows: "Timers . . . trade through brokers or other intermediaries . . . who process large numbers of mutual fund trades every day through omnibus accounts where trades are submitted to mutual fund companies en masse. The timer hopes that his activity will not be noticed among the 'noise' of the omnibus account."[18]

Steps clearly need to be taken to enable mutual funds to better enforce restrictions they establish on short-term trading when such trading takes place through omnibus accounts. One possible approach would be to require intermediaries to provide information about trading activity in individual accounts to funds upon request. Another approach would be to require most types of funds, at a minimum, to impose a 2% redemption fee on any redemption of fund shares within 5 days of purchasing them. If funds had a standardized minimum redemption

[17] Investment Company Institute, 2002 SEC No-Act. LEXIS 781 (November 13, 2003).

[18] Canary Complaint, *supra* note 2, at par. 46.

fee along these lines, it should be easier for intermediaries to establish and maintain the requisite systems to enforce payment of those fees.[19]

We look forward to working with the SEC and other regulators and industry groups on these matters.

## IV. SELECTIVE DISCLOSURE OF PORTFOLIO HOLDINGS

The SEC and other regulators are investigating allegations concerning the selective release by funds of their portfolio holdings to certain persons. In particular, it has been alleged that some funds may have provided information about their portfolio holdings to certain shareholders in order to enable them to trade ahead of the fund, to the potential detriment of the other shareholders. Such conduct, if true, is deplorable. The industry is committed to working with the SEC to determine the best approach to deal with this matter.

One possible way to address this issue would be to require funds to adopt formal written policies in this area. The SEC could require that the policies be approved by the fund's board and that reports of instances when the information was released be provided to the board on a regular basis. In addition, funds could be required to publicly disclose their policies for releasing portfolio information. This approach would have many benefits. Similar to market timing, requiring funds to adopt formal policies would ensure that all funds have a system to

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[19] Funds should retain the flexibility to impose more stringent redemption fee standards, either in the form of higher redemption fees or longer minimum holding periods. As noted above, different types of funds are affected differently by short-term trading; hence, flexibility remains important. In addition, certain types of funds (*e.g.*, money market funds and funds that are designed specifically for short-term trading) should not be required to assess redemption fees.

prevent disclosure that is not in the best interests of shareholders. Board oversight and public disclosure would further enhance compliance with the policies. At the same time, this approach would preserve some flexibility in how funds release information. This is important because many funds release portfolio information for purposes that benefit investors. For example, they may provide it to independent services that analyze mutual funds and to certain intermediaries that provide professional assistance to help investors make decisions such as which funds to invest in and how to allocate their assets among investments.

## V. HEDGE FUND OVERSIGHT

The action brought by the New York Attorney General against Canary Capital also underscores the need for SEC oversight of hedge fund advisers. Currently, the Commission generally has access to records of trading on behalf of hedge funds through the records maintained by the brokers that the hedge fund advisers use and the markets on which they trade. The records, however, are dispersed and it is difficult to detect improper trading activities conducted by a particular hedge fund if such activities were effected through orders placed with multiple brokers and traded on multiple markets. The SEC recently issued a staff report on hedge funds[20] that included a recommendation to require hedge fund advisers to register under the Investment Advisers Act of 1940. The Institute supports this recommendation. As the Staff Report indicates, by requiring hedge fund advisers to register, the Commission would be able to more comprehensively and effectively observe the trading

[20] Staff Report to the United States Securities and Exchange Commission, *Implications of the Growth of Hedge Funds* (Sept. 2003) ("Staff Report").

activities of the funds managed by such advisers. As a result, the Commission would be in a better position to detect improper or illegal trading practices.[21]

## VI. OTHER INITIATIVES

While the regulators have been actively involved in investigating and bringing enforcement actions relating to abusive mutual fund trading practices, as well as considering new regulatory requirements to prevent such practices in the future, it bears noting that these efforts are not the only current regulatory initiatives on behalf of fund investors. Other regulatory reforms, as well as voluntary industry actions, that are underway or have recently been completed also form an important part of overall efforts to reinforce the protection and the confidence of mutual fund investors.

Current initiatives include the following:

***Fund Compliance Programs.*** In February, the SEC proposed a rule to require mutual funds to have compliance programs.[22] Generally speaking, the proposal would require (1) written compliance policies and procedures, (2) identification of persons responsible for administering the policies and procedures, (3) regular review of the policies and procedures, and (4) board oversight of funds' compliance programs. Requirements along these lines could

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[21] *Id.* at 92-95.

[22] *See* Investment Company Act Release No. 25925 (February 5, 2003).

provide an effective way to enhance protections against late trading, abusive short-term trading, and selective disclosure. The Institute generally supports this proposal.[23]

*Mutual Fund Advertisements.* The SEC recently adopted amendments to the mutual fund advertising rules to require enhanced disclosure in fund advertisements, particularly advertisements containing performance information.[24] Under the new rules, fund performance advertisements will have to provide a toll-free or collect telephone number or a website where an investor may obtain more current performance information (current as of the most recent month-end). In addition, fund advertisements will be required to advise investors to consider the investment objectives, risks, and charges and expenses of the fund carefully before investing and that this and other information about the fund can be found in the fund's prospectus.

*Portfolio Holdings and Expense Disclosure.* The SEC is expected to adopt soon a proposal that would require funds to disclose their portfolio holdings on a quarterly (rather than semi-annual) basis, and that would improve disclosure in fund shareholder reports.[25] As part of this proposal, funds would be required to disclose in their shareholder reports the dollar amount of expenses paid on a $10,000 investment in the fund during the period covered by the report. This disclosure, which would supplement the detailed fee disclosure currently required

[23] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated April 17, 2003. In our letter we suggested certain modifications to ensure that the proposed requirement accommodates existing, effective compliance structures. In order for the proposal to achieve its objective of enhancing fund compliance, it is critical that the SEC have the benefit of the input from industry experts and other interested persons.

[24] *See* Investment Company Act Release No. 26195 (September 29, 2003).

[25] *See* Investment Company Act Release No. 25870 (December 18, 2002).

in fund prospectuses, would serve to remind investors about the impact of fund expenses and assist them in comparing the expenses of different funds. The Institute supports this proposal.

*Sales Charge Breakpoints.* Many mutual funds that are sold with front-end sales charges offer discounts to investors who invest specified amounts of money. The investment levels at which investors qualify for the discounts are called "breakpoints." In late 2002 and early 2003, regulatory investigations revealed instances in which some investors did not receive the benefit of sales charge reductions to which they were entitled. Most of these situations did not appear to involve intentional misconduct. These examination findings led to several important initiatives, including the formation of a Joint Industry/NASD Breakpoint Task Force, made up of high-level NASD, mutual fund and broker-dealer representatives. The Joint Industry/NASD Breakpoint Task Force recently issued a report making a series of recommendations designed to ensure that processes are in place to ensure that investors receive applicable discounts.[26] The recommendations include additional required disclosure concerning breakpoint discounts. The Institute is working with its members, other securities industry participants and regulators on the implementation of the Breakpoint Task Force's recommendations and is committed to resolving the problems that have been identified for the benefit of mutual fund investors.

*Supplemental Payments for Distribution.* Sometimes called "revenue sharing," these arrangements involve payments by a fund's investment adviser or principal underwriter out of its own resources to compensate intermediaries who sell fund shares. The principal investor protection concern raised by these payments is whether they have the potential for influencing

[26] Report of the Joint NASD/Industry Task Force on Breakpoints (July 2003).

the recommendations of the financial intermediary that is receiving them. Disclosure concerning these payments is already required in fund prospectuses, and the Institute has long advocated additional, point-of-sale disclosure to help investors assess and evaluate recommendations to purchase fund shares.[27] The NASD recently proposed new point-of-sale disclosure requirements in this area.[28] The NASD proposal also addresses differential cash compensation arrangements, in which a broker-dealer firm pays its registered representatives different rates of compensation for selling different funds. The Institute supports the NASD proposal.[29]

***Fund Governance.*** The recent disturbing revelations have caused some to question the effectiveness of the fund governance system. We do not believe it is fair to place blame upon directors, or the fund governance system. Directors cannot be expected to unearth every instance of wrongdoing, especially if such wrongdoing took place at an unrelated entity. At the same time, it seems apparent that steps need to be taken to enhance the ability of directors to exercise their oversight responsibilities, and some of those steps are discussed above.

Overall, we continue to believe that the system of mutual fund corporate governance has served investors very well through the years. It has even served as a model for reforming the governance of corporate America. In recent years the fund governance system has undergone several enhancements. For example, in June 1999, an Institute advisory group

[27] *See, e.g.*, Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Ms. Joan Conley, Office of the Corporate Secretary, NASD Regulation, Inc., dated October 15, 1997.

[28] NASD Notice to Members 03-54 (September 2003).

[29] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Barbara Z. Sweeney, NASD, Office of the Corporate Secretary, dated October 17, 2003.

composed of investment company independent and management directors recommended a series of fifteen best practices – that went beyond legal and regulatory requirements – to enhance the independence and effectiveness of investment company directors.[30] Subsequently, the SEC adopted rule amendments designed to further strengthen the independence and effectiveness of investment company directors.[31] Last month, at the behest of the Institute's Executive Committee, the Institute's Board of Governors adopted a resolution recommending that Institute member companies adopt additional best practices with respect to (1) the treatment of close family members of persons associated with a fund or certain affiliates as independent directors and (2) the standards for investment company audit committees. The resolution also recommended that Institute members, to the extent they have not already done so, adopt the best practices set forth in the 1999 Best Practices Report.

## VII. Conclusion

The alleged abusive late trading and market timing activities recently uncovered by the New York Attorney General and the SEC are deplorable. Swift and forceful responses are necessary to make clear that there is no place in the mutual fund industry for those who would put their own interests before those of fund shareholders. The industry pledges its commitment to take any steps necessary to make sure that its obligation to place the interests of fund shareholders above all others is understood and fulfilled.

[30] Report of the Advisory Group on Best Practices for Fund Directors (June 24, 1999) ("Best Practices Report").

[31] SEC Release No. IC-24816 (January 2, 2001).

**TESTIMONY OF ARTHUR LEVITT**

**BEFORE THE**

**Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises**

**NOVEMBER 4, 2003**

Chairman Baker, Ranking Member Kanjorski, Members of the Subcommittee:

Thank you for inviting me to share my thoughts on allegations, and unfortunately, burgeoning evidence of self-dealing in the mutual fund industry.

As regulators and lawmakers examine the sale and operation of mutual funds, it is important, at the outset, to remember that mutual funds represent the best vehicle from which the individual investor can access our markets. Regrettably, the industry has taken advantage of this fact. Investors simply do not get what they pay for when they buy into a mutual fund. And most investors don't even know what they are paying for.

The industry often misleads investors into buying funds on the basis of past performance. Fees - along with the effect of annual expenses, sales loads and trading costs -are hidden. Fund directors, as a whole, exercise scant oversight over management. The cumulative effect of this has manifested itself in the form of late trading, market timing and other instances of preferential treatment that cut at the very heart of investor trust.

It would be hard not to conclude that the way funds are sold and managed reveals a culture that thrives on hype, promotes short-term trading, and withholds important information. The SEC and other law enforcement such as the New York Attorney General, no doubt, will aggressively investigate and prosecute criminal activity.

For the longer term, it's well past time to consider meaningful change in the administration and governance of mutual funds. I hope that the industry will recognize the grave threat these questions represent to its health and will embark on substantive reform itself, along with the necessary hand of the SEC. I also want to thank Chairman Baker for his reform efforts and his often lonely voice on behalf of investors.

I think reform may include the following areas:

One of the most effective checks against egregious abuses of the public trust is broken-the strict oversight of independent directors. Many so-called independent directors have professional or collegial ties with fund managers or themselves are recently retired managers. Fund boards should have only one inside director. Everyone else on the board should meet a strict definition of independence from the fund complex.

Equally important, the chairman of the fund company must be independent. That is one of the best ways to improve accountability for management practices. He or she should sit on a reasonable number of boards. For board members or chairman to be compensated for service on as many as one hundred boards is not reasonable.

During recent weeks state and federal authorities working together have uncovered egregious and sometimes criminal violations of the public trust. Such miscreant entities should be required to appoint to their boards an investor ombudsman for a defined period of time.

The largest mutual funds pay money-management advisory fees that are more than twice those paid by pension funds. It is essential that investment company boards be required to solicit competitive bids from those who wish to undertake the management function. Furthermore, boards should justify to their bosses fund shareholders- why they chose a particular investment adviser and each year demonstrate that they have aggressively and competitively negotiated management fees.

Sadly, funds have moved away from a culture of diversification and probity in favor of an almost frenetic competition to market investment products as if they were soap or beer. The fund industry should themselves proactively ban performance advertising. Such misleading hype encourages bad practices such as portfolio pumping to boost quarterly performance. Companies that do not accept the importance of change to protect their franchise and continue to promote and hype performance should be required to advertise returns only after the effect of fees and taxes has been applied. What millions of American investors currently see in magazines and newspapers is just plain deceptive.

Despite the SEC's efforts to persuade the use of Plain English, the language of the industry is still hopelessly arcane. What average investor understands the meaning of 12b-1 fees, closed-end funds, or A,B,C classes of shares? Mutual funds have a long way to go before they start talking in the language of investors.

The executives, fund managers and directors of a fund complex should be required to disclose their compensation. A fund's shareholders should know how much they are paying someone to invest their money and if the incentives of that manager's compensation is in investors' long-term interest. In addition, the trading by managers of fund shares or securities that are part of a fund's portfolio should be prohibited in favor of long-term ownership. Having run several large sales organizations I totally reject the specious argument that such practices are essential to retain competent managers of that such practices hone skills or prove commitment.

I suspect market timing issues are far greater than the industry acknowledges. For instance, the closing down of an unsuccessful fund exchanged for a new fund within the same complex could well be considered an example of a market timing strategy with funds moving back and forth between a stock and a money market fund.

The 1940 Investment Company Act states that mutual funds are to be organized and operated in the interests of shareholders. We should consider a legislative amendment that precedes those words with a statement that it is the fiduciary responsibility of directors to ensure that funds are organized and operated in such a way.

Not long ago, most investors bought directly from mutual funds themselves. Today, more than 80 percent of funds are purchased through brokers and not nearly enough of them disclose revenue-sharing deals that pay them more to put clients in a certain company's funds. The brokerage system of selling mutual funds is riddled with conflicts. Revenue-sharing, sales contests and higher commissions for home grown funds should all be banned.

I have long wrestled with the issue of soft dollars. It's clear that the practice of allowing higher commissions in return for broker-directed research has created great potential for abuse. At the very least, investors should know what commissions they are paying and what the money is going towards.

Disclose it and do it simply. More broadly,in light of the many abuses of this practice Congress should consider revisiting the safe harbor it granted to soft-dollar arrangements shortly after the abolition of fixed commissions in 1975.

"Seek simplicity and distrust it," someone once remarked. I can't help but wonder if they worked in the mutual fund industry. Mutual funds have a lot to answer for. But I've come to know many in the business and most realize that without investor trust, our markets simply can't function. I hope that they will speak out and be the voice of meaningful, yet pragmatic change. In the last year, the voices in Corporate America and Wall Street were largely silent in face of scandal. Mutual funds, given their very form and function, cannot afford to be.

Thank you.

# Statement of Don Phillips

## Managing Director, Morningstar, Inc.

## Before the U.S. House of Representatives

## Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services

## Washington, DC

## November 4, 2003

Thank you for the opportunity to appear before this distinguished Committee. My name is Don Phillips and I am a Managing Director of Morningstar, Inc., an independent investment research firm that provides data and analysis on a variety of investment vehicles, including mutual funds. Morningstar was founded in 1984 and today employs over 800 people covering more than 100,000 investments worldwide. In excess of 150,000 individual investors and 50,000 financial planners subscribe to our services in the U.S. alone. In addition, there are over two million registered users of our investment web site, Morningstar.com.

We currently cover mutual funds in 17 different countries. As such, we've seen how the fund industry has evolved in different settings with various structural and regulatory approaches. As a general rule, funds are structured in one of two ways, contractually or as corporations. When the contractual approach is deployed, the party writing the contract (the fund management company) predictably skews the contract in favor of its interests rather than of those of the investor who signs the contract. Not surprisingly, mutual funds have struggled to earn the public's trust in markets where the contractual format has been used.

The United States has long embraced the corporate structure of funds management, which is why the industry is governed by the Investment Company Act of 1940 (1940 Act), not by an Investment Product or Investment Services Act. In the U.S. and other countries where the corporate structure has been embraced, funds have enjoyed great success. The reason is clear: The corporate structure places investors' interests first. This spirit is captured in the preamble of the 1940 Act, which states that funds are to be "organized, operated (and) managed" in the interests of shareholders rather than in the interests of "directors, officers, investment advisors,...underwriters, or brokers."

The beauty of the corporate structure is that it places the investor at the top of the pyramid. An independent board of directors is created to uphold shareholder interests and to negotiate an annual contract with the money manager to provide services to the fund and its shareholders. As defined by the 1940 Act, the fund management company is not the owner of the fund, but rather the hired hand brought in to manage the assets in the interests of the its shareholders. Clearly, this is a structure that goes out of its way to prioritize and protect the interests of fund investors.

While today's fund executives live by the letter of the 1940 Act, they don't always embrace its spirit. Go to any industry gathering and you will rarely hear investors referred to as "shareholders," and even less frequently as "owners." Instead, they are "customers." In the vernacular of today's industry leaders, fund management companies are "manufacturers" of "products" that are sold through "distribution channels," such as "mutual fund supermarkets," to "customers" who operate, presumably, on the premise of buyer beware. In effect, today's fund leaders have inverted the relationship envisioned by the framers of the 1940 Act. Rather than being at the top of the pyramid, fund investors today find themselves at the bottom of the food chain. Tellingly, one of the fund industry's major debates in recent years has not been how to serve shareholders better, but "Who owns the customer, the manufacturer or the distributor?" In an era where the hierarchy of the investor has been so altered, it is perhaps not surprising that investor protection has lapsed.

Despite these issues, it is our opinion that the mutual-fund industry is neither inherently corrupt nor in need of a major structural overhaul. While the boundaries may need to be clarified, it is not necessary to organize a whole new playing field. The vast majority of people in the fund-management industry, as in any line of work, are honest and hard working. Collectively, they provide a valuable service to the American public. Moreover, the U.S. fund industry does have a good long-term record of serving investors. This record owes not to the superior moral nature of fund executives, but rather to the industry's high level of transparency that has been brought about by the corporate structure of funds. To the extent that the industry has lost its way in recent years, we believe that it is a function of its leaders losing sight of the spirit of the 1940 Act. The profitability of the fund management company or its employees must never take precedence over the interests of fund shareholders.

In Morningstar's opinion, H.R. 2420, also known as the Baker Bill, aptly sought to bolster the 1940 Act. Its adoption, especially in a strengthened version, would go a long way toward better protecting the 95 million shareholders who put their faith in mutual funds. As for other issues this committee might consider in its efforts to protect investor interests, Morningstar would like to submit the following four principles as a possible path toward restoring the public confidence in mutual funds—a confidence that has been badly battered in recent months.

### 1. Apply the Same Disclosure Standards to Investment Companies as to Publicly Traded Operating Companies

If mutual funds are indeed corporations, let's treat them as such. Unless there's a compelling reason to draw the lines differently, there's no good reason to treat publicly traded investment companies (mutual funds) any differently than publicly traded operating companies (stocks). However, because equity shareholders have historically had a louder voice than have fund shareholders, it's not surprising that disclosure standards for stocks remain far higher than those for funds in many areas. It's time for someone to speak up for fund shareholders and level the playing field. This Committee has an opportunity to do just that.

For fund investors to know if their interests are aligned with management's, it's imperative for them to know what their manager's incentives are. Every week, we speak with mutual fund portfolio managers who tell us that before they buy stock in a company, they look to see how management is compensated. They want managers who "eat their own cooking" and who's interests are aligned with theirs. That's why institutional equity managers have long demanded and received detailed information on the compensation and holdings of company stock of senior corporate executives. Indeed, equity investors would protest loudly if this information were denied to them. Why then are fund shareholders not given the same insights into their funds?

Consider the case of a manager's holdings or trades in his or her fund. An equity investor has access to detailed information on the purchases, sales, and aggregate holdings of senior executives and other insiders at an operating company. Stunningly, fund investors are denied access to the very same data about the managers of their funds. While it's easy to appreciate why management might not wish to provide such data, it's hard to argue why an investor shouldn't have the right to see it. Indeed, such sunlight might well have been beneficial in the recent cases of four Putnam portfolio managers or Strong Fund's chairman Richard Strong, who have been accused of market timing their own funds. Can you imagine these executives engaging in such actions if they knew that it would become public information that they were trading so rapidly? Sunlight, indeed, is the best disinfectant.

Not only is there no trading record for managers in their own funds, but even the aggregate investment a manager has in his or her own fund is shielded from the fund shareholders' view. While any equity investor can see how many shares Bill Gates owns in Microsoft, there's no way for a fund investor to see if his or her manager has any "skin in the game." In the wake of the recent fund scandals, several mutual fund portfolio managers have stated publicly that because they invest heavily in their own funds, the kinds of trading abuses seen in other shops would not happen at theirs. This statement is a virtue that any fund manager can claim, but none has to prove. Why would such information that has long been disclosed on corporate insiders, not be available on fund insiders? It's time to level the playing field.

The same principle applies to management compensation and the incentives it creates. Disney shareholders know to the penny what Michael Eisner is paid to run their company. Like all holders of publicly traded stocks, they receive a statement from the compensation committee with their annual proxy materials outlining how the committee has structured the CEO's pay and on which metrics his or her bonus is based. Indeed, it is not uncommon for these materials to include a CEO's entire employment agreement. Given the high level of disclosure on operating companies, it is hard to reconcile why no disclosure whatsoever is provided on fund executive compensation.

Fund investors do not know if their manager's bonus is tied to short-term, quarterly returns or to rolling five-year returns, to pre-tax or post-tax returns. If the manager's pay is linked to pre-tax returns, surely a manager will be less likely to be concerned about the tax consequences of his or her decisions. How can this not be material information to an investor considering placing a fund in either a taxable account or an IRA? In addition, one would hope that a fund manager's compensation is tied to fund performance rather than a fund's asset growth. A manager's incentive should be to manage, not to sell. But, with no compensation disclosure, how can a fund investor be sure?

### 2. Bring More Visibility to the Corporate Structure of Funds and the Safeguards it Provides

The typical fund investor is largely unaware of the corporate structure of funds. Few investors in, say, Fidelity Magellan think of themselves as the owners (alongside their fellow shareholders) of the fund. Instead, they think that Fidelity owns Magellan and they merely purchase its services. It's a notion that the fund industry doesn't discourage. Indeed, funds do little to draw attention to their corporate structure or to the role of the board of directors. In fact, the names and biographical data of fund directors are not even included in many fund prospectuses, but instead are relegated to the seldom-read statement of additional information.

To remedy this situation, Morningstar suggests that each fund prospectus begin with an explanation of the fund's corporate structure, such as the following:

*When you buy shares in a mutual fund, you become a shareholder in an investment company. As an owner, you have certain rights and protections, chief among them an independent board of directors, whose main role is to safeguard your interests. If you have comments or concerns about your investment you may direct them to the board in the following ways...*

By bringing more visibility to the fund's directors and by alerting shareholders to their role in negotiating an annual contract with the fund management company, the balance of power may begin to shift from the fund management company executives where it now resides to the shareholders and directors where it belongs.

It's not surprising that independent directors have been subservient to the needs of the fund management companies, rather than to shareholders. Directors have far more contact with management than they do with fund shareholders. Indeed, several years ago I met a director who served on the board of many funds at a large fund complex. He also served on the board of a Fortune 500 company. He told me that while he received a dozen or so letters a month from shareholders concerning the public company, he had never in more than 10 years received a letter from a fund shareholder. How can fund directors represent shareholder interests if there is no communication between the two groups?

We'd suggest three more things regarding fund directors. First, we believe it is highly beneficial, if not essential, that the chairperson of the fund board be an independent director. While in U. S. operating companies the chairperson and the CEO are often the same, there exists a conflict of interest in funds that does not exist in operating companies. In an operating company there is only one party to which directors, be they independent or not, owe their loyalty—the stockholders. In a mutual fund there are two parties to which the non-independent directors owe their allegiance, one is the fund shareholders, the other is the stakeholders in the fund management company. Only the independent fund directors have a singular fiduciary responsibility to fund shareholders. Accordingly, it stands to reason that fund shareholders are best served when an independent chairperson oversees their fund.

Our second suggestion would be that this independent chairperson be responsible for writing to fund shareholders in the fund's annual report to address the steps the board takes each year in reviewing the manager's performance and the contract that the fund has with the fund management firm. By bringing to light these important review functions, one assures that the structural safeguards of the investment company will work in practice as well as in theory.

Third, we'd advocate a stronger role for fund directors in reviewing all communication between the fund management firm and fund shareholders, including marketing materials designed to attract new investors. The fund's communications and marketing message should effectively communicate the fund's investment strategy and the potential risks it may incur. The better an investor understands a fund, the more likely he or she will use it effectively.

### 3. Insist that Fund Management Companies Report to Fund Shareholders as They Would Owners of the Business

While the above steps begin to address shareholder reporting, there is particular room for improvement in the way that costs are communicated to investors. If one were reporting to an employer on how much of the boss's money had been spent and what it had been spent on, the expectation would be for a full and candid disclosure that quickly conveyed the actual cost to the owner. If there were multiple owners, the costs would be divided so that each owner could quickly see the dollar cost he was incurring. That's not the case with mutual funds. Funds state their costs in percentage terms, not dollars, and they state them as a percentage of assets entrusted to the manager, not in terms of the percentage of the investor's potential gain that has gone to management fees—potentially a far more relevant number.

For example, an investor with $300,000 in a bond fund is currently told that his fund has an expense ratio of 1.5%. However, if an investor expects bonds to return 5% per year over the course of his investment horizon, that 1.5% expense ratio in reality reflects a 30% annual toll on the likely returns he will receive from their investment. While establishing expected returns for asset classes is problematic, it's clear that the real toll of fund fees is dramatically understated (1.5% versus 30%) in the way funds currently report them to shareholders. One solution, as contemplated in the discussions surrounding the Baker Bill this past summer, is to simply state that a $300,000 investor in a fund with an expense ratio of 1.5% will face a bill for asset management services of approximately $4,500 per year. As Vanguard founder John C. Bogle has already told this committee, this calculation could be easily estimated by multiplying a shareholder's end-of-period account balance by the fund's expense ratio and printing this figure on the investor's annual account statement.

For many middle-class Americans, mutual-fund management fees are now one of their 10 biggest household costs, yet the same individual who routinely shuts off every light in their house to shave a few pennies from their electric bill is apt to let these far greater fund costs go completely unexamined. Getting these fees stated in a dollar level that corresponds with an investor's account size is an important first step. We have truth-in-lending laws that detail to the penny the dollar amount a homeowner will pay in interest on his mortgage, isn't it time for a truth-in-investing law that would bring the same commonsense solution to mutual funds, the retirement vehicle of choice for a whole generation of Americans?

Of course, as this committee has previously heard from Mr. Bogle, stated fund expenses are only part of the bite investors face when they buy funds. There are also transaction costs and hidden soft-dollar charges that are hard for even the most astute investor to get her arms around. The Baker Bill took the appropriate steps in seeking to address these issues. Fund investors deserve to see how their money is being spent. Costs should be broken down into investment management costs, operational costs, and distribution costs, including "pay-to-play" arrangements with distributors. We'd like to see the expense ratio broken down into the preceding three parts and see a new transaction cost ratio that combines brokerage costs and the frictional costs of trading added to fund statements. While there are aspects of such a ratio that would require industry discussion, any attempt to give investors a truer sense of the full costs they pay would be a step closer to reporting to owners in a manner consistent with their position as owners.

### 4. Ensure That All Shareholders Are Treated Fairly

Our final point is one that we wouldn't have thought needed to be raised six months ago, but in the wake of the recent fund trading scandals, it has become a significant issue. Funds face a challenge in trying to serve concurrently the interests of traders and long-term investors. While most funds promote themselves as vehicles for long-term investing, their daily valuation and liquidity options make them targets for active traders, such as market timers. There's nothing wrong with funds serving either audience, but as recent events make clear there are times when it is difficult to serve both together.

The most basic answer to the trading challenges is to remove the potential for arbitrage in mutual funds. Traditionally, funds invested primarily in domestic blue-chip stocks and investment-grade bonds—highly liquid securities that started and stopped trading at essentially the same time. Today's funds, however, trade in everything from U.S. micro-cap stocks to Asian private placements—securities that often do not lend themselves to ready pricing at 4 p.m. Eastern time. Clearly, the SEC and the industry need to adopt fair policies to ensure long-term investors that their interests can't be undermined by traders who exploit these opportunities for arbitrage. The desires of a few must not undermine the rights of the many.

In addition to fair-value pricing policies, it is worth considering the implementation of higher redemption fees for short-term trades. From our conversations with fund managers, it is clear that they believe that redemption fees are the best deterrent to market timers. Of course, a fee is only effective if it is enforced. We think funds must be much less lax in waiving fees for bigger accounts or for 401(k) plans, and that directors should by informed when and under which conditions these fees may be waived. In addition, we support a hard close for mutual fund pricing. If a trade order is not in the fund's possession by 4 p.m. Eastern time, it should be transacted at the next day's price. This may mean some funds will become less attractive to some investors, but over time both parties—traders and long-term investors—may be better off by parting ways. In either case, funds need to be clear which audience they serve. If a fund pledges to act in the best interests of long-term investors, it must find a way to eliminate the potential damage that can be done to them by short-term traders.

Collectively, legislators, regulators, and the industry can rebuild and preserve the public's trust in mutual funds by putting stronger structural elements in place that better align fund management company interests with those of fund shareholders. By bringing more visibility to the corporate structure of funds and by leveling the playing field between publicly traded operating companies and investment companies, this Committee can demonstrate to American investors that mutual funds will continue to operate on one of the cleanest, best-lit playing fields in all of finance. The industry doesn't need a wholly new set of operational rules or new oversight groups, it simply needs to be held accountable to both the letter and the spirit of the rules that have guided it well for decades. We believe the simple improvements suggested here can help keep the industry focused on its ultimate mission—helping investors meet their goals and secure a safer future for their families.

**State of New York Attorney General**
**Eliot Spitzer**

**Before the United States House of Representatives**
**Committee on Financial Services**
**Subcommittee on Capital Markets, Insurance**
**and Government Sponsored Enterprises**
**Washington, D.C.**
**November 4, 2003**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Permitting market timing and late trading were not the only examples of the failure of fund directors to protect their shareholders' interests. Perhaps most costly to shareholders is the directors' total abdication of any meaningful effort to negotiate lower advisory and management fees. In 2002, it is estimated that mutual funds paid advisory fees of more than $50 billion and other management fees of nearly $20 billion. That does not even include the tens of billions that the funds spend on trading costs – costs that are no doubt significantly increased by the heavy trading of market timers.

And the fees paid by the mutual funds – or, more precisely, the fees that are paid by mutual fund shareholders -- seem to defy the laws of economics. As my good friend Jack Bogle has pointed out, mutual fund shareholders do not benefit from the economies of scale in the industry: mutual fund assets grew by sixty times between 1980 and 2000, but the funds' fees and expenses grew by ninety times during that same period.

Studies have revealed the extent to which mutual fund investors pay advisory fees that are simply too high -- too high because the fund directors are compromised and do not negotiate hard for their shareholders. A study published in 2001 exposed the fact that mutual funds pay significantly higher advisory fees than pension funds. Mutual funds often pay more than 25 basis points more for advisory services than pension funds pay, even when it is the same advisory company providing the identical advisory service to both the pension and mutual funds.

Why the higher fee? Because fund directors do not -- and can not -- negotiate hard on the fees. Why not? What else would you expect when the chairman of the mutual fund is also the chairman of the advisory company?

And make no mistake about it, 25 basis points matters. A couple that invested their $100,000 retirement nest egg for ten years and received an 8% annual return would receive an increase of almost $6,000 if their advisory fees were reduced by 25 basis points.

A 25 basis point reduction in the advisory fees that all mutual fund shareholders pay would result in a staggering savings to investors of more than $10 billion annually!

The fact is that in no other industry would a board of directors be permitted to issue billions of dollars in no-bid contracts annually. Yet that is par for the course in the mutual fund industry, where the fund directors essentially contract out for all of the fund's operations. We must not permit this to continue.

Mutual funds that permitted improper market timing and illegal late trading must be required to provide restitution to their investors and to disgorge all profits that they earned in connection with those activities. The managers also must disgorge the advisory fees received during the time that they were mismanaging the funds by permitting timing and late trading.

In addition, as with our investigation of conflicts in Wall Street research, any resolution of the inquiries into the mutual fund industry must require structural reforms that will realign the interests of the funds with the interests of their shareholders.

We must require mutual funds to maintain truly independent boards of directors -- with an independent chairman -- that take an active role in overseeing the trillions of dollars that shareholders have entrusted with them. The boards can begin to demonstrate that they have earned that trust by negotiating hard for lower fees from the advisory and management companies. The managers must know that if they do not lower their fees and improve their performance, they will be replaced. That is what happens in every other sector of the economy, and that is what must happen in the $7 trillion mutual fund industry.

While this is by no means an exhaustive list, some of the steps necessary to achieve these reforms are:

1. Requiring mutual funds to demonstrate that they have negotiated advisory and management fees that are in the best interest of their shareholders. This can be done by obtaining multiple bids, an independent evaluation or appraisal, or by some other means that ensures that shareholders are getting the best deal possible.

2. Requiring mutual funds to obtain most-favored nations clauses in their contracts. This will prevent advisory and management companies from charging them fees in excess of those paid by pension funds.

3. Requiring mutual funds to have an independent Board chairman with no relationship to the advisory and management company, and providing that chairman with the authority and ability to demand and receive any and all information from the fund advisory and management company.

4. Requiring independent directors to be truly independent of the advisory and management company.

5. Requiring mutual funds to provide their directors with the staff and data necessary to ensure that shareholder interests are being protected. This may require moving the compliance function from the management companies to the mutual funds themselves.

6. Requiring mutual funds to provide a uniform, complete and categorized disclosure of the fees that they pay for advisory services, management and marketing services, and trading costs.

These reforms would begin the process of restoring the rights and interests of shareholders and vindicating the Investment Company Act's promise to shareholders that mutual funds will be organized, operated and managed in the interests of the funds' shareholders and not the funds' directors, officers and investment advisors.

They can be achieved in a variety of ways – through legislation in Congress, regulation by the S.E.C. or other regulatory bodies, or as the terms of a settlement of current and future investigations. Our investigations are continuing, and we may turn up other abuses as well. Questions have already been raised about 12b-1 fees, soft dollar transactions, and undisclosed financial incentives for brokers to sell particular funds and particular classes of shares to investors. Some of these issues are addressed in H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act.

The S.E.C. enforcement staff does a terrific job. They are aggressive, tough, smart prosecutors. I remain committed to working together with them and others as we continue our investigations and think about solutions. But there must be a fundamental change of mindset that invigorates those who formulate policy and regulations at the S.E.C. to more actively and aggressively prevent mutual funds from acting against their shareholders' interests.

All of us here today -- lawmakers, regulators and industry officials -- have a duty to make sure that happens.

Testimony of

E. Scott Peterson

Global Practice Leader of Defined Contribution Services

Hewitt Associates

Submitted for the Record

U. S. House Committee on Financial Services

Subcommittee on Capital Markets

Hearing on

Mutual Funds: Who's Looking Out for Investors?

November 4, 2003

## Summary

Hewitt Associates is the largest human resources outsourcing and consulting firm in the U.S. and the second largest such firm worldwide. We are the largest independent recordkeeper -- i.e., not an affiliate of an investment management organization -- for 401(k) retirement plans, serving more than 5 million plan participants.

As a 401(k) recordkeeper, we receive, record and communicate investment decisions made by plan participants. Current SEC rules require that orders to purchase or redeem fund shares must be received by the fund before the close of trading in fund shares if they are to receive that day's closing price. Typically this is by 4 p.m. Eastern Time (ET), which we will refer to in our comments as the closing time. We have very clear procedures and processes electronically and in writing about how participants' investment decisions are received, recorded and communicated. These processes and procedures are in adherence with regulatory standards. No exceptions are allowed. In order to completely perform these processes, Hewitt and other recordkeepers enter into agreements with mutual fund organizations whereby we become an agent of the fund. It is the absolute legal and contractual standard that Hewitt and other 401(k) recordkeepers impose a 4 p.m. ET cutoff by which participants must make their investment decisions in order to receive the current day's closing price.

**Illegal After-Hours Trading**: Given the importance of 401(k) plans to tens of millions of participants, any practice that undermines the fairness and trustworthiness of the system—such as illegal after-hours trading—must be promptly and appropriately remedied. Yet, it is also essential that the remedy not inadvertently undermine the 401(k) system. For example, if new rules were to mandate that 401(k) recordkeepers must complete all the needed processing before 4 p.m. ET, that would require the 401(k) plan to cut off participant transaction requests much earlier than 4 p.m. to get that day's price. 401(k) participants would be disadvantaged relative to other fund shareholders, and there would also be significant additional costs of needlessly re-engineering current systems and procedures. As an alternative, Hewitt suggests that enforcement of existing rules be reinforced by requiring recordkeepers that are fund agents to demonstrate that strict audit and review standards are in place to prevent after-hours trading. These strict audit and review standards would involve both design and practice. We ask that any remedy to curb illegal after-hours trading activity be weighed carefully given the large number of individual investors who are likely to be affected, and the fact that any solution is likely to require time -- and potentially material cost -- to implement.

**Excessive Trading**. Hewitt shares the concerns regarding excessive trading that has occurred within investment funds (particularly international funds). We believe it is in the best interest of 401(k) plan participants for an industry-wide standard to be adopted. The cost to administer unique rules for each individual fund manager can become prohibitive. This is a cost that will ultimately be absorbed by the plan sponsor and their participants. We have worked with many fund managers and 401(k) plan sponsors to find appropriate ways to curb this activity among a small group of market timers. Of critical importance, our research has found that redemption fees that are too low (e.g., 1 percent), are effective in slowing down this activity, but are often not very effective in stopping it. On days of wide swings in the market, a redemption fee may not be enough to remove the potential upside of a market timing strategy. One alternative remedy Hewitt has developed is "Aging of Monies," whereby money that is transferred into a restricted fund cannot be transferred out for a set period of days. While the number of days is variable, our research suggests that a limitation of seven days is sufficient to curb the activity.

Mr. Chairman and Members of the Subcommittee:

On behalf of Hewitt Associates we thank you for holding this important hearing and we are pleased to submit this testimony for the record.

My name is Scott Peterson, I am Hewitt's Global Practice Leader for Defined Contribution Services. Headquartered in Lincolnshire, Illinois, Hewitt is the largest human resources outsourcing and consulting firm in the U.S., and the second largest firm worldwide. In North America alone, we employ about 13,000 associates, of whom approximately 7,000 are based in Illinois.

We are the largest independent recordkeeper (i.e., not an affiliate of an investment management organization) for 401(k) retirement plans, serving approximately 5 million employee participants. We would like to share with the Subcommittee the experience of 401(k) participants and discuss how they might be affected under various approaches that may be considered by the Subcommittee and/or the Securities and Exchange Commission.

The two broad issues we would like to address are:

- Illegal after-hours trading in mutual funds
- Market timing and excessive trading in mutual funds, particularly international funds

Tens of millions of workers rely on 401(k) plans as one of the cornerstones of their retirement security. In fact, in a 2003 Hewitt Associates survey of nearly 500 plan sponsors, a majority of plan sponsors (55 percent) described their 401(k) plan as the primary retirement vehicle available to their workers. 401(k) plans are popular because they offer certain tax advantages (and often company matching contributions) that encourage workers to voluntarily invest in the plan, saving part of their current income for retirement. According to a recent Hewitt survey, 96 percent of plans offer employer contributions. Workers benefit from the ease of automatic deductions from their pay into the plan, and from plan sponsor oversight of the investment funds in which participants in 401(k) plans entrust their retirement money. 401(k) plans are also relied upon by workers as trustworthy, transparent, fair, and cost effective.

## Illegal After-Hours Trading

Given the importance of 401(k) plans to so many U.S. workers, any practice that undermines the fairness and trustworthiness of the system—such as illegal after-hours trading—must be promptly and appropriately remedied. Yet, it is also essential that the remedy itself does not inadvertently undermine the 401(k) system. For example, attempts to curb illegal after hours trading by simply changing current trading rules outright could put at risk the fairness and potentially even the cost effectiveness of 401(k) plans for participants.

**Role of the Recordkeeper**

As background, it is important to understand the role of the defined contribution recordkeeper. Recordkeepers receive, record and communicate the investment decisions made by 401(k) participants. Current SEC rules require that orders to purchase or redeem fund shares must be received by the fund or its agent before 4 p.m. Eastern Time (ET) if they are to receive that day's closing price. Hewitt and other recordkeepers enter into agreements with mutual fund organizations whereby we become a designated agent of the fund. It is the absolute legal and contractual standard that Hewitt and other 401(k) recordkeepers impose a 4 p.m. ET cutoff by which participants must make their investment decisions (without exception) in order to receive the current day's closing price.

Once transaction requests are received by 4 p.m. from plan participants, the recordkeeper engages in the extensive processing and calculations that are required in order to complete daily processing. In addition to calculating the value of a single holding, the recordkeeper executes additional processes required to ensure compliance with retirement plan rules (e.g., vesting calculations, rules determining withdrawal amounts or other benefit payments) as well as regulatory requirements (e.g., regulatory caps on amounts that can be borrowed from participant accounts). Many of these processes require that account values be determined before specific calculations can be made. Once the processing has occurred, the recordkeeper communicates the transaction requests to fund companies, generally within several hours of the 4 p.m. cutoff. Here is an illustration of how it works.

| | | | | |
|---|---|---|---|---|
| **Monday, 3:59 p.m. Eastern Time: 401(k) participant submits transaction request, which is time-stamped** | → | **Later that night: Recordkeeper processes time - stamped fund transaction** | → | **Fund company completes the transaction using Monday's closing price (the net asset value or N.A.V.)** |
| **Monday, 4:01 p.m. Eastern Time: 401(k) participant submits transaction request, which is time-stamped** | → | **Tuesday night: Recordkeeper processes time-stamped fund transaction** | → | **Fund company completes the transaction with Tuesday's closing price (N.A.V.)** |

**Impact of Potential Rule Changes**

One option reportedly under consideration would change the current regulations by requiring that *all* entities, including 401(k) recordkeepers, submit mutual fund trades to the mutual fund by 4 p.m. ET. For 401(k) plans, this would effectively mean that for 401(k) recordkeepers to complete their 401(k) processing, 401(k) investors would need to make their investment decisions several hours earlier than 4 p.m. ET. This would be a substantial change within the 401(k) system and place 401(k) mutual fund investors at a comparative disadvantage with respect to other fund shareholders. For 401(k) participants who do not meet the earlier transaction deadline, but who do trade prior to 4 p.m. ET, such a change in regulations would result in such participants' transactions being executed at the next day's price. Employees would have to submit their trades as early as the start of the business day on the West Coast to account for the time difference and the time needed to process the investment requests. Effectively, these 401(k) participants would be trading under different rules than other investors. An investor with money in Fund XYZ in the 401(k) plan who submitted his or her trade at 3:59 p.m. would receive a different price than an investor with money in Fund XYZ outside of the 401(k) plan who placed a trade directly with the fund at the same time. This different treatment could undermine the value of the 401(k) plan in the eyes of plan participants.

Such a change in the existing rules would also increase costs that are likely to be passed through to plan participants. It would result in significant re-engineering of existing defined contribution processing systems. According to Hewitt's recent survey, 93 percent of 401(k) plans offer daily pricing and transfers of existing balances. Over the past 15 years, highly efficient, automated processes have been developed to support these plans. The impact of a substantial, sweeping change in processing systems would affect the vast majority of plans, with the possibility that the cost of implementing such substantial changes could increase the cost of administering—and therefore affect the offering—of plans to participants.

**Alternative Solutions**

Given the impact on 401(k) plans and participants, Hewitt believes that a reasonable alternative to a strict 4 p.m. cutoff for 401(k) recordkeepers would involve requiring recordkeepers to demonstrate that strict audit and review standards are in place to prevent after hours trading. These strict audit and review standards would involve both design and practice.

***Design***

The provider would need to demonstrate that its infrastructure includes the appropriate processes to ensure trades have been accepted prior to the 4 p.m. cutoff. For example, all trades entered into the provider's system would receive an automated time stamp. The provider then would apply the necessary calculations and requirements against the trade requests received by the cutoff, combine these requests and then send them to the fund company later in the day.

***Practice***

The recordkeeper would engage in regular audits of actual activity to verify that the relevant processes are being enforced in practice. Hewitt recommends regular audits of providers' processes in order to determine compliance within the existing rules. The SEC, mutual fund industry, or another third party working with fund transfer agents could be responsible for performing regular audits with these trading partners. And the audit results could be made available for inspection by the SEC. In fact, Hewitt is already registered as a transfer agent and is subject to the regulatory control of the SEC.

**Conclusion on Illegal After-Hours Trading**

To summarize: it is critical that any steps taken to remedy illegal after-hours trading take into account the impact on 401(k) plans central to the retirement income security of tens of millions of U.S. workers. Changing the regulations regarding the 4 p.m. cutoff will impact 401(k) plans adversely by creating a two-tier system of trading—one for investors who transact directly with mutual funds outside of 401(k) plans, and one for investors within 401(k) plans. In essence, the 401(k) investors would be put in the situation of being "second tier" under the proposed regulations. It could also create more costs for 401(k) plans.

In reviewing the history of abuses of after hours trading, it is clear that 401(k) investors—with median balances of $16,000—are not the source of these abuses. Yet, the brunt of the change in regulations would directly affect these investors.

A better remedy lies in allowing recordkeepers the opportunity to demonstrate that rigorous processes are in place to prevent illegal after-hours trading. This can be accomplished through a cooperative effort between recordkeepers, brokers, mutual funds, and the government in establishing a standard for a secure processing system, and a rigorous enforcement procedure. In this way, after hours trading abuses could be curbed within the 401(k) industry, without adversely affecting the average 401(k) participant.

We ask that any remedy to curb illegal after-hours trading activity be weighed carefully given the large number of individual investors who are likely to be affected, and the fact that any solution is likely to require time -- and potentially material cost -- to implement.

## Excessive Trading

Hewitt appreciates and shares the concerns regarding excessive trading within investment funds (particularly international funds). We have worked with fund managers and 401(k) plan sponsors to find appropriate ways to curb this activity when it occurs as we recognize the harm such activity can do to long-term shareholders. We are also committed to working with the appropriate industry groups and regulatory bodies to find common and effective solutions to address this issue, as we feel this is ultimately in the best interest of all 401(k) plan participants.

**Background on Excessive Trading Strategy**

A small number of 401(k) plan participants have been able to take advantage of a trading strategy that has long been discussed in academic circles. This is the same strategy that has been reported as being employed by other investors, including some hedge funds.

Specifically, mutual funds are valued at the close of the market in the U.S. Investors who execute transactions in a mutual fund before 4 p.m. ET have their trades valued at that day's Net Asset Value (NAV). To set the fund's NAV, fund companies typically value the individual securities within their funds based on the closing price of those securities within their local markets. However, in the case of international securities held in the funds, those values may have been determined many hours prior and thus could be considered "stale." News that could affect the "fair value" of those securities could have been released after the close of the local markets but before mutual fund investors are required to place their trade orders in the U.S.

Often, this "news" is in the form of a large market rally or decline in the U.S. market. There is a significant correlation of large changes in the U.S. market with subsequent changes in foreign markets. While a rally in the U.S. market will often result in a rally in foreign markets, those markets have often been closed for several hours and thus their current day closing market prices do not reflect this news. However, when those markets open the next day, the securities traded in that market will be able to react.

Thus, a typical strategy of a market timer is to take advantage of this mispricing by buying into the international fund on the day of a U.S. market rally and then selling out of the international fund a day or two after the purchase, at a higher value, often putting their money in to a more conservative option such as a money market or stable value fund. The following is an illustration.

| | | |
|---|---|---|
| **Day 1:** **Strong rally in S&P 500** | **Day 1:** **International markets have been closed several hours and have not reacted to the news.** | **Day 1:** **Speculator buys shares of international mutual fund valued based on closing market prices in local markets.** |
| **Day 2:** **International markets rally in reaction to U.S. rally.** | **Day 2:** **International fund experiences significant gain in value.** | **Day 2:** **Speculator sells shares to realize the gain in value of mutual fund shares.** |

**Excessive Trading Within the 401(k) Marketplace**

This trading strategy has found its way in to the 401(k) marketplace. Overall, the number of participants who engage in this activity is very small. Most participants do not trade actively in their 401(k) accounts. Hewitt research finds that only 5 percent of 401(k) participants made more than 10 trades in their account in 2002.

There are some unique features to the 401(k) marketplace that, if unchecked, can allow participants in a company-sponsored 401(k) plan to take advantage of this market-timing strategy. That being said, there are also proven remedies that can restrict a plan participant from engaging in this behavior. Hewitt is committed to implementing these strategies, in conjunction with plan sponsors and their fund managers. We also recognize the need within the recordkeeping industry for a standard approach to addressing this issue.

As the 401(k) industry has evolved, plan participants have benefited greatly from platforms that offer a broad choice of investment options from a variety of fund managers. Further, because of their tax-deferred status, participant transfers within 401(k) plans are not subject to the immediate tax consequences of frequent trading. In addition, because of their institutional nature, 401(k) plans are designed to provide participants with a low-cost, daily trading environment, where fees such as "loads" can be waived. Such features have made 401(k) plans attractive investment vehicles for long-term retirement savings. However, some participants have taken advantage of this low cost trading platform by engaging in the market timing activities outlined above.

**Remedies for the 401(k) Marketplace**

We believe it is in the best interest of 401(k) plan participants for an industry-wide standard to be adopted. The cost to administer unique rules for each individual fund manager can become prohibitive. This is a cost that will ultimately be absorbed by the plan sponsor and their participants.

Due to the absence of an industry-wide standard to stop excessive trading, one alternative remedy Hewitt has developed is "Aging of Monies," whereby money that is transferred into a restricted fund cannot be transferred out for a set period of days. While the number of days is variable, our research suggests that a limitation of seven days is sufficient to curb the activity.

We developed this approach after conducting research of participant trading activity after various restrictions were put into place, and after consulting with plan sponsors and fund managers. We have found this approach to be extremely effective in curbing excessive trading, more than any of the other approaches that we have studied. In one plan that adopted this "Aging of Monies" approach, the average daily trading volume in that fund dropped by 98.7 percent in the 30-day period after the restriction was put in place. In addition, in the 30-day period prior to implementation, the largest daily trading activity equaled 62.2 percent of the total plan balances. In the 30-day period after the restriction, the largest single trading day equaled 0.5 percent of the total balances.

While we recognize that redemption fees have been suggested to stop the activity, Hewitt does have some reservations about this approach. The need to set accounting processes for those accounts and to administer the movement of those fees will raise additional costs to plan participants. Most importantly, our research has found that redemption fees that are too low (e.g., 1 percent) are effective in slowing down this excessive trading activity, but are often not very effective in stopping it. On days of wide swings in the market, the threat of a redemption fee may not be enough to remove the potential upside of a market timing strategy.

**Conclusion on Excessive Trading**

Hewitt is dedicated to finding a solution to stop the market-timing behavior that a few participants in 401(k) plans have followed. In the interest of the average 401(k) investors, we think it is critical to retain features such as daily valuation, investment choice, tax deferral, and low cost trading, in order to provide participants with an attractive vehicle in which to invest their retirement savings. At the same time, we strongly endorse the implementation of an industry-wide standard to address the market-timing behavior that many plan sponsors and their recordkeepers are working to stop.

**Subcommittee on Capital Markets,**
**Insurance and Government Sponsored Enterprises**

**Hearing entitled, "Mutual Funds: Who's Looking Out for Investors?"**

**Tuesday, Nov. 4, 2003**

**Responses to Questions Submitted by Rep. Sue Kelly to Mr. Stephen M. Cutler, Director, Division of Enforcement, Securities and Exchange Commission**

Question 1

In the Senate hearing on November 3, Mr. Spitzer stated several conditions that companies will have to meet to "get a settlement with me." [*In summary, Mr. Spitzer revealed that companies will have to: 1) assure a compliance program that will guarantee that no violations occur again; 2) provide full disgorgement of all fees earned related to any fund during the time that illegal behavior occurred.*]

a) Did you work with Mr. Spitzer on these conditions?

b) What are your thoughts on these conditions Mr. Spitzer laid out?

c) Do you see this shaping up to be another Global Settlement, or is it too premature to tell at this time?

d) Does talking about a settlement in the cases of mutual fund fraud take prosecution and criminal charges off the table? Do you have enough information to make this determination at this time?

Answer

The SEC staff did not work with Mr. Spitzer to develop the conditions he identified as necessary to settling cases with the New York Attorney General's Office. We were aware of his belief, however, that it was important for firms to disgorge all fees earned while violations were being committed. As for settlements with the SEC, we intend to evaluate each action independently to determine what relief is most appropriate in that particular situation. Like Mr. Spitzer, we believe that compliance reforms, restitution/ disgorgement, and significant penalties are important components of any final settlement of a case relating to abusive market timing and/or late trading.

Currently, the SEC is addressing the violative conduct in the mutual fund area on a case-by-case basis. This seems to be working well. For this reason, and in light of the Commission's aggressive rulemaking agenda on mutual fund issues, which would implement change on an industry-wide basis, we do not anticipate a need for a global settlement of the type we pursued in the research area.

The decision to settle a civil SEC enforcement action is unrelated to the SEC staff's determination whether to refer a matter to the criminal authorities. The SEC staff refers a matter to the criminal authorities for investigation and possible prosecution based on a number of factors, including (but not limited to) the egregiousness of the conduct, the extent of investor harm or market impact, and the level of scienter. That decision is made independent of the decision whether to settle an SEC matter. It is important to note, as well, that we frequently are contacted by criminal authorities interested in working with the SEC to bring a parallel criminal action. In such instances, there is no need for the SEC to refer the matter.

Question 2

Prosecuting criminals and returning money directly to injured investors go a long way toward improving investor confidence. The SEC has actively lobbied states to return all fines and restitution to investors through the FAIR Fund. Without convictions or an admission of guilt, we've seen many civil suits related to the Global Settlement dismissed. Isn't this another reason that we should require ALL fines levied to be returned to investors to maximize the money they can recoup, as opposed to sending the money to States?

Answer

We agree that returning money to harmed investors is an important part of the effort to improve investor confidence in the markets. Section 308(a) of the Sarbanes-Oxley Act -- the Fair Fund provision -- was an important step in helping the Commission return more money to defrauded investors. The Fair Fund provision provides that in Commission actions where both disgorgement and penalties are obtained against a defendant or respondent, the amount of the penalty may be added to the disgorgement fund for the benefit of victims of the violation. To date, more than $1.5 billion in disgorgement and penalties have been designated for return to harmed investors using fair funds.

The disposition of monies paid in settlement of state proceedings is governed by state laws. In the case of the research analyst Global Settlement, which resolved both federal and state proceedings, the Commission urged the states to contribute their settlement amounts to a federal Fair Fund for return to harmed investors. The SEC does not have the authority to require states to do so.

# A P P E N D I X

November 6, 2003

November 6, 2003

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Hearing entitled, "Mutual Funds: Who's Looking Out for Investors?" Day 2

Thank you again, Mr. Chairman, for calling these important hearings to allow a full exploration of recent trading abuses and a full discussion of the changes necessary in our current regulatory structure overseeing the mutual fund industry.

As we all discussed in Tuesday's hearing, mutual funds manage some $7 trillion in investments for 95 million investors. They allow millions of average Americans to access the stock market, often through their pension fund investments, with the benefit of professional fund managers.

Clearly the questionable trading practices discussed this week and resulting in the high profile removal of Putnam Investments LLC chief executive Lawrence J. Lasser, as well as Juan M. Marcelino, head of the New England regional office of the Securities and Exchange Commission (SEC), have exposed widespread problems in oversight of the mutual fund industry.

During Tuesday's hearing we discussed the responsibilities of fund managers, state regulators, and the Securities and Exchange Commission (SEC) in ensuring that such manipulations do not continue. I am interested to hear more from our witnesses today on the question of whether further regulation or stronger enforcement is the most effective way to address these problems.

On September 30, 2003 SEC Chairman Donaldson outlined a five-part regulatory action plan to address the questionable trading practices recently uncovered and this Committee took the first step toward strengthening federal regulation of the mutual funds industry in passing the Mutual Funds Integrity and Fee Transparency Act (HR 2420) last July.

Thank you again, Mr. Chairman, for your leadership on this issue and I look forward to continuing our important discussion of necessary reforms within the mutual fund industry.

**OPENING STATEMENT OF**
**RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI**

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES**

**HEARING ON MUTUAL FUNDS: WHO'S LOOKING OUT FOR INVESTORS?**

**THURSDAY, NOVEMBER 6, 2003**

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Thank you for the opportunity to offer my thoughts before we begin our second hearing this week on wrongdoing in the mutual fund industry.

As you know, Mr. Chairman, the recent troubles at companies like Strong Capital Management, Janus Capital Group, and Putnam Investments, among others, have caused me great concern. This unease led me to call upon you in late October to arrange for hearings so that we could identify the steps the participants in the mutual fund industry and their regulators are taking to protect investors' interests and restore investor confidence in light of these scandals. In my view, we have an obligation to American investors to monitor these developments. I therefore commend you for promptly responding to my request and convening these proceedings.

With approximately 95 million investors and $7 trillion in assets, the dynamic mutual fund industry constitutes a major part of our securities markets. Heretofore, many experts had extolled the mutual fund industry for working to democratize investing for millions of average Americans, allowing them to easily participate in our capital markets with a diversified portfolio.

During the last two months, however, we have learned about several alleged and/or demonstrated incidents of "market timing" and "late trading" abuses in the mutual fund industry. Because investor protection is a priority for my work on this panel, I am very concerned about the effects of these events on small investors, who likely lost money as a result of these transgressions and probably became further discouraged about participating in our securities markets. I also believe that all participants in the securities industry have a responsibility to behave ethically and follow the rules. As a result, the announcement of each new case of misdeeds in the mutual fund industry has greatly disturbed me.

Many parties are also now taking action to address these problems, including New York Attorney General Eliot Spitzer and Massachusetts Commonwealth Secretary William Galvin. The Chairman of the Securities and Exchange Commission has additionally noted that his staff is "aggressively investigating the allegations and is committed to holding those responsible for violating the federal securities laws accountable and seeking restitution for mutual fund investors that have been harmed by these abuses." In addition, the Investment Company Institute has "unambiguously reaffirmed that shareholders' interests must be placed before all else."

As you also know, Mr. Chairman, I believe that it is very important for us to explore market timing and late trading problems in the mutual fund industry, as we have not previously examined these matters in the 108th Congress. Earlier this year, we considered and approved H.R. 2420, the Mutual Fund Integrity and Fee Transparency Act. In general, H.R. 2420 seeks to enhance the disclosure of mutual fund fees and costs to investors, improve corporate governance for mutual funds, and heighten the awareness of boards about mutual fund activities.

Although we held two hearings in the Capital Markets Subcommittee to review numerous topics related to the mutual fund industry before marking up H.R. 2420 in the full Committee, we did not specifically explore the issues of market timing and late trading. In light of the current public revelations about these abusive practices, I am consequently pleased that we are examining these important matters now.

Furthermore, Mr. Chairman, I share your concerns that our panel must continue to conduct vigorous oversight to examine whether our regulatory system is working as intended and to determine how we could make it stronger. It is my hope that today's proceedings will help us to better understand the current problems in the mutual fund industry. Our goal in any further legislative efforts in these matters should be to ensure that we advance the interests of average investors by preventing these problems in the future and improving the performance of the mutual fund industry in the long term.

In closing, Mr. Chairman, I look forward to hearing from our distinguished witnesses on these important issues. Mutual funds have successfully worked to help middle-income American families to save for an early retirement, higher education, and a new home. We need to ensure that this success continues.

TESTIMONY OF WILLIAM FRANCIS GALVIN

Secretary of the Commonwealth of Massachusetts

Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"Mutual Funds: Who's Looking Out for Investors?"

November 6, 2003

I am Bill Galvin, Secretary of State and Chief Securities Regulator of Massachusetts. I want to thank Representative Baker for calling today's hearing to examine abuses in the mutual fund industry. I also want to again thank Senators Fitzgerald, Akaka and Collins for the hearing they held on the Senate side earlier this week.

Representative Baker, while we may have not seen eye to eye on all issues in the past, I want to thank you for your leadership in this area. Months ago, long before the recent abuses came to light, you put the spotlight on mutual fund governance, fees and conflicts of interest. You deserve much credit for your foresight and for your commitment to America's investors and our securities markets.

The bill you have crafted, H.R. 2420, adds important disclosures and addresses areas of abuse that we have seen relating to fund sales practices and operations and I support it. In two specific areas I think it could go further, and I'll address those in a moment.

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

Investors have placed their trust in mutual funds with the understanding that they would be treated fairly – that fund managers would do their duty as fiduciaries.

Unfortunately, we are here today because in too many instances the mutual fund industry has failed to live up to its fiduciary duty. The common theme running through all of the mutual fund issues that we have exposed in recent months is that the mutual fund industry is putting its own interest ahead of its customers.

Another reason we are here today is because industry self policing and government oversight have failed to effectively protect the mutual fund investor. In too many instances, a culture of compromise and accommodation has overwhelmed enforcement efforts. Too often the guilty neither admit or deny any wrongdoing and routinely promise not to cheat again until they can come up with another way to do what they just said they would not do again.

It has taken the coincidence of dramatic and tragic recent investor losses and aggressive state enforcement by people like Attorney General Spitzer and myself to convert investor outrage to a call for action. Any suggestion that state regulators have hindered federal enforcement of securities laws is completely false. Any effort to restrict or pre-empt state enforcement must be called what it clearly is – anti-investor.

Let's be clear: Mutual fund investors should have an equal opportunity for profit and an equal opportunity for risk. Mutual funds should be precisely that – mutual. Unfortunately, that is not the case. Our investigation has revealed that special opportunities exist for certain mutual fund investors at the expense of the vast majority.

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

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

We have uncovered an unsettling pattern of deceit, breach of duty, breach of trust at Putnam, the nations' fifth-largest mutual fund company. Mutual funds are traditionally designed to be long-term investments for buy and hold investors and are the favored investments for the retirement plans of working Americans. Certain investors, however, have attempted to use mutual funds to generate quick profits by rapidly trading in and out of certain mutual funds. Typically, these so called "market timers" seek to capitalize on stale fund prices, often focusing on price discrepancies involving international funds.

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

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

The investigation by Massachusetts securities regulators found that Putnam administered the retirement plan of the Boilermakers Local Lodge No. 5 of New York. Despite prospectus disclosures that indicated market timing would not be tolerated, from at least January 2000 to September 2003 participants in the Boilermakers' retirement plan were permitted to market time Putnam international and other mutual funds.

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

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

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

The Voyager Fund prospectus also clearly stated that Putnam fund management has the authority to reject market-timing trades. For the sake of retaining plan assets invested in Putnam mutual funds, and in order to secure future business, Putnam failed to reject short-term trades and permitted certain shareholders, such as the Boilermakers, to market time their international mutual funds. By permitting market-timing activity by certain plan participants, Putnam effectively allowed these customers to capture a portion of the fund's gains from the long-term shareholders within the fund.

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

What makes this case so egregious is that Putnam executives knew the firm's policies were being violated. Not only did they conceal this violation, but they joined in it.

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

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

Market timing activity by Putnam fund managers amounts to a blatant violation of the manager's fiduciary duty to protect the interests of all of the fund's shareholders. Moreover, the fund manager's market timing activity is a flagrant violation of the fund's prospectus disclosure, which states that Putnam management will police and prevent rapid short term trading. Such trading activity and practices is fraud under the Massachusetts Uniform Securities Act.

Unfortunately, the Putnam case is not an isolated example of mutual fund investors being deceived or cheated. In August, for instance, my office charged Morgan

Stanley with violations of Massachusetts anti-fraud laws by offering cash prizes and other incentives to encourage brokers to sell Morgan Stanley mutual funds to investors creating a high-pressure sales culture. My office found that Morgan Stanley brokers competed in contests to sell certain Morgan Stanley owned and affiliated mutual funds, for which they received higher commissions than other funds. The contests and higher commissions were not disclosed to investors – material omissions that constitute fraud under the Massachusetts Securities Act.

Even more recently, this week my office charged five former Prudential Securities brokers and branch managers with fraud in a scheme that enabled offshore hedge fund clients to profit at the expense of mutual fund shareholders. The particular complaint alleges in vivid detail how a group of brokers, with the active connivance of managers and a see-no-evil attitude by the company, were able to manipulate the mutual fund trading system for the benefit of certain select clients to the detriment of fund shareholders. Company policies against market timing and short-term trading were clear; disciplinary action was non-existent.

For the sake of enriching themselves and their hedge fund clients, the branch managers and registered representatives allegedly engaged in fraudulent tactics and financially harmful trading activity and no one stopped them.

These enforcement actions are only a few examples of deeper problems in the industry. Mutual fund executives violate investor trust:

- when mutual funds allow marketing timing by their employees;
- when mutual funds allow market timing for certain outside investors, perhaps as an incentive to generate or retain business;
- when mutual funds allow late-trading in a fund's shares;

- when mutual funds pay higher commissions to brokers or offer other incentives to sell proprietary, or in-house, funds to investors rather than funds that may be more suitable to an investor's needs; and
- when breakpoint discounts are ignored or concealed.

As the cases involving Putnam, Morgan Stanley and Prudential Securities illustrate, state securities regulators are often first to identify investment-related problems and to bring enforcement actions to halt and remedy these problems.

H.R. 2420 is a positive response to the many problems investors in mutual funds now face. And I endorse its objectives. I endorse its provisions to enhance the independence of fund board members and audit committees; to improve disclosure of fund fees, and expenses; to make board members responsible to oversee soft dollar arrangements; to require the Securities and Exchange Commission to study soft dollar arrangements and other disclosure issues; to prevent funds from restricting share redemptions, and to require funds hire compliance officers.

This bill can be improved however. I believe the bill could do more.

First, instead of studying and disclosing soft dollar arrangements, I would ask you to consider an outright ban on them. Funds should simply seek the best price and execution for their portfolio trades.

At best, soft dollar arrangements obscure the true costs of mutual fund overhead, and they artificially inflate funds' trading costs. And in far too many cases, soft dollar arrangements constitute severe conflicts of interest for fund managers, because brokerage firms provide benefits to those managers in exchange for a portion of a fund's trading transactions. Soft dollar arrangements have been criticized for many years as fundamentally abusive practices, so this is not a matter that requires further study. Instead, we must act now to draw a bright, clear line prohibiting soft dollar arrangements by mutual funds.

In addition, it may be appropriate to advocate that Section 2(a)(1) of the bill be amended to restore the requirements that each investor receive disclosure of the fund costs and expenses paid by his or her fund account (rather than costs payable on a hypothetical $1000 investment). This would make disclosure more meaningful to individual investors.

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

Representative Baker, I know that you share my opinion that this sort of behavior, this corporate culture, is deplorable, outrageous and unconscionable -- a serious breach of duty and trust, a betrayal of customers faith that their interests come first. In these cases, I'm afraid, greed trumped good business practices. I want you to know that we won't rest until we get to the bottom of this and punish those responsible. Investment and our markets are built on trust. This behavior is equivalent to picking the customers' pockets.

Market timing, which is essentially day trading, sends a simple message to long-term investors: do as we say, not as we do. Fund customers, long-term investors, didn't know that their money was being managed by day traders out for themselves.

These charges involve Massachusetts companies. These cases have had a profound impact on the image and reputation of local companies. I know people who work at these firms, as does my staff. These companies employ Massachusetts's residents, they pay state taxes, they give to local charities.

The actions of a few at these firms have put the jobs of many at risk and threaten to destroy reputations built over many years. This further underscores that our markets are built on trust and how fragile that trust can be. For a relatively small amount of money, management winked at corrupt behavior and risked the reputation and future of multibillion-dollar enterprises. This case should be a lesson to others.

Our investigation took many weeks. It involved substantially my whole securities division. We deposed many people, took pains to corroborate testimony, talked to legal and other experts before deciding to move forward with formal charges. We were very much aware what impact our actions could have and we acted with a sense of sadness as well as a sense of duty to investors in Massachusetts and across this country.

Representative Baker, I again want to commend you for focusing attention on these issues. With tougher laws and vigorous enforcement we can give our nation's investors the fairness and honesty they seek and the protection they deserve.

Thank you.

STATEMENT

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT-SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ON

"THE MUTUAL FUND INDUSTRY"

NOVEMBER 6, 2003
2128 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, D.C.

WITNESS: CHARLES LEVEN
VICE PRESIDENT,
SECRETARY/TREASURER
AARP BOARD OF DIRECTORS

For further information, contact:

Roy Green
Federal Affairs Department
(202) 434-3800

National Headquarters | 601 E Street, NW | Washington, DC 20049 | 202-434-2277 | 800-424-3410 | 877-434-7598 toll-free TTY
James G. Parkel, President | William D. Novelli, Executive Director and CEO | www.aarp.org

Good morning Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises. My name is Charles Leven. I am the Vice President of AARP's Board of Directors.

I appreciate this opportunity to testify on behalf of AARP's over 35 million members on a matter of great importance to the financial security of all Americans -- savings that they have invested in, and entrusted to, the mutual fund industry. Mutual funds control 21 percent of U.S. corporate equity (representing an estimated $19 trillion in assets). More than 95 million Americans are invested in mutual funds, representing more than half of all American households. A 1998 survey of mutual fund shareholders directed by the Investment Company Institute (ICI) produced estimates that:

- Twenty-two percent mutual fund shareholders were born in 1965 or later
- Fifty-one percent are shareholders were born between the years of 1946 and 1964, and
- Twenty-seven percent of the shareholders were born prior to 1946.[1]

AARP supports the efforts of this Subcommittee, under your leadership Chairman Baker, to improve investor awareness of mutual fund costs, and to improve the independent oversight and governance functions of fund boards of directors. The legislation you introduced, and that is now pending before the House, "The Mutual Fund Integrity and Transparency Act of 2003" (H.R. 2420), would put into effect an overdue upgrade in investor protection for the ordinary saver-investor. Similar – although not identical – legislation ("The Mutual Fund Transparency Act of 2003') was recently introduced in the Senate by Senators Akaka, Fitzgerald and Lieberman

These reforms were already warranted by the continuing evolution in market practices and the growth in market choices. They are now more urgently required. Real damage has been done to the economic security and financial well-being of many Americans in or near retirement. This has been in part due to the market's natural cycles – tracking the general economy downward over the last couple of years. But some of the damage was caused by corporate financial reporting, accounting transgressions and market manipulations.

AARP sponsored a national survey (N=1,013 telephone interviews), conducted from November 15 to December 5, 2002, regarding the extent to which stock market declines over the previous two years affected individuals age 50 to 70, who owned stock either as individual stocks, mutual funds, or other types of investment accounts including 401(k)s and IRAs. Key findings include:

- More than three in four (77 percent) of these individuals indicated that they had lost money;
- More than three in four (77 percent) of those investors who lost money in stocks reported that their losses had altered their retirement lifestyles, work plans, or expectations about retirement in at least one of the ways measured;
- Of those who lost money in stocks and had not yet retired, one in five (21 percent) have postponed retirement as a result of their losses; and
- Of investors who lost money in stocks and had already retired, one in ten (10 percent) either have returned to work after retirement due to their losses or are still working due to their losses.[2]

Apart from corporate reporting and accounting scandals, mounting allegations of illegal – or at best unethical -- practices by mutual fund management companies, executives and brokers highlight the need for prompt remedial action. Startling results were reported just this week from a U.S. Securities and Exchange Commission (SEC) survey of 88 of the largest mutual fund complexes in the country and 34 brokerage firms, including all of the nation's registered prime brokers. Preliminary findings reveal the apparent prevalence with which mutual fund companies and brokerage firms had arrangements that allowed favored customers, including themselves, to exercise after-hours trading privileges and market timing options – as well as to participate in other abusive practices.

Among the most troubling of the SEC's preliminary findings is that:

- More than twenty-five percent of the responding brokerage firms reported that customers have received 4 p.m. prices for orders placed or confirmed after 4 p.m.;
- Fifty percent of responding fund groups appear to have had at lest one arrangement allowing for market timing by an investor;
- Almost seventy percent of responding brokerage firms reported being aware of timing activities by their customers; and finally
- More than thirty percent of responding fund companies appears to have disclosed portfolio information in circumstances that may have provided certain fund shareholders the ability to make advantageous decisions to place orders for fund shares.

These apparent violations of the fiduciary duty owed to investors have caused real harm – both in confidence and in lost dollars. These allegations come on top of other more recent examples of conflicts of interest in the industry. We must do more to protect the individual investor. In addition, we are increasingly concerned that lay investor confidence in the mutual fund industry not be allowed to deteriorate further – specifically in its ability to reliably provide fairly priced benefits of investment diversification and expert management.

With regard to initiatives designed to increase fund transparency, we strongly support H.R. 2420's provisions to require, among other new obligations, that:

- fees be disclosed in dollar amounts;
- fee disclosures incorporate all fees, including portfolio transaction costs;
- fee disclosures identify all distribution expenses;
- compensation paid to portfolio managers and retail brokers be fully disclosed;
- disclosure of breakpoint discounts to investors be improved; and
- directed revenue sharing, brokerage and soft dollar arrangements be made to conform to the fiduciary duties to the funds and their investors.

While greater transparency is essential to fair competition among funds for investors, we believe it does not provide a sufficient check on the cost of fund governance. Mutual funds allow investors to share the costs of professional money managers — who under the 1940 Investment Company Act are called "advisers." However, most funds are not established by investors but rather are incorporated by advisory firms, who then contractually provide research, trading, money management and customer support services, and who also have some representation on the fund's board. The advisory firms have their own corporate charters and are accountable to their own boards of directors, posing – as we are seeing -- a range of potential conflicts of interest in the costs of services provided to the fund.

We see these failures of mutual fund governance, not simply as a lack of statutory or regulatory authority, but as a failure of compliance and enforcement. We support the provisions in HR 2420 designed to strengthen the role and independence of boards of directors and further target directors' energies where potential conflicts of interest between the fund adviser and fund shareholders are greatest. HR 2420 seeks to strengthen the role and independence of fund directors by making the board responsible for more than auditing the performance of the advisory firm and making sure there is no malfeasance or any accounting problems. In addition, the board is explicitly charged with advocating shareholder interests in its fee-for-service negotiations with the advisory firm.

Specifically, we strongly recommend the final measure include provisions requiring that:

- A super-majority (i.e., two-thirds to three-fourths) of fund board members be independent;
- The board chairman be selected from among the independent members; and
- The independent directors be responsible for establishing and disclosing the qualification standards of independence, and for nominating and selecting all subsequent independent board members.

In summary, the importance of the mutual fund market as a critical component of the economic security of all Americans – especially older persons – should not be underestimated. We urge prompt bipartisan passage of H.R. 2420 by the House. Full disclosure of expenses and requirements for stronger fund governance will help hold fund advisers accountable for their trading practices, which should reduce costs to investors. We believe these changes will introduce more vigorous price competition into the mutual fund marketplace. We look forward to working with you, Chairman Baker and Ranking Member Kanjorski, and with the other Members of this Subcommittee, in further perfecting and working to enact this important piece of investor protection legislation.

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[1] See: 1998 Profile of Mutual Fund Shareholders, Research Series, Investment Company Institute, published Summer 1999.
[2] See: Impact of Stock Market Decline On 50-70 Year Old Investors, AARP, published December 2002.

## THE AARP FOUNDATION
### History and Role

The AARP Foundation was established in the District of Columbia in 1961 as a 501(c)(3) nonpartisan charitable corporation, contributions to which are tax deductible. The Foundation was originally named the Retirement Research and Welfare Association and was set up to engage in the study and discussion of issues affecting aging persons.

In 1983, the Retirement Research and Welfare Association changed its name to the AARP Foundation and shifted its emphasis to promoting projects and community service endeavors related to the social welfare, maintenance, and improvement of health and educational services for older persons. During the 1980s and early 1990s, the AARP Foundation received grants for various AARP projects and also awarded small grants to a variety of community service, educational, and social welfare groups.

On December 19, 1995, the President signed into law the Lobbying Disclosure Act of 1995 which prohibits 501(c)(4) organizations that lobby from receiving federal funds. Although the lobbying act only applies to new grants, AARP transferred all of its public and private grant programs (staff, funds, and administration) to the AARP Foundation. These transfers were approved by all of the federal funding agencies.

The AARP Foundation administers educational, employment and community service programs funded by both private and federal grants. Federal funding totaled an estimated $53 million in 2002. Major grant programs of the AARP Foundation include the AARP Senior Community Service Employment Program and the AARP Tax-Aide Program. The Foundation also includes the AARP Foundation Litigation group. The AARP Foundation's seven-member Board of Directors is appointed by the AARP Board of Directors and provides oversight and guidance to the AARP Foundation's management. The Director and Managing Director of the AARP Foundation supervise the Foundation's administrative, financial, and professional activities. Under a service provider agreement, AARP provides the AARP Foundation with support services and specialized skills needed to carry out some of the grant-funded programs.

***AARP Foundation Managing Director's Office, September 24, 2003***

**AARP Statement of Federal Grants & Contracts Pursuant to Rule XI, Clause 2(g)**

On December 19, 1995, the President signed into law the Lobbying Disclosure Act of 1995 which prohibited 501(c)(4) organizations that lobby from receiving federal funds. Although the lobbying act only applies to new grants, AARP transferred its current grant programs (staff, funds, and administration) to the AARP Foundation, a 501(c)(3) nonpartisan, charitable corporation established in the District of Columbia in 1961. These transfers, effective January 1, 1996, were approved by all of the federal funding agencies.

| | 2000 Audited | 2001 Audited | 2002 Audited |
|---|---|---|---|
| **Revenues** | | | |
| Department of Labor: AARP Senior Community Services Employment Program (SCSEP) (1) | $53,539,723 | $52,147,002 | $49,103,856 |
| Internal Revenue Service: AARP Tax-Aide (2) | 3,418,098 | 3,335,653 | 3,201,891 |
| Housing and Urban Development: AARP Reverse Mortgage Education Project [3] | 181,356 | 612,307 | 655,284 |
| Health & Human Services: | | | |
| Special Programs for the Aging Title IV and Title II Discretionary Projects | | | 306,163 |
| AARP National Legal Training Project | 138,898 | 212,758 | |
| AARP Technical Support for Legal Hotlines | 118,465 | 52,446 | 0 |
| AARP Mental Health Coalition Building Project | 24,771 | 85,261 | 0 |
| AARP Senior Medicare Patrol Project | 162,895 | 205,051 | 0 |
| Alaska Senior Medicare Patrol Project Subgrant | 16,000 | 0 | 0 |
| Department of Justice: | | | |
| AARP Telemarketing Fraud Prevention and Education | 67,495 | 372 | 163,831 |
| **Total Federal Grants** | $57,667,701 | $56,650,850 | $53,431,025 |

Three Largest Programs:

(1) The AARP SCSEP is a work-training program authorized under the Older Americans Act of 1965. Eligible program applicants must be at least 55 years of age, physically able to work, and have income at or below 125% of the federal poverty level. In 2002, this program operated in approximately 94 sites in 31 states and Puerto Ri For the grant-year ending June 30, 2002, the program served 18,000 individuals and had an unsubsidized placement rate of 54%.

2) The AARP Tax-Aide Program provides free tax counseling for low and middle-income individuals, with special attention to those 60 and over, through a network of approximately 9000 sites and approximately 31,000 volunteers. In 2002, this program helped more than 1.8 million taxpayers.

(3) The AARP Reverse Mortgage Education Project improves the quality and availability of consumer counseling and information and increases consumer awareness of reverse mortgage options and their alternatives.

Revised 9.25.03

NASD

**Testimony**

**of**

**Mary L. Schapiro**

**NASD Vice Chairman and President**
**Regulatory Policy and Oversight**

**Before**
**the**
**Subcommittee on Capital Markets, Insurance and**
**Government Sponsored Enterprises**
**House Financial Services Committee**

**Hearing on Mutual Fund Trading Abuses**

**United States House of Representatives**

**November 6, 2003**

Mr. Chairman and Members of the Subcommittee: NASD would like to thank the committee for the invitation to submit this written statement for the record. NASD strongly supports H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act of 2003.

**NASD**

NASD, the world's largest securities self-regulatory organization, was established in 1939 under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. Every broker/dealer in the U.S. that conducts a securities business with the public is required by law to be a member of NASD. NASD's jurisdiction covers nearly 5,400 securities firms that operate more than 92,000 branch offices and employ more than 665,000 registered securities representatives.

NASD writes rules that govern the behavior of securities firms, examines those firms for compliance with NASD rules, MSRB rules, and the federal securities laws, and disciplines those who fail to comply. Last year, for example, we filed a record number of new enforcement actions (1,271) and barred or suspended more individuals from the securities industry than ever before (814). Our investor protection and market integrity responsibilities include examination, rulewriting and interpretation, professional training, licensing and registration, investigation and enforcement, dispute resolution, and investor education. We monitor all trading on The NASDAQ Stock Market -- more than 70 million orders, quotes, and trades per day. NASD has a nationwide staff of more than 2,000 and is governed by a Board of Governors at least half of whom are unaffiliated with the securities industry.

NASD's involvement with mutual funds is predicated on our authority to regulate broker/dealers. NASD does not have any jurisdiction over investment companies or the fund's investment adviser; rather, we regulate the sales practices of broker/dealers who sell the funds to investors. Our investor education efforts also place special emphasis on mutual funds due to their widespread popularity with investors.

Our examination and enforcement focus in this area has concentrated on five main areas: first, the suitability of the mutual funds that brokers are selling; second, broker sales practices; third, the disclosures provided to investors; fourth, the compensation arrangements between the funds and brokers; and, fifth whether brokers are delivering to their customers the benefits to which they are entitled, such as breakpoint discounts. We have brought some 60 enforcement cases this year in the mutual fund area, and more than 200 over the last three years. We also have a number of ongoing examinations and investigations involving mutual fund issues, including late trading and market timing.

**NASD Strongly Supports H.R. 2420**

NASD strongly supports H.R. 2420. Indeed, in those areas where NASD has jurisdiction, we have already begun the rulemaking process to implement some of the principles of H.R. 2420. Sections 2 and 12 of H.R. 2420 would require mutual funds and brokers to provide extensive information on mutual fund expenses and conflicts of interest, including sales compensation and revenue sharing arrangements. NASD strongly supports the goals of these provisions, and commits itself to working with Congress and the SEC to ensure that they are implemented in a manner that best serves fund shareholders.

NASD already has taken action in this area. In September, NASD proposed to require that broker/dealers provide investors with information about revenue sharing arrangements; that is, payments made by the Fund Adviser to the broker-dealer for "shelf space." We also proposed to require similar disclosure concerning "differential compensation" arrangements, which are cash compensation payments by a broker/dealer to a registered representative that are designed to favor one fund product, such as the broker/dealer's proprietary mutual funds, over another. Our proposal would require disclosure of the mutual fund companies that are the subject of these arrangements, when a customer opens an account and on a semi-annual basis thereafter. The comment period on the proposal recently ended and we expect to file with the SEC soon.

We similarly support the requirement in Section 7 that the SEC or an SRO adopt a rule clarifying the definition of the term "no-load fund," so that investors better understand the term. NASD Rule 2830(d)(4) allows the advertisement of a fund as "no-load" only if the fund imposes no front-end or deferred sales load, and does not impose a 12b-1 fee or service fee that exceeds 0.25% per annum.

The NASD rule was intended to ensure that investors do not purchase a so-called "no load" fund that in fact charges high 12b-1 or other sales-related fees. We do permit broker/dealers to earn a fee of 25 basis points for servicing a customer's account and answering questions about the fund without having to refer to the fund as a load fund. Of particular concern is the fact that while NASD can limit the fees that a *broker/dealer* receives for selling a no-load fund, we cannot limit the fees that the fund's investment adviser receives. Consequently, no-load funds may pay significant adviser fees and other expenses. We agree that a more comprehensive review by the SEC and NASD would be constructive. We look forward to working with the Subcommittee and SEC on this important issue.

We also look forward to working with the Subcommittee and the SEC on technical issues that may arise as H.R. 2420 moves forward and the SEC proceeds with rulemaking to implement the provisions of H.R. 2420.

**Recent Enforcement Efforts**

NASD has several rules that govern the relationship between broker/dealers and fund companies. For example, our rule governing cash and non-cash compensation, Rule 2830, generally prohibits the award of non-cash compensation, such as lavish trips and entertainment, to brokers for the sale of mutual fund shares. The rule thus prohibits contests that encourage brokers to steer their customers into unsuitable investments. The rules are designed to prevent the conflicts of interest that may arise for the broker when faced with such a choice.

Cash and Non-Cash Compensation Cases

In September, we brought a case under this rule against Morgan Stanley that resulted in a $2 million fine against the firm. Morgan Stanley had been conducting prohibited sales contests for its brokers and managers to push the sale of Morgan Stanley's own proprietary mutual funds. In addition to censuring and fining the firm, NASD also censured and fined a senior member of the firm's management – the head of retail sales.

Between October 1999 and December 2002, the firm had conducted 29 contests and offered or awarded various forms of non-cash compensation to the winners, including tickets to Britney Spears and Rolling Stones concerts, tickets to the NBA finals, tuition for a high-performance automobile racing school, and trips to resorts.

The obvious danger of such contests is that they give firm personnel a powerful incentive to recommend products that serve the broker's interest in receiving valuable prizes, rather than the investment needs of the customer. And one of the most troubling things about this case is Morgan Stanley's failure to have any systems or procedures in place that could detect or deter the misconduct.

In January 2003, NASD censured and fined IF Distributor, Inc., and VESTAX Securities Corp. a total of $150,000 for failing to disclose special cash compensation they paid to their sales force in the sale of mutual fund shares. Prior to disclosing this special cash compensation, the reps sold over $20 million in Class A shares to over 200 customers. Brokers selling these shares received approximately $220,000 in special cash compensation.

NASD Rule 2830

We also are conducting an examination sweep where we are looking at more than a dozen broker/dealers, specifically with a view to determine how investment companies pay for inclusion on firms' featured mutual fund list or why they receive favored promotional or selling efforts. We are looking at different types of firms, including full-service, discount and online broker/dealers. Thousands of funds are presented to investors through discount and on-line broker-dealer "supermarkets." In addition, we are examining a similar number of mutual fund distributors, who are also our members. Mutual fund sponsors and distributors that once marketed exclusively through a single, traditional distribution channel often now compete head-to-head in the same distribution channels vying for visibility and valuable "shelf space." We want to see what the distributors' role may be in these types of practices.

At issue in this sweep is NASD Rule 2830, which expressly prohibits members from directly or indirectly, favoring or disfavoring the sale of shares of any investment company or group of investment companies on the basis of brokerage commissions received or expected by that member from any source. In short, an NASD member cannot seek brokerage commissions from a fund or investment company as a condition to the sale or distribution of investment company securities. Exchanging prominent placement of a fund or family of funds on a firm's Web site or in the firm's marketing material or placing a fund on a "featured" or "preferred" list of funds in exchange for brokerage commissions from the fund may be misleading to investors and a violation of NASD rules.

Class B Shares

Many mutual funds offer different classes of the same investment portfolio. Each class is designed to provide brokers and their customers with a choice of fee structure. Class A mutual fund shares charge a sales load when the customer purchases shares. Class B shares do not impose such a sales charge. Instead, Class B shares typically impose higher expenses that investors are assessed over the lifetime of their investment. Class B shares also normally impose a contingent deferred sales charge (CDSC), which a customer pays if the customer sells the shares within a certain number of years. In addition, investors who purchase Class B shares cannot take advantage of breakpoint discounts available on large purchases of Class A shares.

NASD has found that some brokers have unscrupulously recommended Class B shares in such large amounts that the customer would have qualified for breakpoint discounts had the broker recommended Class A shares instead. Some brokers also have recommended transactions in Class B shares that are so frequent as to cause the customer to incur CDSC charges. In both cases, the broker may receive higher compensation for the Class B recommendations. NASD has vigorously prosecuted these violations, and we are continuing a comprehensive review of Class B shares sales practices. Over the last two years, NASD has brought more than a dozen enforcement actions against firms and individual brokers for these types of violations.

For example, in May the SEC affirmed a disciplinary action NASD took against Wendell D. Belden, who was found to have violated NASD's suitability rule by recommending that a customer purchase Class B mutual fund shares in five different mutual funds within two fund families instead of Class A mutual fund shares. Because of the size of his customer's investment ($2.1 million) and the availability of breakpoint discounts for Class A shares, Belden's recommendations caused his customer to incur higher costs, including contingent deferred sales charges.

Belden tried to justify his recommendations to customers that they purchase the Class B shares instead of the Class A shares because he received greater commissions on the sales of these shares. He stated that he "couldn't stay in business" with lower commissions. Belden was fined, suspended, and ordered to pay more than $50,000 back to his customers.

In June we announced a settled action against McLaughlin, Piven, Vogel for violations in this area. The firm was fined $100,000 and ordered to pay restitution of approximately $90,000 to 21 customers. In August we announced five more actions for unsuitable sales of Class B shares.

**Breakpoints**

Mutual funds typically offer discounts to the front-end sales load assessed on Class A shares at certain pre-determined levels of investment, which are called "breakpoints." The extent of the discount is based on the dollar size of the investor's investment in the mutual fund. For example, breakpoint discounts may begin at dollar levels of $25,000 (although, more typically, at $50,000) and increase at $100,000, $250,000, $500,000, and $1,000,000. At each higher level of investment, the discount increases, until the sales charge is eliminated.

An investor can become entitled to a breakpoint discount to the front-end sales charge in a number of ways. First, an investor is entitled to a breakpoint discount if his single purchase is equal to or exceeds the specified "breakpoint" threshold. Second, mutual funds generally allow investors to count future purchases toward achieving a breakpoint if the investor executes a letter of intent that obligates him to purchase a specified amount of fund shares in the same fund or fund family within a defined period of time. Similarly, mutual funds generally grant investors "rights of accumulation," which allow investors to aggregate their own prior purchases and the holdings of certain related parties toward achieving the breakpoint investment thresholds (including reaching investment thresholds necessary to satisfy letters of intent).

Mutual fund families began to offer these breakpoint discounts to make their funds more attractive to investors. Over time, funds expanded the rights of accumulation they offered by expanding the categories of accounts that could be linked or aggregated for the purpose of obtaining breakpoint discounts. Mutual funds view their aggregation rules as important competitive features of their products. Accordingly, these rights of accumulation can vary from fund family to fund family, and many fund families define the related parties that can aggregate their holdings to determine breakpoint discount eligibility differently. For instance, one fund family may allow parents to link their accounts with a "minor child," while another fund family may allow parents to link their accounts with any child residing at home.

During routine examinations of broker-dealers by our Philadelphia District Office, NASD discovered that broker-dealers selling front-end load mutual funds were not properly delivering breakpoint discounts to investors. Following this discovery, in November and December 2002, the SEC and New York Stock Exchange joined us for an examination sweep of 43 firms selling front-end load mutual funds. We found that most of those firms did not give investors all the breakpoint discounts they should. Failures to give the discounts stemmed from a variety of different operational problems, including a failure to link share classes and holdings in other funds in the same fund family and a failure to link accounts of family members.

NASD issued a *Notice to Members* on December 23, 2002, reminding firms to explain and deliver breakpoints. And, we issued in January 2003 an Investor Alert to advise customers of breakpoint opportunities.

Also in January 2003, the SEC asked NASD to lead a task force to find breakpoint solutions. The task force had 24 members, including representatives from broker/dealers, mutual funds, transfer agents, clearing facilities, academia, the SEC staff, other SRO's and trade associations.

The Task Force issued its report in July 2003, in which it recommended a number of technological and operational changes, as well as modifications to mutual fund prospectus and other disclosure and sales practices, to ensure that customers are not overcharged. Working groups, consisting of knowledgeable representatives of the mutual fund and securities industries, are currently engaged in implementation of the Task Force recommendations. NASD and the SEC receive periodic reports from these Working Groups and are monitoring progress as implementation moves forward.

H.R. 2420 Section 2(a)(6) is right on target by requiring disclosure of breakpoint schedules and the persons who are eligible for breakpoints. The Task Force recommendations echo this by calling on the SEC and NASD to require mutual funds and broker/dealers to provide information to investors to ensure that investors get the breakpoints to which they are entitled.

As for the transactions that should have received discounts, NASD supplemented its referenced examination effort with a survey of every NASD member to learn more about each member's overall mutual fund activities. The survey, in turn, provided NASD with information that helped us frame a self-assessment. Specifically, NASD directed firms to perform a self-assessment of their own of breakpoint discounts delivery. These self-assessments were carried out through use of a carefully constructed sample of transactions, which permitted NASD to extrapolate each firm's performance to its entire universe of transactions. NASD has concluded that, during the 2001 to 2002 period covered by the self-assessments, investors were overcharged in about one out of every five transactions in which they were eligible for breakpoint discounts. Those overcharges, in our view, total at least $86 million, and the average overcharge was $243. When the assessments were complete, firms were directed to refund overcharges to investors, with interest. In addition, NASD will require that most of the firms involved undertake further action, including contacting their customers individually to alert them to possible overcharges. Disciplinary or enforcement proceedings will be brought against certain of the firms.

**Late Trading and Market Timing**

Investment Company Act Rule 22(c)(1) generally requires that mutual fund shares be sold and redeemed at a price based on the net asset value (NAV) of the fund computed after the receipt of the order. In practice this requirement means that mutual fund shares are priced according to the value of their securities portfolio, computed at the next close of the national securities exchanges. For example, if a mutual fund receives an order to purchase shares before the close of the securities exchanges, 4 p.m. EST, the investor should receive a price based on that 4 p.m. close. If, however, a mutual fund receives an order to purchase shares after the 4 p.m. close, the investor should receive a price based on *the next day's* 4 p.m. close. This "forward pricing" requirement represents a fundamental principle of the Investment Company Act, for it prevents investors who might have access to the NAV of the portfolio from trading on that information.

The failure to meet the forward pricing standard has become known as "late trading." Late trading, however, should be distinguished from the practice, followed by many broker/dealers and other intermediaries of transmitting orders after 4 p.m. because they require additional processing time. For example, some intermediaries may net out transactions by pension plan participants in order to simplify their order to the mutual fund company. In these instances, the participants entered their orders before or at 4 p.m., but the orders of the plan were not processed and transmitted until after 4 p.m.

The frequent trading of mutual fund shares in order to take advantage of pricing inefficiencies or market movements has become known as "market timing." Market timing is not per se illegal. Market timing activities become illegal when they violate the fiduciary duty of the fund's investment adviser; they also are problematic when they violate a stated policy of the fund as disclosed in the fund's prospectus. Many mutual funds police market timing by their shareholders, because market timing can increase fund expenses and harm fund performance for the other shareholders. When a mutual fund has disclosed a policy of protecting investors from market timers, a broker/dealer may not knowingly or recklessly collude with the fund in order to effect a market timing transaction. Broker/dealers must have in place policies and procedures reasonably designed to detect and prevent this collusion.

In response to prevailing issues concerning mutual fund execution, in September NASD sought information from roughly 160 firms regarding late trading and impermissible market timing.

As a preliminary matter, we have determined that numerous firms' conduct warranted a referral to NASD's Enforcement Department for further investigation and possible disciplinary action. Another group of firms are being examined by our Member Regulation Department for potential late trading and impermissible market timing misconduct.

Specifically, a number of firms disclosed that they had, or probably had, received and entered mutual fund orders after U.S. markets closed for the day. Some of these firms disclosed specifically that they had accepted and entered late trades; other firms disclosed that they "probably" accepted and entered late trades. This imprecision in the latter group indicates separate issues of poor internal controls and record keeping; we will also pursue these areas. These matters, too, have been referred to NASD's Enforcement Department for action.

NASD also has identified a number of firms that were involved in market timing and it remains to be determined whether their activities were impermissible under our rules or applicable statutes. These firms appear to have facilitated a customer's market timing strategy in mutual funds or variable annuities, had employees who agreed with a mutual fund or variable annuity to market time the issuer's shares, or had an affiliate involved in some form of market timing of mutual funds or variable annuities. We are investigating any broker/dealer that made any of these disclosures in our investigations. We will investigate whether these firms simply allowed market timing, which is not per se illegal, or whether they colluded with the mutual fund companies to evade the fund's stated policies against market timing.

**Investor Education**

Mutual funds have been a particular focus of NASD's investor education efforts. This year alone, we have issued Investor Alerts on:

- Mutual fund share classes
- Mutual fund breakpoints
- Principal protected funds
- Class B mutual fund shares

Each of these Investor Alerts educates investors about the wide variety of mutual fund fee structures that exist and urges investors to scrutinize mutual fund sales charges, fees, and expenses.

Research has shown that many investors are unaware of how much they pay to own mutual funds and that even small differences in fees can result in thousands of dollars of costs over time that could have been avoided. To help investors make better decisions when purchasing mutual funds, we have unveiled an innovative "Mutual Fund Expense Analyzer" on our Web Site. Unlike other such tools, the Expense Analyzer allows investors to compare the expenses of two funds or classes of funds at one time, tells the investor how the fees of a particular fund compare to industry averages, and highlights when investors should look for breakpoint discounts. To make this tool more widely available to investors, we are developing a version of the Expense Analyzer for broker/dealer Web sites.

**Conclusion**

NASD commends the Committee for its work on H.R. 2420 and stands ready to help as the bill moves through the House. We applaud your efforts to bring increased transparency to the mutual fund industry and will continue to do our part in this area as well. NASD will continue its vigorous examination and enforcement focus on the suitability of the mutual fund share classes that brokers are selling, the compensation practices between the funds and brokers, and the question of whether brokers are delivering to their customers the benefits offered to them, such as breakpoint discounts. And as we continue our examinations and investigations into late trading and market timing issues, we will enforce NASD rules with a full range of disciplinary options-- which include stiff fines, restitution to customers and the potential for suspension or expulsion from the industry. While NASD cannot alone solve all the problems revealed in recent months in the mutual fund industry, we have jurisdiction over all broker/dealers that sell these products to investors and will rigorously exercise our authority to take actions against violators as part of our overall efforts to protect investors and to restore investor confidence.

Testimony of Eric W. Zitzewitz

Assistant Professor of Economics

Stanford Graduate School of Business

(Visiting Columbia Business School, 2003-4)

before the

Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises

Committee on Financial Services

United States House of Representatives

On

"Mutual Funds: Who's Looking Out For Investors"

November 6, 2003

Chairman Baker, Ranking Member Kanjorski, members of the Subcommittee, thank you for the opportunity to discuss the issues of late trading and stale-price arbitrage (also known as market timing) in mutual funds.[1]

My name is Eric Zitzewitz. I am an Assistant Professor of Economics at Stanford's Graduate School of Business. I am the author of three studies related to the issues being examined by the Subcommittee. I have also worked with the industry on the issues of fair value pricing and estimating the extent and cost of stale-price arbitrage trading. I will draw on my research and experience, as well as the work of other academics, in the course of my testimony.[2]

Let me begin by summarizing some of the main conclusions of my research:

- My analysis of daily flows for a sample of funds[3] reveals flows consistent with stale-price arbitrage in the international funds of over 90 percent of fund companies and consistent with late trading in 30 percent.[4]
- In 2001, a shareholder in the average international fund in my sample lost 1.1 percent of assets to stale-price arbitrage trading and 0.05 percent of assets to late trading. Losses are smaller, but still economically

[1] Market timing is misnomer in this context, since it is commonly thought to mean guessing the future direction of the market. Most of the "market timing" occurring in mutual funds is actually arbitrage activity based on the use of stale prices to calculate NAVs.

[2] My work includes "Who Cares About Shareholders? Arbitrage-proofing mutual funds," *Journal of Law Economics and Organization*, October 2003, 245-280 and two unpublished papers, "How Widespread is Late Trading in Mutual Funds", and "Another Kind of 'Weekend Effect' in Financial Markets." All of these are available on my webpage, http://faculty-gsb.stanford.edu/zitzewitz. Other academic studies are cited therein.

[3] My data comes primarily from TrimTabs, which collects a daily asset and NAV data from approximately 12 percent of fund firms. I am grateful to Charles Biderman of TrimTabs for sharing this data with me. The TrimTabs sample is not necessarily representative of the rest of the fund industry: dilution rates may be higher or lower outside the sample.

[4] For all equity funds, I found flow consistent with late trading in 16 percent of fund families. By that I mean a strong, statistically-significant correlation between a fund's inflows and whether market timing or late trading would be profitable on a particular day. The fact that late trading was occurring in a fund does not necessary imply that the fund company facilitated the trading, since the trading could have occurred through a broker. My finding of late trading in 16 percent of families roughly anticipated the results of the SEC survey reported by Stephen Cutler in his Senate testimony on November 3, 2003. Mr. Cutler reported that over 10 percent of surveyed fund groups were aware of late trading in their funds (although it was phrased as "almost 90 percent were not aware").

significant, in funds holding small-cap equities or illiquid bonds (e.g., municipals, convertibles, and high-yield bonds).

- The source of these losses is arbitrageurs buying funds for less than their current value and selling funds for more than their current value. In an open-ended mutual fund, the long-term shareholders are on the other side of these disadvantageous trades.
- Dilution rates have declined since the beginning of 2003, but not to zero. Even for September 2003, after the announcement of the investigation by the state and federal regulators, international-fund shareholders were still diluted at an annual rate of about 0.3 percent.
- In April 2001, the SEC sent a letter to the fund industry reminding it of its obligation to use fair value pricing to eliminate stale prices, especially in their international funds.[5] Despite this, a statistical analysis of fund net asset values reveals that in 2003 over 50 percent of fund families removed less than 10 percent of the staleness in their net asset values. This implies that they are fair valuing extremely rarely, if at all. The average fund is a removing just over 20 percent of the staleness in their net asset values.
- Short-term trading fees and monitoring by the fund family are imperfect solutions to the problem. I find that dilution due to stale-price arbitrage is only 50 percent lower in funds with fees. This is because arbitrageurs can wait out the fees, because the fees cannot be applied in all channels (e.g., 401(k) plans, variable annuities), and because the collection of fees is not always enforced. The SEC survey reports that almost all fund families monitor for stale-price arbitrage, and yet dilution is still substantial in at least some of these funds.
- Industry averages mask substantial heterogeneity across families. Just under 10 percent of fund families are fair value pricing their international funds frequently enough to remove over 70 percent of staleness. Another 10-15 percent are removing about 50 percent of staleness. Although

[5] Letter from Douglas Scheidt to Craig S. Tyle regarding valuation issues, April 30, 2001. Available at http://www.sec.gov/divisions/investment/guidance/tyle043001.htm.

almost every international fund has been diluted by stale-price arbitrage, about 75 percent of dilution is concentrated in the 25 percent most affected international funds.

- I have found that fund families with more independent directors and lower expense ratios experienced less dilution and were more likely to use fair value pricing and short-term trading fees to limit arbitrage activity.

Policy makers and regulators face two challenges: 1) ensuring that affected investors are fairly compensated, and 2) ensuring these and similar problems cease and do not reoccur. The first is a non-trivial issue; simply relying on the reimbursement calculations of the affected firms may be insufficient, since the affected firms will certainly be tempted to apply a narrow definition of damages, which could lead to an under-compensation of investors. Policy makers obviously may choose to provide some guidance here.

But I will devote my attention for now to the second issue. I believe that a complete solution to the market timing and late trading issues needs to involve three components:

1. **A pricing solution**. The most direct method of eliminating stale-price arbitrage is to eliminate the staleness in NAVs via fair value pricing. It is already standard practice to use fair value pricing for corporate and treasury bonds, except we do not call it fair value pricing, we call it evaluated or matrix pricing. Fair value needs to be extended to international and perhaps small-cap equities, and evaluated bond pricing should be extended to currently excluded asset classes such as convertibles and high-yield.

   The SEC allows for fair value pricing, but as I noted, it has been underutilized by the industry. A cynical view might be that funds have dragged their feet on fair value to preserve the ability to allow favored customers to arbitrage their funds. This may be true in some cases, but adoption of fair value has also been limited by the vagueness of the SEC's April 2001 letter. In particular, the SEC reminds funds of their obligation to fair value after a "significant event," but does not define the term. Some funds have used such a narrow definition of a significant event (e.g., an earthquake, or a 3 percent move in the value of international securities) that they end up fair valuing extremely rarely. In some cases, this may be due to perceived legal risk of fair valuing more frequency; in some cases, the perceived legal risk may being used as an excuse.

In his testimony on October 9, 2003, SEC Chairman Donaldson, listed as one response to these issues emphasizing the obligation of funds to fair value "under certain circumstances." It is vital that the SEC define, perhaps not exhaustively, what these circumstances are. In order for fair value to be effective, this definition will need to be broader than it is currently.[6]

Allowing fair value pricing to be done using an *ad hoc* process is dangerous, since it invites manipulation. A better approach is to use a model that updates the most recent market price for recent changes in market indicators (e.g., for Sony, these might be the ADR price, the Nikkei future, the S&P 500, a sector index, and the Yen) on a security-by-security basis. The model could be calibrated using historical correlations, and should be subjected to rigorous testing, both before implementation and on an on-going basis.[7]

I should emphasize that short-term trading fees or restrictions are not substitutes for fair value pricing. The greatest danger I see in the current debate is that this will not be recognized. Fees have not been fully effective historically, for the reasons I mentioned. Even if the Investment Company

[6] For example, assuming the levels of market volatility from 1998-2003 persist, using a threshold for fair valuing of a 75 basis point change in the S&P 500 (or comparable movement in other market indicators) would be necessary to remove 90 percent of the staleness from NAVs. This is the threshold that I recommend to funds that ask my opinion.

[7] In the interests of full disclosure, I should mention that I helped develop the model used by one of the third-party fair value pricing services, Financial Times Interactive Data. My views on fair value pre-date this work.

Institute's proposed 2 percent fee for trades within 5 days is perfectly enforced in every channel, which is far from certain, arbitrageurs could simply wait until day 6 to sell. A quick simulation I ran revealed that a mandatory 5-day hold reduced arbitrage excess returns only from 48 percent to 24 percent per year, hardly enough to be a serious deterrent.[8] Even a complete ban on selling within 90 days would only reduce arbitrage excess returns to 5 percent per year: these excess returns are still going to be attractive to hedge funds. And my guess is that average investors would not appreciate such a ban. Fees may be a good idea, but they are not a substitute for eliminating stale prices.

A related danger I see in the current debate is that the SEC might allow funds to use solutions that allow them to deny arbitrage opportunities to some investors, but allow them to others. Fair value pricing removes arbitrage opportunities equally to all investors. Other solutions, such as short-term trading fees, monitoring by the fund company, and allowing funds the *option* to either delay exchanges or retain gains from short-term trades, can be applied or not applied as funds see fit. This limitation of many of the currently popular "solutions" has clearly contributed to the recent scandal.

2. **A third-party monitoring solution**. Fair value pricing addresses stale price arbitrage, but there is no pricing solution for late trading. Furthermore, no fair value pricing formula will be perfect. Therefore, we need to provide tools for boards, regulators, and even shareholders to monitor trading activity in funds. One possibility would be to require funds to publicly disclose daily inflows and outflows, perhaps with a two-month lag to alleviate any front running concerns. This would allow anyone, including data and advisory firms, to use the formula from my and other academic studies to estimate dilution. An alternative would be to require the disclosure of this information to regulators, boards, and a limited number of third-party firms, who would disclose only

[8] Note that a mandatory 5 day hold is even stricter than a 2 percent fee or a requirement that any gains from short-term trading be retained by the fund.

the most egregious cases. My guess is that, either way, this idea will meet significant resistance from some in the industry, but you should ask yourself: is there any good reason why these disclosures should not be made?

3. **A governance solution**. My research suggests that boards with more independent directors perform better in limiting arbitrage; earlier research has shown that these boards negotiate lower expense ratios on behalf of their investors. I agree with the proposals that have been made to increase the percent of independent directors to 75 percent or higher, and to tighten the definition of independent. Of course, there is a tradeoff between knowledge and independence; the worst possible board may be a board of non-financially trained members who are forced to trust management. But in my experience, there is no shortage of independent-minded people who know about finance; funds simply need to be given the incentives to fill their boards with these people, and not management cronies. While it is difficult to legislate true independence, we tend to know it when we see it. Your ongoing oversight of the industry will be just as important as any legislation you pass in ensuring that fund boards become more independent and effective.

   The issue of independence also arises with respect to regulatory bodies. Staffing a regulatory body with personnel who spend a few years with the body and then return to jobs in industry is a textbook recipe for regulatory capture, especially if an industry is aggressive about working only with ex-regulators who have taken friendly positions while in office.[9] At the same time, staffing the regulatory body in such a manner may be the only way to attract expertise at a reasonable cost. The solutions may be to: 1) recognize and reward independence when we see it, and 2) ensure that sufficient power is held by those whose subsequent income does not depend too heavily on the favor of the industries they regulate.

[9] These statements should not be taken to mean that everyone who faces incentives for capture responds to them; only that, on average, economists expect people to respond to incentives. Furthermore, I do not mean to imply that economists do not face similar incentives.

Chairman Baker, in your invitation letter, you asked for feedback on HR 2420. Although my research is less directly relevant to the issues addressed in that bill, I am somewhat familiar with them.

- Mutual funds are a product for unsophisticated investors, and based on some of the investment choices we observe in the data, in some cases that lack of sophistication appears to extend to an inability to multiply an expense ratio by the total dollars invested. I thought the provision that required each investor to be furnished with the extra dollar figure that they paid in expenses was a good idea, and was disappointed to see it deleted during the committee process.
- Providing investors, not just boards, with information on brokerage commissions paid by the fund and soft dollar benefits received by the management company is also a good idea. The differences in brokerage fees paid by funds for a given trading volume can be dramatic, and soft dollar benefits are a significant explanatory factor. These costs are difficult for most investors to observe.

**How Widespread is Late Trading in Mutual Funds?**

Eric Zitzewitz*
Stanford Graduate School of Business

September 2003

**Abstract**. This paper uses daily fund flow data to examine the extent of late trading in the mutual fund industry. Using data from a 10-15 percent subsample of the industry, I find annual long-term shareholder losses due to late trading of about 5 basis points in international equity funds and 0.6 basis points in domestic equity funds in 2001, and similar dilution rates in a separate dataset for February to July 2003. If these dilution rates prevail industry-wide, it would imply shareholder losses of about $400 million per year. Although shareholder losses due to late trading are smaller than those due to market timing, international fund inflows are almost as sensitive to 4 PM to 7 PM market movements as they are to pre-4 PM movements, suggesting that the practice is almost as widespread as the timing of international funds. Furthermore, there is statistically significant evidence of late trading in the international funds of 15 out of 50 fund families in the sample.

* On leave at Columbia Graduate School of Business for 2003-4: 3022 Broadway, Uris Hall 624, New York, NY, 10027. Tel: (212) 854-5775. Email: ericz@stanford.edu. The author would like to thank Jon Reuter for helpful suggestions and comments, and TrimTabs for sharing its fund flow data.

**Introduction**

On September 3, 2003, New York Attorney General (NYAG) Eliot Spitzer announced an investigation into the trading practices of mutual funds. This investigation asked whether specific mutual funds had colluded with hedge funds to facilitate the late trading of their funds. Under the forward pricing rule, trades in U.S.-based open-ended mutual funds are to be priced at the next net asset value (NAV) calculated after an order is received.[1] The vast majority of U.S.-based mutual funds calculate NAVs once per day at 4 PM Eastern Time, and so for these funds, orders received before 4 PM should be priced at the NAV calculated on the day of the trade while trades received after 4 PM should instead be priced at the next-day net asset value.

Late trading occurs when investors placing trades after 4 PM receive the 4 PM price. These late traders can use the information revealed after 4 PM to guide their trades: buying funds when their current value is greater than their 4 PM value and selling the funds when the reverse is true. Doing so allows them to earn expected abnormal returns at the expense of the fund's long-term shareholders.

Prior to 1968, most mutual funds practiced backward pricing, pricing trades using the most recent *prior* NAV. This created an opportunity for investors, particularly those who were able to avoid sales loads, to dilute long-term shareholders, and the forward pricing rule was adopted to protect average shareholders from this dilution. The rule is extremely well known throughout the industry, since it determines the dating and thus the pricing of mutual fund trades.

The NYAG's investigation alleges that mutual fund managers allowed hedge funds to place trades after 4 PM, in some cases as late as 9 PM, that received the 4 PM price. This lowered the returns of the funds involved, but the hedge funds compensated the fund managers by purchasing other financial products. These deals were viewed by the NYAG as the hedge funds essentially paying mutual funds to allow them to dilute their shareholders' assets.

This is such an egregious violation of a fund manager's fiduciary responsibilities that one might suppose that it was limited to a few isolated cases. This paper uses daily flow data from a 10-15 percent sample of the fund industry to estimate the extent of late trading, concluding that the practice was more widespread than one might have supposed. I find that in both 2001 and 2003, the average investor in a sample of international and U.S. equity funds lost about 5 and 0.6 basis points to this practice, respectively. If these dilution rates applied industry-wide, it would imply losses to shareholders of about $400 million per year. In addition, there is statistically significant evidence of late trading in the international funds of 15 out of 50 fund families in the sample.

[1] See rule 22c-1 enacted in 1968 under the Investment Company Act of 1940.

**Late trading and market timing**

Late trading is related to a practice commonly called market timing. A market timer trades mutual funds in asset classes in which the most recent price as of 4 PM is stale, i.e. does not fully reflect recent market movements.[2] Examples include international equities (due to the earlier closure of foreign markets) and less-liquid assets such as small-cap equities and high-yield and municipal bonds. As is the case with late trading, the market timer buys (sells) funds following positive (negative) market movements, when the current fund value is above (below) the NAV, diluting long-term shareholders in the process. Unlike late trading, market timing has been documented in the academic literature and discussed in the popular press.[3]

Market timing is legal, whereas late trading is not. But the SEC has been encouraging funds to restrict market timing opportunities through a combination of fair-value pricing (i.e., updating stale prices to reflect recent market movements) and other deterrents such as monitoring and short-term trading fees. At least until mid-2003, most funds showed a strong preference for addressing the problem solely through fees and monitoring, despite the shortcomings of these solutions. The most notable shortcoming is that whereas proper fair-value pricing removes dilution opportunities from all investors equally, it is difficult to ensure that fees and monitoring are applied to all investors. I remarked on this puzzling preference for fees and monitoring in Zitzewitz (2003), and postulated that one possible explanation was that fund managers wanted to preserve the right to selectively allow dilution opportunities to specific investors. A component of the NYAG investigation is examining whether funds exempted specific investors from fees and monitoring in exchange for compensation.

Late trading is often practiced in combination with market timing. This is unsurprising, since both practices are based on the underlying principle of trading using information not yet reflected in fund NAVs, both involve the frequent buying and selling of funds, and both benefit from the complicity of the fund manager. In the case of Canary Capital Management, the first company investigated by the NYAG, late trading was added onto pre-existing market timing arrangements with a fund and a fund custodian. Since the most profitable market timing opportunities are in international equity funds, and we might expect late trading to be concentrated in these funds as well.

**Data and Methodology**

The extent of late trading can be determined by measuring the correlation between daily mutual fund flows and unanticipated post-4 PM market movements. In the absence of

[2] Market timing is a misnomer, since a "market timer" in an international fund is usually not investing to time the market, but to exploit the stale pricing of mutual fund shares. But since market timing is the term that is widely used in the press, I will use it as well in this paper.

[3] Academic papers on the subject include Bhargava, Bose, and Dubofsky (1998), Chalmers, Edelen, and Kadlec (2001), Goetzmann, Ivkovic, and Rouwenhorst (2001), Greene and Hodges (2002), Boudoukh, Richardson, Subrahmanyam, and Whitelaw (2002), and Zitzewitz (2003). Press coverage includes Hulbert (2000), Lucchetti (2000), Bullard (2000), Stone (2002), and Carnahan (2003).

late trading, all trading decisions for the current day must be made before 4 PM, and thus any correlation between current-day flows and unanticipated post-4 PM market movements is likely to evidence of late trading.[4]

I test for late trading by using the following regression model:

$$\frac{flow_t}{assets_{t-1}} = \beta_0 + \beta_1 \cdot \Delta SP_t^{3:00-11:30} + \beta_2 \cdot \Delta SP_t^{11:30-16:00} + \beta_3 \cdot \Delta SP_t^{16:15-21:00} + \varepsilon_t . \quad (1)$$

The dependent variable is net inflows to the fund, normalized by prior-day assets, where inflows are defined as the difference between the assets of the fund(s) in question and the prior-day assets adjusted for current-day fund returns. The independent variables are changes in the Chicago Mercantile Exchange S&P 500 futures price. The first two terms control for market timing using pre-4 PM information; the third term captures late trading using post-4 PM information. Controlling for pre-4 PM market movements serves two purposes: 1) it controls for any correlation between pre and post-4 PM market movements, which given the liquidity of the S&P 500 future, is minor, and 2) by reducing the variance of the error term, it improves the efficiency of estimation.

A starting time of 4:15 is used for the third term to prevent any staleness in the 4 PM S&P futures price from being improperly classified as late trading. The S&P future is extremely liquid, with bid-ask spreads that are 1-2 basis points at 4 PM, so any staleness should be minor. 9 PM is taken as the stopping time since that was the latest late trading time mentioned in the complaint against Canary Capital Partners, LLC.[5] The starting times for the first two terms are the approximate closing times of most Asian and European equity markets, respectively.

Dilution due to late trading can be measured using the following formula:

$$dil_t = \frac{NAV_t^{9PM} - NAV_t^{4PM}}{NAV_t^{4PM}} \cdot flow_t . \quad (2)$$

Conceptually, dilution is the difference between the actual assets of the fund and what the assets would have been had the fund priced itself using the 9 PM value of its assets. If inflows are uncorrelated with post-4 PM market movements, then this measure will be zero. In practice, funds do not calculate a 9 PM NAV, but we can substitute the expectation of the next-day NAV conditional on the 4 PM to 9 PM change in the S&P futures. This approach is analogous to the approach to measuring dilution from market timing used in Zitzewitz (2003).

[4] Another possibility is that it is evidence of insider trading. For example, an Intel employee is aware that Intel will announce a positive earnings surprise after 4 PM, and exp loits this knowledge by buying a technology fund rather than Intel stock to make their actions less obvious. Given the magnitude of the correlation and its concentration in international funds, this seems unlikely to be its primary source.

[5] State of New York v. Canary Capital Partners, LLC (2003), *Complaint*, p. 7.

The daily fund flow data comes from TrimTabs, which collects daily assets, returns, and distributions from a 10-15 percent sample of the industry and uses these to construct measures of flows. I have daily fund-level data from February 1998 to September 2001, and I supplement this daily asset-class-level data for international and U.S. equity funds from February to July 2003.

An issue with the TrimTabs data is that inflows are reported with a one day lag for most funds (see Zitzewitz, 2003, Section 4 for a discussion of this issue).[6] I correct for this lag by calculating flows assuming each day's asset figures are pre-flow rather than post-flow, but perform checks below to ensure that this correction is appropriate.

**Results**

Table 1 presents estimates of equation (1) for international and U.S. equity funds. Both equal-weighted and asset-weighted estimates are provided for the 1998-2001 period in which I have fund-level data, while only asset-weighted estimates can be calculated for 2003, when I have only asset-class-level data.

The estimates show clear evidence of a correlation between post-4 PM market movements and mutual fund inflows, which is consistent with late trading and difficult to explain in its absence. Late trading appears to have become more common in international funds in 2001 and 2003, compared with 1998-2000, but less common in U.S. equity funds.

If late trading were practiced as a stand-alone strategy, we might expect it to be practiced in domestic equity funds, since these funds should be more responsive to 4 to 7 PM U.S. market news. One possible reason for the apparent shift in late trading from U.S. to international funds is that 4:15 PM to 9 PM volatility declined after 2000, reducing the profitability of late trading as a standalone strategy, and leading late trading to be done mainly in tandem with international fund market timing. The standard deviation of S&P changes in that time period dropped from 46 basis points from 1998-2000 to 31 basis points in 2001 to 17 basis points in the 2003 sample.

Interestingly, inflows into international funds in 2001 and 2003 are almost as sensitive to post-4PM market movements as to 11:30AM – 4PM market movements. Sensitivity to pre-4PM market movements is evidence of market timing, while sensitivity to post-4PM market movements is evidence of late trading. If timing were always being practiced in combination with late trading, one might expect these coefficients to be roughly equal, since traders would be trading based on the 11:30 AM to 7 PM market movement.[7] The

[6] An exception to this are funds that cater to high-frequency traders (e.g., Rydex, Profunds, Potomac), which do not report with a lag to TrimTabs. I drop these funds from the sample.

[7] A caveat: the beta of international equity markets with respect to the S&P futures varies by time of day, depending on the nature of the news that is typically released at that time of day. I find that the beta of the average international fund with respect to the S&P is roughly 0.4 for 11:30 AM to 4 PM and 4 PM to 5 PM market movements, but rises to about 1.0 from 5 PM to 9 PM. So if the investors practicing market timing and late trading in tandem are sophisticated enough to take the time-varying beta into account and trade

closeness of the coefficients suggests that a large share of market timing is being done in tandem with late trading.[8]

Table 2 repeats the analysis in Table 1 with a greater disaggregation of time periods on the right-hand-side. In international and domestic equity funds, inflows are statistically significantly related to market movements until at least 7 PM.

Table 2 also provides a check of the appropriateness of correcting for the lag in TrimTabs flow data. It is clear from Table 2 that the sensitivity of inflows to market movements from 3AM to 4PM the next day is (a precisely estimated) zero. This suggests that the evidence of late trading reported in Table 1 is not an artifact of improperly adjusting the timing of flows in the TrimTabs data.

Table 3 reports estimates of the losses due to late trading. These are calculated using equation (2) above, where $NAV_t^{9PM}$ is the predicted next-day NAV conditional on the 4 PM to 9 PM change in the S&P 500. From 1998-2000, late trading was occurring to a statistically significant extent in U.S. equity funds, but by 2001 it appears to have shifted to international funds. Dilution of long-term shareholders due to late trading in the first nine months of 2001 was about 5 basis points in international funds and under 1 basis point in U.S. equity funds. If we assume that dilution was occurring at roughly the same rate in funds outside the TrimTabs sample, this imply would losses to long-term shareholders of about \$400 million per year in 2001; \$200 million per year each in international and U.S. equity funds.

These losses are small relative to the losses due to market timing reported in Greene and Hodges (2002) and Zitzewitz (2003). Although Tables 1 and 2 suggest that fund inflows were almost as sensitive to 4-7 PM market movements as to pre-4 PM movements, the volatility of markets is much lower after 4 PM, and so there is less news on which to trade.

Another way in which to examine how widespread late trading was is to repeat the analysis in Table 1 for individual fund families. My agreement with TrimTabs prevents me from reporting results for individual fund companies, but I can report there is statistically significant evidence (at a 95 percent confidence level) of late trading in international funds from 1998-2001 for 15 out of the 50 fund companies in the TrimTabs sample.[9] In domestic equity funds there is evidence of late trading for 12 out of 96

based on the 11:30 AM to 7 PM change in the expected next-day foreign market price, then one would expect inflows from these investors to be more sensitive to post-4PM changes in the S&P futures. In this case, the coefficients in Table 2 would imply that market timing is practiced in tandem with late trading until 5 PM about 85% of the time, and in combination with late trading until 7 PM about 35% of the time.

[8] Or alternatively, that market timing and late trading are being practiced separately but in roughly equal magnitudes. But this seems unlikely, since investors who are practicing late trading in international funds are likely to also be aware of the market timing opportunity.

[9] In other words, the coefficient on the 4:15 to 9 PM market movements is positive and significant for 15 out of 50 fund families. The coefficient is negative and significant for 0 and 2 families for international and domestic equity funds, respectively. Regressions for fund families are run by constructing a time series of equal-weighted average inflow-to-assets ratios for a family's funds in a given asset class.

families. Across both samples, there was evidence of late trading in at least one asset class for 16 out of 104 families.

This does not necessarily imply that all 16 fund firms were colluding with late traders. First, given a 95 percent, two-tailed confidence level, one would expect a false positive rate of 2.5 percent. In addition, the NYAG's complaint against Canary Capital Partners suggested that it placed trades through the Bank of America and through a retirement plan administrator, perhaps without the knowledge of some of the fund families involved.

**Conclusion**

While the amount of long-term shareholder wealth lost due to late trading is large in absolute dollar terms, it is small relative to that lost to market timing. It is also probably smaller than the impact of excess trading due to incentives created by soft dollars (Siggelkow, 2003) and smaller than the cost to investors of choosing high-expense-ratio index funds (Hortascu and Syverson, 2003).

But charging a high expense ratio for an index fund, overtrading to earn soft dollars, and even allowing market timing are not illegal, whereas allowing late trading is. Late trading is thus suggestive of a different kind of oversight and agency problem within mutual funds than these other practices. Understanding the extent to which the mutual fund industry engaged in illegal activity that harmed shareholders is of first-order importance in understanding the degree of agency problems in the industry. This is in turn informative about the extent to which policy should rely on the industry as a savings gathering vehicle. In particular, it's informative about the wisdom of policies that compel the use of a particular mutual fund family, such as section 529 educational savings plans and some social security privatization proposals.

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**Table 1. Regressions of daily mutual fund flows on changes in the S&P futures**
Dependent variable: flow_t/assets_t-1

| | | | Independent variables: S&P futures changes | | | | | |
|---|---|---|---|---|---|---|---|---|
| Asset class | Time period | Obs. | 3 AM to 11:30 AM | | 11:30 AM to 4PM | | 4:15 to 9:00 PM | |
| Equal-weighted | | | | | | | | |
| International equity | 1998-2001 | 691 | 0.377*** | (0.030) | 0.466*** | (0.026) | 0.189*** | (0.056) |
| | 1998 | 176 | 0.419*** | (0.074) | 0.372*** | (0.056) | 0.189 | (0.120) |
| | 1999 | 184 | 0.422*** | (0.046) | 0.467*** | (0.040) | -0.006 | (0.071) |
| | 2000 | 190 | 0.363*** | (0.052) | 0.416*** | (0.048) | 0.146 | (0.106) |
| | 2001 | 141 | 0.398*** | (0.067) | 0.665*** | (0.065) | 0.648*** | (0.188) |
| U.S. equity | 1998-2001 | 691 | 0.056*** | (0.009) | 0.067*** | (0.008) | 0.070*** | (0.016) |
| | 1998 | 176 | 0.072*** | (0.017) | 0.055*** | (0.013) | 0.049* | (0.027) |
| | 1999 | 184 | 0.073*** | (0.018) | 0.123*** | (0.016) | 0.076*** | (0.028) |
| | 2000 | 190 | 0.060*** | (0.019) | 0.031* | (0.017) | 0.069* | (0.038) |
| | 2001 | 141 | 0.037*** | (0.014) | 0.065*** | (0.014) | 0.032 | (0.040) |
| Asset-weighted | | | | | | | | |
| International equity | 1998-2000 | 550 | 0.210*** | (0.018) | 0.233*** | (0.015) | 0.075** | (0.031) |
| | 2001 | 141 | 0.218*** | (0.043) | 0.407*** | (0.041) | 0.355*** | (0.120) |
| | 2003 | 78 | 0.247*** | (0.035) | 0.396*** | (0.040) | 0.385** | (0.180) |
| U.S. equity | 1998-2000 | 550 | 0.027 | (0.022) | 0.074*** | (0.019) | 0.022 | (0.037) |
| | 2001 | 141 | 0.019 | (0.014) | 0.056*** | (0.014) | 0.036 | (0.040) |
| | 2003 | 78 | 0.020*** | (0.007) | 0.029*** | (0.008) | 0.057 | (0.036) |

inflows on changes in the S&P futures at various times. Standard errors are in parenthesis; significance at the 10, 5, and 1 percent level is indicated with 1, 2, and 3 asterisks, respectively. For equal-weighted regressions, the dependent variable is the arthimetic average of the flow_t/assets_t-1 ratio for each fund in that asset class. For asset-weighted regressions, it is the ratio of the sum of flow_t and assets_t-1 for all funds in that asset class. In both cases, flow is defined as assets_t - assets_t-1*(nav_t+dist_t)/nav_t-1. The 1998-2001 sample runs from 2/1/98 to 9/30/01; the 2003 sample runs from 1/24/03 to 8/12/03.

**Table 2. Until when does late trading occur?**
Dependent variable: equal-weighted inflows and next-day returns for the asset class

| Dependent variable | Flow_t/assets_t-1 | | Return_t+1 | |
|---|---|---|---|---|
| | International | U.S. equity | International | U.S. equity |
| Observations | 649 | 649 | 649 | 649 |
| 3 AM to 11:30 AM | 0.400*** | 0.058*** | 0.249*** | 0.056* |
| | (0.031) | (0.009) | (0.039) | (0.031) |
| 11:30 AM to 4 PM | 0.480*** | 0.072*** | 0.367*** | 0.120*** |
| | (0.028) | (0.008) | (0.037) | (0.029) |
| 4 to 4:15 PM | 0.427*** | 0.053** | 0.547*** | 0.703*** |
| | (0.088) | (0.026) | (0.113) | (0.125) |
| 4:15 to 5 PM | 0.411*** | 0.084*** | 0.504*** | 0.713*** |
| | (0.084) | (0.025) | (0.115) | (0.123) |
| 5 to 6 PM | 0.436** | 0.089 | 1.085*** | 1.193*** |
| | (0.199) | (0.058) | (0.228) | (0.194) |
| 6 to 7 PM | 0.430** | 0.181*** | 0.915*** | 0.974*** |
| | (0.202) | (0.059) | (0.215) | (0.151) |
| 7 to 8 PM | -0.003 | 0.087 | 1.259*** | 0.753*** |
| | (0.204) | (0.059) | (0.194) | (0.186) |
| 8 to 9 PM | 0.253 | 0.112 | 1.355*** | 0.987*** |
| | (0.246) | (0.072) | (0.395) | (0.225) |
| 9 PM to 3 AM (t+1) | -0.130 | 0.061** | 1.415*** | 0.964*** |
| | (0.107) | (0.031) | (0.140) | (0.120) |
| 3 AM to 11:30 AM (t+1) | -0.020 | 0.008 | 0.734*** | 1.071*** |
| | (0.030) | (0.009) | (0.040) | (0.033) |
| 11:30 AM to 4 PM (t+1) | -0.022 | -0.012 | 0.232*** | 0.884*** |
| | (0.029) | (0.008) | (0.042) | (0.054) |

Each column is a regression of inflows on changes in the S&P futures at various times. Standard errors are in parenthesis; significance at the 10, 5, and 1 percent level is indicated with 1, 2, and 3 asterisks, respectively. The sample is from 2/98 to 9/01 (2003 is excluded since fund-level data is not available).

**Table 3. Estimating dilution from late trading**
Annualized dilution in basis points

| | International equity | | | U.S. equity | | |
|---|---|---|---|---|---|---|
| | 1998-2000 | 2001 | 2003 | 1998-2000 | 2001 | 2003 |
| Equal weighted | | | | | | |
| | 1.30 | 6.46*** | | 2.21*** | 0.87 | |
| | (0.81) | (1.84) | | (0.50) | (0.60) | |
| Asset weighted | | | | | | |
| | 0.69 | 4.69** | 4.18** | 0.72** | 0.44 | 0.57 |
| | (0.42) | (0.77) | (2.16) | (0.30) | (0.46) | (0.54) |

Dilution is estimated as the sum of (NAV_9PM - NAV_4PM)*flow(t) (equation 2 in the text), where NAV_9PM is the predicted next-day fund NAV conditional on the 4:15 to 9 PM change in the S&P futures. Standard errors are in parenthesis.

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# Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds

Eric Zitzewitz
Stanford Graduate School of Business

As is becoming increasingly widely known, mutual funds often calculate their net asset values (NAVs) using stale prices, which causes their daily returns to be predictable. By trading on this predictability, investors can earn 35–70% per year in international funds and 10–25% in asset classes such as small-cap equity and high-yield and convertible bonds. These abnormal returns come at the expense of long-term shareholders, dilution of whom has grown in international funds from 56 basis points in 1998–99 to 114 basis points in 2001. Despite these losses and pressure from the Securities and Exchange Commission (SEC), the vast majority of funds are not market-updating their prices to eliminate NAV predictability and dilution, but are instead pursuing solutions that are only partly effective. The speed and efficacy of a fund's actions to protect shareholders from dilution is negatively correlated with its expense ratios and the share of insiders on its board, suggesting that agency problems may be the root cause of the arbitrage problem.

## 1. Introduction

Financial markets may be efficient enough to prevent widely known arbitrages, but are financial institutions? Mutual funds currently use pricing policies that allow market timers to earn large trading profits at the expense of long-term shareholders. Despite the fact that this arbitrage opportunity has been understood by the industry for 20 years and heavily exploited since at least 1998, the fund industry was still taking only limited

This article replaces an earlier draft entitled "Daily Net Asset Value Predictability and the Associated Trading Profit Opportunity." The author would like to thank Alexander Aganin, Peter Ciampi, Steven Cohen, Elizabeth Duggan, Ken French, Luis Garicano, Will Goetzmann, Jason Greene, Paul Joskow, Sendhil Mullainathan, Robert Pindyck, Jim Poterba, Venkat Subrahmaniam, an anonymous referee, and seminar participants at MIT and Tulane for helpful suggestions and comments. Thanks also to TrimTabs for sharing their daily flow data, to Jason Greene and Charles Hodges for sharing their classification of fund flow timings in the TrimTabs data, and to Cassandra Flenker for excellent research assistance. All views expressed and any errors or omissions are mine alone. The financial support of a National Science Foundation Graduate Research Fellowship is gratefully acknowledged.

*The Journal of Law, Economics, & Organization*, Vol. 19, No. 2,
 DOI: 10.1093/jleo/ewg011

action to protect its long-term shareholders as of late 2002. This article contributes to the documentation of the arbitrage opportunity and resulting losses to long-term shareholders, discusses the shortcomings of the industry's response to date, and examines the relationship between funds' governance and their actions to protect their long-term shareholders.

The source of the arbitrage opportunity is the way in which open-end mutual funds price their shares. Whereas investors in closed-end or exchange-traded funds trade with each other on the equity exchanges, investors in open-end mutual funds trade directly with the fund itself. Transactions in open-end funds are priced using the net asset value (NAV) per share calculated by funds at the end of the business day. Funds have traditionally calculated their NAVs by valuing their assets using their most recent transaction prices as of the close of U.S. equity markets at 4:00 P.M. eastern time (ET) and allowed investors to place trades up until that time.

For many asset classes, the most recent transaction price at 4:00 P.M. ET does not fully reflect all available market information. The most obvious example is international equities that trade on exchanges that are located in different time zones and close 2–15 hours before U.S. markets. In addition, domestic small-cap equities and high-yield and convertible bonds often trade infrequently and have wide bid-ask spreads. This can cause the most recent transaction price to be systematically different from the price that would prevail in a liquid market at 4:00 P.M., even for assets that trade on exchanges that are open at that time.

Investors can take advantage of mutual funds that calculate their NAVs using stale closing prices by trading based on recent market movements. For example, if the U.S. market has risen since the close of overseas equity markets, investors can expect that overseas markets will open higher the following morning. Investors can buy a fund with a stale-price NAV for less than its current value, and they can likewise sell a fund for more than its current value on a day that the U.S. market has fallen. Analogous opportunities exist when the values of infrequently or illiquidly traded domestic assets have recently changed.

A series of recent studies have shown that the potential returns to even a very simple trading strategy are quite high. Arbitrageurs who buy international funds on days the S&P 500 has risen and sell them on days it has declined can earn uncompounded excess returns of 35% per year; refinements to the trading strategy can double these returns. The arbitrage returns available in domestic small-cap and convertible and high-yield and convertible bond funds are smaller but still substantial, at 20–25% and 10–25%, respectively. These excess returns come at the expense of long-term shareholders, who are diluted by advantageously timed inflows and outflows. This article presents evidence from a sample of funds that suggests long-term shareholders are losing about $5 billion per year across all asset classes. Dilution is concentrated in international equity funds, where the arbitrage opportunities are largest; in 2001 it averaged 1.1% and

2.3% of assets per year in general and regionally focused international funds, respectively.

Dilution of long-term shareholders has grown rapidly in the last four years, and the mutual fund industry is beginning to respond. But given the size of the problem, the industry response has been surprisingly slow, and it has almost exclusively consisted of countermeasures that have significant shortcomings. The Securities and Exchange Commission (SEC) is not only permitting, but actively encouraging international funds to use systematic methods to substitute market-updated (or "fair-value") prices for stale prices when calculating their NAVs. But the fund industry, as represented by the Investment Company Institute, is lobbying the SEC to back down from requiring fair-value pricing and to allow funds to address the problem solely by adding transaction fees and by monitoring trades for arbitrage activity. These solutions are only partially effective, as evidenced by the fact that dilution is still large even in funds that employ them. In addition, they can be and usually are selectively applied, potentially giving fund companies the discretion to allow certain investors the opportunity to arbitrage their funds. Only a very limited number of funds are regularly using fair-value prices to calculate their NAVs.

Given the magnitude of dilution of long-term shareholders, the industry's surprisingly slow response to the arbitrage issue is suggestive of a conflict between the interests of shareholders and those of either the management company or its employees. One can use this issue to size the extent of these agency problems: simple calculations imply that fund companies that fail to fair value or that consciously allow arbitrage activity in order to increase the short-term size of their funds care less than five cents on the dollar about shareholder returns. Given the relationship between a fund's performance and its future size, these decisions do not maximize the net present value (NPV) of fund company profits for any reasonable discount rate, suggesting an agency problem within management companies as well as between fund managers and shareholders.

Funds have boards of directors that are charged with representing shareholder interests, and I find that funds with more outside directors are more likely to have introduced short-term trading fees or fair-value pricing.[1] This is also the case for funds with lower expense ratios, which is consistent since expense ratios are the result of bargaining between a fund's manager and its board, and a low expense ratio for a fund within a given asset class and management style should indicate stronger representation of shareholder interests (Tufano and Sevick, 1997). Despite these correlations, the slow response by the industry in general suggests that fund boards have been ineffective in protecting investors on this issue, perhaps because they have been captured by managers, as Jensen (1993) argues is the case for corporate boards. Agency problems and governance quality in

1. This echoes the findings of Weisbach (1988), who finds that outsider-dominated corporate boards are more likely to remove managers after poor performances.

asset management are of interest beyond this particular issue, particularly given the debate over social security privatization and the emergence of tax-advantaged savings plans, such as state Section 529 educational savings plans, that require the use of particular asset managers in order to obtain the tax advantages.

Several academic articles have discussed NAV predictability and the associated arbitrage opportunity: Bhargava, Bose, and Dubofsky (1998), Chalmers, Edelen, and Kadlec (2001), Goetzmann, Ivkovic, and Rouwenhorst (2001), Greene and Hodges (2002), and Boudoukh et al. (2002).[2] These articles focus on different asset classes and aspects of the problem: Bhargava, Bose, and Dubofsky (1998) and Goetzmann, Ivkovic, and Rouwenhorst (2001) focus on international funds while Chalmers, Edelen, and Kadlec (2001) studies small-cap U.S. equity funds as well. Goetzmann, Ivkovic, and Rouwenhorst (2001) and Greene and Hodges (2002) provide estimates of dilution, while Boudoukh et al. (2002) examines the extent to which arbitrage trading strategies can be hedged. Relative to those articles, this article focuses on examining the industry response to the issue and the role of fund governance, although it also extends past work on estimating arbitrage returns and dilution. In doing so, it contributes to the literature on agency in fund management that includes work by Chevalier and Ellison (1997) on fund company incentives and risk taking, Tufano and Sevick (1997) on board independence and management fees, and Sigglekow (2003) on 12b1 fees and soft-dollar commissions.

The remainder of the article is organized as follows. The next section provides background on the NAV arbitrage and shareholder dilution issues. Sections 3 and 4 provide estimates of fund arbitrageability and shareholder dilution by asset class. These sections extend past work (1) by providing comparable estimates of arbitrage profitability by asset class, noting for the first time that arbitrage profits are also high in high-yield bond and convertible bond funds, and (2) by providing more disaggregated and more recent calculations of shareholder dilution that highlight both its recent growth and high level in certain asset classes. Section 5 analyzes the effectiveness of solutions that are currently popular in the industry, with results that generally support the current SEC position that they are not substitutes for calculating NAVs using fair-value prices. Section 6 discusses the emerging SEC position and official industry resistance to fair valuation in more detail. Section 7 provides the evidence of a correlation between fund governance and proactiveness on the arbitrage issue that is suggestive of governance as an explanation for the slow

2. These articles draw on earlier work on the underlying financial market phenomena. On international financial market correlations see Eun and Shim (1989), Becker, Finnerty, and Gupta (1990), Engle, Ito, and Lin (1990), Becker, Finnerty, and Friedman (1993), and Lin, Engle, and Ito (1994). On predictability of indices of illiquidly traded domestic securities, see Lo and MacKinlay (1990) and Boudoukh, Richardson, and Whitelaw (1994). On the dilution of a retirement plan from an unrelated form of stale price trading, see Stanton (1999).

response of the industry to the issue in general. A conclusion follows, summarizing what this issue teaches us about agency problems in the fund industry in general.

## 2. Background

The existence of NAV arbitrage has been known to industry experts for at least 20 years, but it has become more widely known since the circulation of academic studies in late 1999 and early 2000 and financial press coverage shortly thereafter. In 1981 the SEC issued a no-action letter to two Putnam funds, taking no action against the international equity fund's practice of calculating NAVs using local closing prices on all days except if "some extraordinary event were to occur after the close." The Putnam request letter had recognized that postclose information could cause local closing prices to be "no longer a reasonable estimate of such securities values as of 4:00 P.M." This suggests that both Putnam and the SEC understood the nature of the problem, as should have other funds, to whom the letters were available.

Although the no-action letter allowed Putnam and other funds to "fair value" their assets if they concluded that local closing prices did not reflect current market value, in practice, funds did so extremely rarely. This practice was justified at the time by funds and the SEC as resulting from fair valuing being "too costly in light of the small risk that significant dilution would result from a failure to fair value."[3] One widely discussed exception occurred on October 28, 1997, when Asian markets closed following a 9% prior-day drop in the S&P 500, but, after Asian markets closed, the U.S. market rallied by 10% from its morning lows. Most U.S.-based Asian funds priced using local closes, allowing arbitrageurs to earn one-day returns of 8–10%, but Fidelity determined that a significant event had occurred and fair-value priced its Asian funds. The SEC investigated Fidelity following complaints from some investors (presumably arbitrageurs), but concluded that Fidelity had acted correctly. The SEC clarified its position in December 1999 and April 2001 letters to the Investment Company Institute, stating in increasingly clear terms that funds were responsible for monitoring for "significant events," including market volatility, that would cause local closing prices to not be considered "readily available market prices."

Net asset value arbitrage is receiving increasing attention from the SEC in part because of increased awareness of it outside the industry. All but one of the academic articles listed above were circulated in late 1999 and early 2000, along with the first draft of this article, and coverage in the financial press followed shortly thereafter (Bullard, 2000a, b; Hulbert, 2000; Lucchetti, 2000). As Section 4 discusses, dilution of long-term

3. Then Director of the SEC's Division of Investment Management Barry Barbash, as paraphrased in Bullard (2000b).

shareholders was substantial before these reports but has increased following them.

The current NAV arbitrage problem is not the first example of arbitrageurs with knowledge of mutual fund pricing practices diluting long-term investors. Prior to the passage of the Investment Company Act of 1940, NAVs were typically calculated at 4:00 P.M., but did not become effective for transactions until 10:00 A.M. the following day. Mutual fund insiders could transact after 4:00 P.M. at the prior-day NAV with full knowledge of the current-day NAV and earn riskless arbitrage returns based on the difference. Insiders were also sometimes sold mutual fund shares at a discount to the NAV, diluting the other shareholders of the fund. The Investment Company Act was at least partly a response to the impression that these arbitrage opportunities were leading to fairly widespread dilution; one of the primary goals of the 1940 act was to eliminate the opportunity for insiders to trade fund shares at prices that differ from their true value.

The act eliminated the opportunities described above, but until 1968, most funds processed transactions at the most recent *prior* NAV, allowing investors to transact at prior-day NAVs on days that the market had moved significantly. The SEC eliminated this practice and adopted rule 22c-1, requiring the current practice of "forward pricing," that is, of processing transactions at the next calculated NAV *after* orders are received. Both the pre-1940 and pre-1968 arbitrage opportunities reportedly led to substantial dilution of long-term shareholders, and in both cases, action by Congress or the SEC was required before the dilution was eliminated; the interests of long-term shareholders were not well enough represented at most funds to lead to change in the absence of government regulation.[4]

## 3. Excess Returns to NAV Arbitrage

This section provides estimates of excess returns to arbitrage strategies that exploit predictabilities in NAV changes. In particular, it analyzes an arbitrage strategy that switches between a fund and cash depending on the sign of the expected next-day fund return. Since the source of the arbitrage opportunity is that stale-price NAVs do not fully reflect recent market movements, a trading strategy would involve predicting next-day fund returns using current-day changes in the prices of related assets and then buying the fund when predicted next-day returns are positive. The analysis in this section assumes that arbitrageurs trade at maximum frequency, can make decisions up until 4:00 P.M. ET, and do not face transaction costs; this was usually the case in practice for investors trading directly with fund families in the late 1990s. Section 5 discusses the efficacy of short-term trading fees and trading frequency restrictions in reducing arbitrage and dilution.

4. For more detail on pre-1968 arbitrage and dilution, see Securities and Exchange Commission (1992) and Ciccotello et al. (2002).

The other articles listed above that have studied NAV arbitrage have also provided excess return estimates; the main contribution of this section is to provide them for all 48 Morningstar asset classes using a consistent methodology. Doing so highlights the breadth of NAV predictability: there are statistically and economically significant arbitrage opportunities in 44 of 48 Morningstar fund categories; the exceptions being the large-cap U.S. equity and specialty-utilities categories. It also provides useful background for the subsequent discussion of dilution and industry responses. Although arbitrage activity and the resulting losses to long-term shareholders are currently concentrated in international funds, the existence of opportunities in so many other asset classes suggests that any solution that only solves the problem in international funds will simply redirect activity to other asset classes.

### 3.1 Data

Standard sources of monthly mutual fund return data, such as Center for Research in Security Prices (CRSP) and Morningstar, do not have daily data for fund returns or net inflows, which one needs in order to estimate dilution. Funds are required to report their inflows and outflows only on a monthly basis, but TrimTabs (TT) surveys about 12% of U.S.-based open-ended funds on a daily basis in an attempt to obtain more timely information. Like Chalmers, Edelen, and Kadlec (2001), Goetzmann, Ivkovic, and Rouwenhorst (2001), and Greene and Hodges (2002), this article uses TT as its data source for daily flows, but like Goetzmann, Ivkovic, and Rouwenhorst, it supplements the TT daily return data using a more comprehensive data source, in this case, data from quote.yahoo.com.

Supplementing the TT data is useful for two reasons. First, TT is only a 12% sample of funds, and thus there are inevitable questions about its representativeness of the universe of funds. Second, the coverage of asset classes such as convertible bonds, precious metals, real estate, and European, Japanese, and Latin American equities is limited: each of these asset classes are represented by fewer than 10 funds in TT.

I attempted to collect daily NAVs for every mutual fund in the Morningstar universe that has a ticker symbol from quote.yahoo.com, and succeeded for 11,556 of 11,599 funds. The Yahoo data do not contain information on daily flows, but one can use it to confirm that TT is roughly representative of the Morningstar universe in terms of the excess returns available to arbitrageurs. The results reported in the tables use the Yahoo data; average arbitrage returns for the TT sample, using either TT or Yahoo data, are within 1 percentage point for all asset classes.

### 3.2 Predicting Returns

The first step in measuring excess returns to an arbitrage strategy is to predict next-day fund returns using information available at 4:00 P.M. ET. Since the source of the arbitrage opportunity is that NAVs calculated using stale prices do not fully reflect recent market movements, one would expect a positive relationship between next-day fund returns and current-day changes in the value of similar assets. I therefore regress next-day fund returns on current-day market indices and use the resulting model to predict next-day returns out of sample.

When applying a predictive model out of sample, one usually obtains better results when one limits the number of predictive variables to limit any data-snooping bias in estimation. I limit the model to three market indices that one would expect to be predictive of future returns on a priori grounds. For international equity funds, I use (1) the difference between the 4:00 P.M. price of the Chicago Mercantile Exchange (CME) Nikkei 225 future and its 2:00 A.M. ET closing value in Tokyo, (2) the change in the S&P 500 index after 11:30 A.M. ET, when most European markets close, and (3) the change in the S&P 500 index from 4:00 P.M. the prior day until 11:30 A.M.[5] For the Japan stock category, one might expect the Nikkei future to be the best single indicator of their value as of 4:00 P.M. ET, and thus the future-local close difference as the best predictor of the next-day return in a fund that prices using local closing prices. Likewise, for a Europe stock fund, the change in the S&P 500 index after the close of most European markets at 11:30 P.M. ET should be the best single predictor of next-day fund returns.

For other assets classes, I use the best available measures of recent changes in the value of similar assets. For domestic equity funds I use the 2:00–4:00 P.M. change in the S&P 500 along with the 24-hour change in the Russell 2000 and S&P 500. For hybrid funds and convertibles, I replace the 24-hour S&P 500 change with the change in the 10-year Treasury yield, and for specialty equity funds, I replace it with an index appropriate to the equity category. For bond asset classes such as high-yield and municipal bonds, indices are less widely available in real time, so I use the current-day average NAV change as a proxy for an index that an arbitrageur might calculate on her own.[6]

Table 1 presents the results of these predictive regressions. The results in Table 1 are estimated using data from the January 1998–October 2001 period; the arbitrage returns estimated below estimate the same predictive model using two years of prior data and apply the results out of sample (i.e., they assume that arbitrageurs traded in 1998 using a model estimated

5. The value of the S&P 500 index at a certain time is measured using the most recent transaction price for the S&P 500 exchange-traded fund (ticker symbol SPY) from the New York Stock Exchange (NYSE Trades and Quotes) data. The 4:00 P.M. Nikkei futures price is the most recent transaction price as of 4:00 P.M. from the CME time and sales data (which differs from the closing price since the CME closes at 4:15 P.M.).

6. Current-day NAVs are not published until approximately 5:30 P.M. ET, so strictly speaking, the average current-day NAV for a category will not be known at 4:00 P.M. All of the prices that are used to calculate it will be, however, and so in principle an arbitrageur could estimate the average current-day NAV change using recent bond quotes reasonably well.

Table 1. Regressions Predicting Next-Day Fund Returns, January 1998–October 2001

| | Regression predicting next-day NAV change using three indices | | | | | | Predictive indices used for asset class | | |
|---|---|---|---|---|---|---|---|---|---|
| | Index 1 | | Index 2 | | Index 3 | | | | |
| Morningstar category | Coefficient | SE | Coefficient | SE | Coefficient | SE | Index 1 | Index 2 | Index 3 |
| International equity | 0.31* | 0.04 | 0.16* | 0.05 | 0.17* | 0.05 | SPY 11:30–4 | SPY pre-11:30 | Nikkei future |
| Diversified emerging markets | 0.33* | 0.06 | 0.21* | 0.06 | 0.19* | 0.06 | SPY 11:30–4 | SPY pre-11:30 | Nikkei future |
| Europe stock | 0.43* | 0.05 | 0.11* | 0.05 | 0.07 | 0.06 | SPY 11:30–4 | SPY pre-11:30 | Nikkei future |
| Foreign stock | 0.34* | 0.04 | 0.14* | 0.05 | 0.16* | 0.05 | SPY 11:30–4 | SPY pre-11:30 | Nikkei future |
| Latin America stock | 0.25* | 0.10 | 0.14 | 0.11 | 0.06 | 0.12 | SPY 11:30–4 | SPY pre-11:30 | Nikkei future |
| World stock | 0.27* | 0.05 | 0.12* | 0.05 | 0.09* | 0.05 | SPY 11:30–4 | SPY pre-11:30 | Nikkei future |
| Diversified Pacific/Asia | 0.43* | 0.06 | 0.17* | 0.06 | 0.25* | 0.06 | Nikkei future | SPY pre-11:30 | SPY 11:30–4 |
| Japan stock | 0.46* | 0.08 | 0.03 | 0.08 | 0.20* | 0.07 | Nikkei future | SPY pre-11:30 | SPY 11:30–4 |
| Pacific/Asia ex-Japan | 0.37* | 0.08 | 0.30* | 0.07 | 0.26* | 0.07 | Nikkei future | SPY pre-11:30 | SPY 11:30–4 |
| Mid- and small-cap equity | 0.29* | 0.10 | 0.14* | 0.06 | –0.07 | 0.07 | SPY 2–4 | Russell 2000 | S&P 500 |
| Equity-debt hybrids | 0.06* | 0.01 | 0.07* | 0.01 | –0.01* | 0.01 | | | |
| Convertibles | 0.27* | 0.06 | 0.12* | 0.03 | –0.05 | 0.03 | SPY 2–4 | Russell 2000 | 10-year T-bond |
| Domestic hybrid | 0.06 | 0.04 | 0.03 | 0.02 | –0.04 | 0.02 | SPY 2–4 | Russell 2000 | 10-year T-bond |
| High-yield bond | 0.56* | 0.06 | 0.03* | 0.005 | –0.01 | 0.01 | Own NAV | Russell 2000 | 10-year T-bond |
| Multisector bond | 0.01 | 0.01 | 0.04* | 0.01 | –0.02 | 0.01 | Own NAV | Russell 2000 | 10-year T-bond |
| International bonds | 0.12* | 0.07 | 0.01* | 0.02 | –0.03* | 0.02 | | | |
| Emerging markets bond | 0.23* | 0.09 | 0.03 | 0.02 | –0.01 | 0.02 | Own NAV | Russell 2000 | 10-year T-bond |
| International bond | 0.07* | 0.03 | 0.011 | 0.007 | –0.05* | 0.01 | Own NAV | Russell 2000 | 10-year T-bond |
| International hybrid | 0.09* | 0.04 | 0.10* | 0.01 | –0.03* | 0.01 | Own NAV | Russell 2000 | 10-year T-bond |
| Municipal bonds | 0.38* | 0.05 | 0.003 | 0.003 | –0.002 | 0.01 | Own NAV | Russell 2000 | 10-year T-bond |
| Specialty equity | 0.14* | 0.09 | 0.10* | 0.06 | –0.04* | 0.06 | | | |
| Specialty-Communication | 0.04* | 0.13 | 0.09* | 0.02 | –0.14* | 0.07 | SPY 2–4 | Phil Semi (SOXX) | 10-year bond |
| Specialty-Financial | 0.22* | 0.10 | 0.04 | 0.04 | –0.07 | 0.05 | SPY 2–4 | NYSE Financial | 10-year bond |

*Continued*

Table 1. *Continued*

| Morningstar category | Regression predicting next-day NAV change using three indices: Index 1 Coefficient | SE | Index 2 Coefficient | SE | Index 3 Coefficient | SE | Predictive indices used for asset class: Index 1 | Index 2 | Index 3 |
|---|---|---|---|---|---|---|---|---|---|
| Specialty-Health | 0.29* | 0.10 | 0.07 | 0.04 | −0.05 | 0.05 | SPY 2–4 | Russell 2000 | 10-year bond |
| Specialty-Natural Resources | 0.11* | 0.03 | 0.08* | 0.04 | −0.01 | 0.07 | Oil Index (XOI) | Russell 2000 | SPY 2–4 |
| Specialty-Precious Metals | 0.11* | 0.02 | 0.10* | 0.05 | −0.17 | 0.10 | Gold Index (XAU) | Russell 2000 | SPY 2–4 |
| Specialty-Real Estate | 0.30* | 0.05 | −0.02 | 0.02 | 0.14 | 0.04 | MS REIT (RMS) | Russell 2000 | SPY 2–4 |
| Specialty-Technology | 0.17* | 0.05 | −0.14 | 0.09 | 0.10 | 0.18 | Phil Semi (SOXX) | Russell 2000 | SPY 2–4 |
| Specialty-Utilities | 0.05 | 0.03 | 0.04 | 0.03 | 0.02 | 0.06 | DJ Utilities | Russell 2000 | SPY 2–4 |
| Large-cap equity | 0.10 | 0.09 | 0.03 | 0.06 | −0.01 | 0.06 | SPY 2–4 | Russell 2000 | S&P 500 |
| Vanguard 500 Index | 0.04 | 0.10 | 0.01 | 0.06 | −0.02 | 0.07 | SPY 2–4 | Russell 2000 | S&P 500 |
| Investment-grade bonds | 0.39* | 0.12 | 0.005 | 0.005 | 0.05* | 0.02 | Own NAV | Russell 2000 | 10-year T-bond |

Each row reports a regression that predicts the (equal-weighted) average next-day return for a given Morningstar asset class using current-day changes in three predictive indices. Current-day changes are close ($t-1$) to close ($t$), except for the Nikkei future, which is the 4:00 P.M. CME futures price less the spot close in Tokyo, and the SPY (S&P 500 exchange-traded fund) changes, which are intraday. "10-year T-bond" refers to the yield on the 10-year Treasury bond. "Own NAV" is the current-day return for that fund category. For space reasons, funds classified as "Mid- and small-cap equity," "Municipal bonds," "Large-cap equity," and "Investment-grade bonds" are aggregated into super-categories.

*Significant at 5%.

using 1996 and 1997 data). The index that one would expect to be most important on a priori grounds is listed as Index 1. For international funds, the relative importance of the predictive indices is as expected: the Nikkei future is the best predictor for Japanese and Asian funds, while the post-11:30 A.M. change is the best predictor for Europe. Of interest is that even the pre-11:30 A.M. price change has predictive power for European stock funds, suggesting that European equity prices do not fully respond to U.S. market movements even when their markets are still open.

## 3.3 Measurement of Excess Returns

The simplest way to measure the excess returns to an arbitrage strategy is to compare the returns to the strategy with what the investor would most likely do in the absence of an arbitrage opportunity: buying and holding either the fund in question or a money market, or some combination. Whereas most other studies have measured excess returns relative to a 100% buy-and-hold strategy, this study measures excess returns relative to a mixture of the fund and cash that yields the same average daily exposure to the fund.

This measure of excess returns has the useful property that it is independent of the average return to a fund or asset class in the time period studied.[7] In contrast, a comparison of the excess returns to arbitrage to 100% buy-and-hold would yield lower (higher) excess returns in periods when the fund outperforms (underperforms) cash. Having measured excess returns as independent of asset class performance is particularly helpful when making cross asset class comparisons. This definition of excess returns is also a cleaner measure of the market timing ability of a strategy, since the expected excess returns to a strategy that randomly chose which days to hold a fund would be zero in expectation, regardless of the average returns to the fund in the time period studied.[8]

Daily excess returns as defined above can be written as

$$\frac{\sum[R_t^{fund} \cdot Own_t + R_t^{cash} \cdot (1 - Own_t)]}{T} - \left[\frac{\sum R_t^{fund}}{T} \cdot \frac{\sum Own_t}{T} + \frac{\sum R_t^{cash}}{T} \cdot \frac{\sum 1 - Own_t}{T}\right], \tag{1}$$

7. The wild-card option value calculated by Chalmers, Edelen, and Kadlec (2001) also has this property.

8. Another advantage of this definition is that any error in measuring fund returns (e.g., due to omitted distributions, which is a problem in the Yahoo data) will not bias estimates of excess returns, so long as those measurement errors are not correlated with whether an arbitrageur would have held the fund (i.e., with prior-day market returns). Any definition of excess returns relative to a benchmark that involves holding mutual funds does have the disadvantage of slightly overstating excess returns relative to a market model, since almost all mutual funds are not on the risk-adjusted return frontier. For example, if the fund being studied has risk-adjusted excess returns (or an alpha) of −2% then the excess returns reported in this article will be roughly 1% higher than the returns relative to a market model.

where $R_t^{fund}$ and $R_t^{cash}$ are the returns to the fund and cash, respectively, on day $t$ and $Own_t$ is equal to one if the investor owns the fund and zero otherwise. Define the following notation for the returns conditional on ownership and the share of days the fund is owned:

$$\overline{R}^{fund}|Own = \frac{\sum R_t^{fund} \cdot Own_t}{\sum Own_t}$$
$$s(Own) = \frac{\sum Own_t}{T}.$$

If the returns to holding cash are constant or otherwise uncorrelated with ownership of the fund, Equation (1) can be rewritten as

$$(\overline{R}^{fund}|Own - \overline{R}^{fund}|NotOwn) \cdot s(Own) \cdot [1 - s(Own)]$$
$$= (\overline{R}^{fund}|Own - \overline{R}^{fund}) \cdot s(Own). \tag{2}$$

As is clear from Equation (2), excess returns are positive if and only if the average return on days the fund is owned is higher than the average return on days it is not owned.

### 3.4 Results

Table 2 reports the annualized excess returns to arbitrage trading at maximum frequency from January 1998 to October 2001. Results are presented for a single-index model that uses only the "Index 1" for a particular asset class given in Table 1 and for a model that uses all three. Excess returns are highest for international funds, but double-digit excess returns are also present for small and mid-cap U.S. equities, specialty equity funds, and high-yield, convertible, and emerging market bonds. Municipal bond funds have highly statistically significant return predictabilities, but price volatility is so low for this asset class that excess returns are as well.

Table 3 reports excess returns for general international funds by year since 1986, the first year for fund return data is available from Yahoo. The arbitrage returns in a given year are a function of the volatility and the extent to which international returns are correlated in that year. To see this, note that excess returns as given in Equation (2) can be written as

$$\mathrm{Avg}[y - \overline{y}|E(y - \overline{y}|x) > 0)] \cdot s, \tag{3}$$

where $y$ is the next-day return on the fund, $x$ is the vector of market information known at 4:00 P.M. ET, $\overline{y}$ is the expectation of $y$ unconditional on $x$, and $s$ is the share of days when expected excess returns are positive, that is, when $E(y - \overline{y}|x) > 0$. Given the linear predictive model, the expectation of $E(y - \overline{y}|x) = \beta(x - \overline{x})$, one can write the expectation of Equation (3) as

$$E[\beta(x - \overline{x})|(x - \overline{x}) > 0] \cdot s = \beta \cdot E[(x - \overline{x})|(x - \overline{x}) > 0] \cdot s$$
$$= \beta \cdot E(|x - \overline{x}|) \cdot s. \tag{4}$$

Table 2. Estimates of Maximum-Frequency Trading Strategy Excess Returns, January 1998–October 2001

| | Annualized excess returns estimates | | | |
|---|---|---|---|---|
| | Single-index model | | Multi-index model | |
| Morningstar category | Estimate | SE | Estimate | SE |
| International equity | 32.8* | 3.8 | 40.2* | 3.7 |
| Diversified emerging markets | 36.5* | 4.8 | 44.5* | 4.8 |
| Diversified Pacific/Asia stock | 59.5* | 4.6 | 53.5* | 4.7 |
| Europe stock | 39.1* | 4.5 | 36.2* | 4.5 |
| Foreign stock | 34.1* | 3.8 | 37.8* | 3.8 |
| Japan stock | 58.0* | 5.6 | 43.2* | 5.7 |
| Latin America stock | 24.6* | 7.7 | 31.1* | 7.7 |
| Pacific/Asia ex-Japan stock | 54.1* | 5.5 | 51.1* | 5.6 |
| World stock | 26.1* | 3.8 | 29.9* | 3.8 |
| Mid- and small-cap equity | 20.1* | 5.5 | 26.2* | 5.5 |
| Equity-debt hybrids | 7.7* | 1.1 | 11.6* | 1.1 |
| Convertibles | 22.7* | 3.7 | 28.6* | 3.8 |
| Domestic hybrid | 5.6* | 2.5 | 7.1* | 2.5 |
| High-yield bond | 12.3* | 0.7 | 12.8* | 0.8 |
| Multisector bond | 3.2* | 0.7 | 4.9* | 0.7 |
| International bonds | 9.9* | 1.8 | 7.4* | 1.8 |
| Emerging markets bond | 20.2* | 3.7 | 16.7* | 3.5 |
| International bond | 5.7* | 1.0 | 6.5* | 1.0 |
| International hybrid | 13.3* | 1.4 | 16.4* | 1.4 |
| Municipal bonds | 5.7* | 0.5 | 3.6* | 0.5 |
| Specialty equity | 12.5* | 5.2 | 18.3* | 5.3 |
| Specialty-Communication | 18.9* | 7.7 | 28.5* | 7.6 |
| Specialty-Financial | 12.5* | 5.6 | 19.8* | 5.7 |
| Specialty-Health | 23.3* | 6.2 | 25.1* | 6.3 |
| Specialty-Natural Resources | 20.6* | 5.2 | 16.5* | 5.3 |
| Specialty-Precious Metals | 20.6* | 7.0 | 22.5* | 7.0 |
| Specialty-Real Estate | 25.6* | 2.7 | 23.4* | 2.7 |
| Specialty-Technology | 30.0* | 11.1 | 38.6* | 11.0 |
| Specialty-Utilities | 3.0 | 3.6 | 3.0 | 3.3 |
| Large-cap equity | 7.4 | 5.0 | 12.7* | 5.2 |
| Vanguard 500 Index | 1.7 | 5.3 | –1.7 | 5.2 |
| Investment-grade bonds | 3.0* | 0.8 | 2.5* | 0.8 |

The annualized excess returns to a simulated trading strategy are reported for the (equal-weighted) average fund in each Morningstar category. For each year, 1998–2001, the predictive model in Table 1 is estimated using two years of prior data and applied out-of-sample. The single-index model uses only the "Index 1" given in Table 1 for the category; the multi-index model uses all three. Arbitrageurs are assumed to hold the asset class when predicted returns are greater than zero. Excess returns are defined as in Equation (2) in the text: they are the returns to the arbitrage strategy less a proportionate mix of the fund and cash that has the same average exposure to the asset class.

*Significant at 5%.

Table 3. Annualized Excess Returns by Year—International Equity Funds

| Year | S&P coefficient | Average absolute daily S&P change | Annualized excess returns single-index model |
|---|---|---|---|
| 1986 | 0.22 | 0.67 | 18.9 |
| 1987 | 0.22 | 1.13 | 31.8 |
| 1988 | 0.18 | 0.74 | 17.0 |
| 1989 | 0.25 | 0.58 | 18.4 |
| 1990 | 0.34 | 0.77 | 33.3 |
| 1991 | 0.28 | 0.67 | 23.6 |
| 1992 | 0.30 | 0.46 | 17.4 |
| 1993 | 0.21 | 0.40 | 10.6 |
| 1994 | 0.37 | 0.46 | 21.8 |
| 1995 | 0.42 | 0.37 | 19.7 |
| 1996 | 0.28 | 0.56 | 19.5 |
| 1997 | 0.36 | 0.85 | 38.5 |
| 1998 | 0.29 | 0.92 | 33.9 |
| 1999 | 0.32 | 0.90 | 36.6 |
| 2000 | 0.36 | 1.06 | 48.1 |
| 2001 (Jan.–Oct.) | 0.25 | 1.08 | 34.3 |
| 1986–91 | 0.25 | 0.76 | 23.8 |
| 1992–96 | 0.31 | 0.45 | 17.6 |
| 1997–2001 | 0.32 | 0.96 | 38.8 |

As discussed in Section 3.4 of the text and summarized in Equation (4), expected excess returns from a single-index model are proportional to the product of the NAV predictability coefficient and the average absolute deviation in the predictive variable. This table reports expected returns for a single-index model by year for international equity funds. In addition, it provides predictability coefficients and average absolute change data by year, so that, for example, the increase in arbitrage profitability from 1992–96 to 1997–2001 can be decomposed into changes in market comovement and volatility.

In other words, one can multiplicatively decompose expected excess returns into the slope of the relationship between next-day NAV change and the market variables and then average absolute deviation of the market index. From this decomposition in Table 3, one can see that arbitrage returns have more than doubled from 1992–1996 to 1997–2001, and that this doubling was due mainly to increased market volatility.

### 3.5 Further Refinements

This analysis ignores several ways in which trading strategies could be further refined. First, it assumes that arbitrageurs trade an equal-weighted portfolio of funds in a given asset class; this is equivalent to assuming that they choose the fund to arbitrage randomly. For example, international funds that hold higher beta and smaller capitalization equities and fewer American Depository Receipts (ADRs) or other instruments traded in the United States will have higher arbitrage returns. By focusing on the 10% of funds with the highest predicted arbitrage returns, arbitrageurs can raise their expected returns by a factor of approximately 1.2.[9]

9. See Table 5 of the March 2002 version of this article (available from the author). This analysis was removed for space reasons.

Second, it assumes that arbitrageurs are restricted to trading in and out of a single fund, but an arbitrageur can do better by trading multiple asset classes. For example, on days when markets rise between the time when Asian and European markets close (usually 2:00–6:00 A.M. and 11:00 A.M.–2:00 P.M. ET, respectively) it will be optimal to buy an Asian fund, whereas on days when markets decline during this time but rise after European markets close, it will be optimal to buy a European fund. Simulations of a three asset-class trading strategy suggest that by switching among European, Japanese, and Asian funds and cash, arbitrageurs can earn excess returns of 69% compared with 38% by switching between a general international fund and cash.[10]

Further refinements are possible. Arbitrageurs can select funds within a region with holdings in sectors that have appreciated globally since local close. They can add sector funds to the multiregion strategy described above; it might be particularly useful to add gold funds, since gold stocks are inversely correlated with other equities. They can monitor for post-local close news items that affect particular foreign stocks and then buy funds with large holdings of that stock. They can condition trading on exchange rate movements, by either buying funds with holdings in stocks that would benefit from post-local close exchange rate movements or by taking advantage of the fact that most funds convert local prices to dollars using exchange rates as of 12:00 P.M. ET, so foreign exchange appreciation after this time predicts NAV appreciation. These additional refinement opportunities are small relative to the ones analyzed in this section, but they are additional reasons to believe that the extremely high returns to maximum frequency trading documented in this section may actually be underestimates.

## 4. Estimating Dilution

This section uses data from the TT sample to estimate the losses to long-term shareholders from arbitrage trading. Dilution is defined as the losses to buy-and-hold shareholders due to arbitrageurs trading at stale-price NAVs rather than fair-value NAVs. The dilution occurring on a given day is

$$d_t = \frac{\Delta shares_t \cdot (NAV_t^{FV} - NAV_t^{ACT})}{assets_t} = \frac{flow_t}{assets_t} \cdot \frac{NAV_t^{FV} - NAV_t^{ACT}}{NAV_t^{ACT}}, \tag{5}$$

where

$$\begin{aligned} \Delta shares_t &= \frac{assets_t}{NAV_t^{ACT}} - \frac{assets_{t-1}}{NAV_{t-1}^{ACT}} \\ flow_t &= assets_t - assets_{t-1} \cdot \frac{NAV_t^{ACT}}{NAV_{t-1}^{ACT}} \\ NAV_t^{FV} &= E(NAV_{t+1}^{ACT} | \Omega_t). \end{aligned} \tag{6}$$

10. See Table 6 of the March 2002 version. This analysis was removed for space reasons.

The fair-value $NAV_t^{FV}$ is defined for the purposes of this calculation as the statistical expectation of $NAV_{t+1}^{ACT}$ given all the information known at 4:00 P.M. ET ($\Omega_t$). $NAV_t^{FV}$ is estimated using the same multi-index predictive model applied out of sample as in Section 3. Dilution, defined as above, is also equal to the profits of the arbitrageurs from transacting at stale-price rather than fair-value NAVs. Dilution is zero-sum, but funds may incur other costs from handling the arbitrage flow (e.g., extra transactions, extra cash holdings, administrative costs).[11]

Table 4 reports the results of this formula. Although arbitrage is possible in many asset classes, dilution is understandably concentrated in the asset classes with the highest arbitrage profits. Long-term shareholders of regionally focused international equity funds in the TT sample lost about 1.6% of their assets per year to arbitrageurs from 1998 to 2001. Dilution was lower but still statistically significant in general international equity funds (81 basis points), specialty equity funds (33 basis points), Latin American and global equity funds (23 basis points), and small and mid-cap U.S. equity funds (12 basis points).

If one assumes that TT funds are representative of their asset classes and scales these results up to the Morningstar universe, the total annualized dilution in the first three quarters of 2001 can be estimated at $4.9 billion per year, $4.3 billion of which is in international equity funds. Of course, the decision to participate in the TT sample may depend on the arbitrage activity a fund is experiencing. A fund may be less likely to participate if they are experiencing heavy arbitrage and are thus more concerned about releasing their asset data. If this is the case, then estimates of industry-wide dilution based on the TT sample will be downwardly biased. Alternatively, funds that are more aware of the arbitrage issue may have both less dilution and be less willing to cooperate with TT, leading the TT sample to be upwardly biased.

Comparing the estimated arbitrage returns in the TT and broader Yahoo samples yields only small differences, but one can obtain more direct evidence on the direction of any selection bias in the TT data by examining the 35% of the 167 international funds in TT that exit the sample before the data ends in September 2001. Controlling for asset class and time period fixed effects, the exiting funds have dilution that is roughly 40 basis points higher than both the nonexiting funds and the funds that replace them in the sample, suggesting that selection may be downwardly biasing estimates of dilution using the TT sample. In any case, one might argue that even the $480 million worth of dilution that is occurring in the international TT funds themselves is a large number, regardless of total industry-wide dilution.

11. Greene and Hodges (2002) regress buy-and-hold fund returns on market performance and the dilution for a particular and find a coefficient on dilution of 2.8. Giving this a causal interpretation would imply that the direct effect of dilution is less than half of the total negative effect on returns.

Table 4. Annualized Dilution of Mutual Funds in the TrimTabs Sample

| | TrimTabs sample | | | | | | Morningstar universe | |
|---|---|---|---|---|---|---|---|---|
| | | Annualized dilution | | | | | | |
| | Funds in sample | 2/98–12/98 | 1999 | 2000 | 1/01–9/01 | Average | Assets 6/01 ($billions) | Annualized dilution at 2001 rate ($billions) |
| International equity | 165 | 0.66 | 0.46 | 0.63 | 1.14 | 0.69 | 416.7 | 4.34 |
| Regionally focused funds (European, Japan, Pacific) | 25 | 2.00 | 1.05 | 1.35 | 2.28 | 1.60 | 32.2 | 0.73 |
| Global, Latin, and diversified emerging markets | 74 | 0.32 | 0.20 | 0.18 | 0.25 | 0.23 | 167.5 | 0.41 |
| General international funds | 66 | 0.59 | 0.51 | 0.81 | 1.47 | 0.81 | 217.0 | 3.20 |
| Small- and mid-cap equity | 170 | 0.17 | 0.14 | 0.10 | 0.08 | 0.12 | 470.9 | 0.37 |
| Equity-debt hybrids | 134 | 0.01 | 0.01 | 0.01 | 0.01 | 0.01 | 402.2 | 0.05 |
| International bonds | 40 | 0.01 | 0.01 | 0.04 | 0.00 | 0.01 | 37.7 | 0.00 |
| Municipal bonds | 135 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 280.6 | 0.00 |
| Specialty equity | 67 | 0.42 | 0.36 | 0.36 | 0.14 | 0.33 | 214.3 | 0.29 |
| Precious metals | 8 | 1.57 | 1.25 | 1.28 | 0.26 | 1.17 | 1.8 | 0.00 |
| Large-cap equity | 335 | 0.04 | 0.02 | 0.02 | −0.01 | 0.02 | 2089.8 | −0.15 |
| Investment-grade bonds | 119 | 0.00 | 0.00 | 0.01 | 0.00 | 0.00 | 368.2 | 0.00 |
| Total | 1165 | 0.16 | 0.11 | 0.13 | 0.17 | 0.14 | 4698.9 | 4.90 |

Daily dilution is calculated as the percentage difference between today's actual NAV and what today's NAV would have been if yesterday's inflows had been priced at the expected (fair value) rather than the actual stale-price NAV: $\text{dilution}(t) = [A(t)/\text{NAV}(t) - A(t-1)/\text{NAV}(t-1)]^{*}[\text{NAV\_FV}(t-1) - \text{NAV}(t-1)]/A(t)$. Fair-value NAVs are estimated exactly as predicted returns are estimated in Tables 1 and 2. Standard errors of the point estimates of dilution for the entire period are all less than 1 basis point for all categories except international equity, for international equity they are less than 10 basis points (SEs are heteroscedasticity-robust and adjusted for clustering within days). The last two columns report the total assets of all funds in the category according to Morningstar as of June 2001 and an estimate of total dilution, assuming that TrimTabs funds are representative. Given that TrimTabs funds may not be representative, this estimate should be treated with some caution.

### 4.1 Relationship with Prior Estimates of Dilution

Two other articles have calculated dilution using TT data. Greene and Hodges (2002) report dilution of 50 basis points from February 1998 to June 1999 for all international equity funds; this appears to be consistent with my results for that asset class and time period. The main difference between Greene and Hodges and this article is that they substitute the actual next-day $NAV_{t+1}^{ACT}$ for its expectation. This causes the results to be noisier in a small sample, which may explain why this article is able to report dilution for smaller time periods and subsamples than they do. On average, however, I obtain an only slightly higher dilution figure (56 basis points versus 50 basis points) for all international funds for the 1998–1999 period.

The extra detail provided in Table 4 yields important additional conclusions: (1) that dilution of up to 2% of assets is occurring in some asset classes, (2) that dilution is worse in exactly the asset classes one would expect, given the results in Table 2, and (3) that some dilution is occurring even in less profitable asset classes such as global and small-cap equity funds. This third conclusion suggests that some investors know about the arbitrage opportunity and yet are trading in channels in which they do not have access to the highest-profit asset classes; the fact that arbitrageurs are using multiple distribution channels has implications for the effectiveness of certain antiarbitrageur measures, as discussed in the next section.

The other article that uses TT data to measure dilution, Goetzmann, Ivkovic, and Rouwenhorst (2001), reports a much lower dilution estimate of 1.6 basis points for the same period and sample as Greene and Hodges. The source of the difference is in its treatment of the timing of the flows in the TT data. As described in Edelen and Warner (2001), TT surveys funds in the morning and collects asset data for the prior day. In principle, these assets figures should include all inflows that are priced at the prior-day NAV, that is, "postflow," in practice, however, it is not certain that funds are aware of all flows in time to include them in the asset figures. This is especially true of funds whose customers trade mainly through intermediaries, such as brokerages or 401(k) plan providers, as opposed to directly with the fund family.

Generally accepted accounting principles (GAAPs) require that the asset figures in annual reports be postflow. Goetzmann, Ivkovic, and Rouwenhorst verified that TT asset data match CRSP data on the last day of the month, and concluded from this that both TT and CRSP asset figures were therefore likely to be postflow. Greene and Hodges, however, compared TT assets with N-SAR and N-30D reports filed with the SEC and found that TT asset figures matched better for two-thirds of funds if one assumes that they are either entirely or largely preflow. In estimating dilution, Greene and Hodges treated the TT asset figures for these two-thirds of funds as if they were preflow, and the remaining third of funds as if they were postflow.[12]

12. In a recent article coauthored by Goetzmann, Brown et al. (2002) adopt the Greene and Hodges approach of determining fund flow timing by matching with SEC reports.

In doing so, they assumed that the funds whose TT assets matched their SEC reports matched because both were postflow, that is, that all funds followed GAAPs with respect to this issue. Another possibility, however, is that the asset figures matched because both were preflow: that TT figures are always (or at least largely) preflow, and that only two-thirds of funds follow GAAPs with respect to this issue.

Table 5 contains evidence consistent with this second possibility. In Table 5, I regress flows on current and three lagged changes in the S&P 500. If one assumes that TT asset data are preflow, that is, that today's flows show up tomorrow, the coefficients estimated for international funds imply that there are inflows of 0.45% of assets on a day with a 1% S&P increase, followed by outflows of 0.34% of assets over the next two days. This is exactly what one would expect to see if funds were being arbitraged by short-term traders. On the other hand, if one assumes that TT asset data are postflow, then Table 5 would imply that market timers do not buy on the day that it would be profitable to do so; instead they buy a day late and then sell most of what they bought over the next two days. While one might expect to see some returns-chasing behavior on the day after a large market movement, the magnitudes and almost immediate outflow seem very inconsistent with behavioral returns-chasing, and very consistent with arbitrage flows, reported a day late.[13]

When I disaggregate international funds into those classified as preflow and postflow by Greene and Hodges (they were kind enough to share their classification), I find that there is essentially no difference in the apparent timing of flows. The timing of flows appears similar, albeit with much smaller magnitudes, for noninternational funds, with one exception that helps prove the rule. The so-called "timer funds" (i.e., the Rydex, ProFunds, and Potomac families) that cater primarily to short-term traders appear to report postflow to TT. These funds experience a very high variance in daily inflows (their net inflow:asset ratio has a standard deviation of 8.2%, compared with 2.2% for the average fund) and track indices, and they thus need to closely monitor their inflows so that they can remain properly invested.

For the reasons discussed above, it seems highly implausible that even the funds classified as postflow by Greene and Hodges really are, and more plausible to assume that one-third of funds simply do not follow GAAPs with respect to this issue. I repeat the analysis in Table 5 for individual funds, looking for funds with current-day S&P coefficients that are

13. Other evidence consistent with these flows being arbitrage reported a day late includes the fact that the flows target the most arbitrageable funds (coefficients on $dS\&P(t-1)$ are 0.75, 0.48, and 0.22 for Europe/Japan/Pacific, general international funds, and global funds, respectively), and do so on the most advantageous days, targeting Europe funds when the S&P change is largely in the afternoon, Asian funds when the change is in the morning or when its accompanied by a change in the Nikkei futures, and specialty equity funds when there is a large change in the relevant sector index (see Table 11 and Appendix A in the March 2002 version of this article).

Table 5. Timing of Inflows in TrimTabs Data

| | | | dS&P(*t*) | | dS&P(*t*−1) | | dS&P(*t*−2) | | dS&P(*t*−3) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Observations | Funds | Coefficient | SE | Coefficient | SE | Coefficient | SE | Coefficient | SE |
| International equity funds | 102,891 | 165 | 0.000 | 0.013 | 0.453* | 0.018 | −0.217* | 0.014 | −0.125* | 0.013 |
| Preflow, per Greene and Hodges | 71,108 | 90 | −0.002 | 0.013 | 0.409* | 0.016 | −0.188* | 0.014 | −0.103* | 0.013 |
| Postflow, per Greene and Hodges | 23,889 | 32 | −0.003 | 0.026 | 0.558* | 0.027 | −0.279* | 0.020 | −0.165* | 0.022 |
| Not classified by GH | 7,048 | 43 | 0.029 | 0.040 | 0.538* | 0.061 | −0.295* | 0.051 | −0.206* | 0.061 |
| Market timer funds (non-international) | 2,730 | 3 | 1.332* | 0.115 | −0.175 | 0.127 | −0.373* | 0.115 | −0.046 | 0.123 |
| All other funds | 660,652 | 997 | 0.001 | 0.003 | 0.028* | 0.003 | −0.012* | 0.003 | −0.002 | 0.003 |

Dependent variable: change in log of shares outstanding (assets/NAV).

Each line is a regression of the change in the log of shares outstanding in a fund (a measure of the inflow-to-assets ratio) on current and lagged changes in the S&P 500 for a subset of the funds covered by TrimTabs. The coefficients for international equity funds imply that large inflows are reported to TrimTabs the day after an increase in the S&P 500, and that these inflows are followed by outflows the next two days. The dependent variable is log change in the number of shares outstanding, calculated as the end-of-day assets reported to TrimTabs divided by that day's NAV. As we argue in the text, the evidence in this table is consistent with TT assets not reflecting current day flows, except for the market-timer funds. While the purpose of this analysis is to determine whether TrimTabs assets data include current-day flows, it is fairly clear from the data that current-day NAV changes are consistently reflected in current-day asset figures. So assets(*t*)/NAV(*t*) as reported in TrimTabs is shares outstanding either before or after day *t* inflows.

*Significant at 5%.

statistically different from zero. I find that I can reject this null hypothesis at the 5% significance level for 6% of funds (10 of 165), close to the rejection rate one would expect if the null were true for all funds. Rather than classify these funds as postflow, which would induce a data-snooping bias given that I would be using the same data to classify funds as I am using to measure dilution, I choose instead to classify all funds as preflow.

## 5. Analyzing Currently Popular Solutions

This section examines the effect of short-term trading fees, restrictions on trading frequency, and partial fair-value pricing on arbitrage trading profits. These are currently the most popular solutions to the NAV arbitrage problem, but as this section discusses, they have serious shortcomings.

### 5.1 Short-Term Trading Fees

Short-term trading fees are currently a popular device for limiting arbitrage flows; 30% of international mutual funds have adopted them as of November 2001. Dilution is lower in funds with short-term trading fees: in the first three quarters of 2001 dilution was 61 versus 166 basis points of dilution for general international funds in the TT sample with and without fees, respectively, and 138 versus 232 basis points for region-specific funds with and without fees. Despite their popularity, short-term trading fees have at least three shortcomings.

First, short-term fees reduce the attractiveness of mutual funds to the average investor. Zero transaction costs are not available to investors in financial markets, they are a unique feature of no-load mutual funds, and a potential competitive advantage over individual stocks or the recently introduced exchange-traded funds. So long as inflows and outflows are roughly balanced and not opportunistically timed, mutual funds can match buy and sell orders internally and provide zero transaction cost liquidity without significantly altering their holdings or trading themselves. Unfortunately NAV predictability, once understood by investors, guarantees that these conditions will not be met. Funds ultimately face a choice between achieving NAV nonpredictability through fair-value pricing or abandoning one of the competitive advantages of their product; so far more funds have chosen the latter.

In addition to their effect on the attractiveness of funds to nonarbitrageurs, there are also limitations to the effectiveness of short-term trading fees in preventing arbitrage. The first effectiveness issue is that short-term fees are difficult and/or costly to apply uniformly across channels. Under the terms of most existing variable annuity contracts, short-term trading fees cannot be imposed.[14] In addition, fees are difficult to apply to 401(k)

14. While new variable annuity contracts typically either allow management companies to restrict the frequency of trading or impose transaction fees, many existing variable annuity contracts do not. Anecdotally, some investors that are grandfathered into unrestricted annuities have been aggressively taking advantage of the absence of restrictions.

and 403(b) accounts; many funds that charge short-term trading fees in regular accounts do not charge them in 401(k)s. Since fees cannot be applied uniformly to all investors, funds that attempt to prevent NAV arbitrage through only the use of short-term trading fees are open to the criticism that they are selectively allowing certain investors to dilute their funds. Selectively allowing certain investors to dilute the fund may open a management company to criticism, particularly if the investors who benefit are disproportionately those whom a management company might otherwise have an incentive to favor (e.g., favored clients, industry insiders, management company employees, fund directors).

A second effectiveness issue is that short-term trading fees have to be fairly large and of long duration to eliminate the arbitrage opportunity. The SEC has thus far limited short-term trading fees to 2%.[15] Although fees of this magnitude are sufficient to redirect arbitrage activity to other funds, once all funds have adopted them, they will not be sufficient to prevent arbitrage activity.

Table 6 analyzes the profitability of arbitrage trading with various levels of short-term trading fees. As in Table 2, I estimate a predictive model using two years of prior data and then apply the model out of sample. Since predicted returns can be noisy due to imprecise coefficient estimates, I multiply them by a discount factor that is estimated from a regression of prior-year actual returns on predicted returns (i.e., actual year $Y-1$ returns on predicted returns from a model estimated on year $Y-2$ and $Y-3$ data). For the fund categories in Table 6, this discount factor averages 0.9. I assume that an arbitrageur trades when the absolute value of predicted next-day returns is greater than 50% of the short-term trading fee.

From Equation (2), excess returns are given as

$$(\overline{R}^{fund}|Own - \overline{R}^{fund}) \cdot s(Own). \tag{7}$$

This can be decomposed and written as

$$\begin{aligned}&\overline{R}^{fund}|Own\&B \cdot s(Own\&B) + \overline{R}^{fund}|Own\&WB \cdot s(Own\&WB)\\&\quad + \overline{R}^{fund}|Own\&NotS \cdot s(Own\&NotS) - \overline{R}^{fund} \cdot s(Own),\end{aligned} \tag{8}$$

15. The SEC's no-action letter to Fidelity Korea on March 7, 2001, allowed Fidelity Korea to temporarily impose a 4% short-term redemption fee during the period of its conversion from a closed-end to an open-end fund, but it reiterated the requirement that short-term fees be limited to a reasonable estimate of the administrative and transaction costs for that asset class and an upper bound of 2% on that estimate. This limitation is consistent with the SEC position that funds should not use short-term fees as a substitute for accurate valuation of the fund.

Table 6. Annualized Excess Returns with Short-Term Trading Fees, January 1998–October 2001

| | | | | Annualized excess return estimates | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Excess return per RT | | Day-after-signal returns only | | | Simulation results | | |
| Category and short-term fee | Round-trips per year | Coefficient | SE | Gross | Net | SE | Gross | Net | SE |
| Pacific/Asia ex-Japan stock | | | | | | | | | |
| 0 | 56.2 | 0.97* | 0.10 | 54.7* | 54.7* | 5.4 | 54.1* | 54.1* | 5.4 |
| 0.25 | 51.3 | 1.04* | 0.10 | 53.5* | 40.7* | 5.0 | 53.4* | 40.6* | 5.5 |
| 0.5 | 38.8 | 1.28* | 0.12 | 49.8* | 30.4* | 4.5 | 50.4* | 31.0* | 5.5 |
| 0.75 | 28.6 | 1.56* | 0.14 | 44.6* | 23.2* | 4.0 | 47.0* | 25.6* | 5.6 |
| 1 | 19.5 | 1.79* | 0.16 | 34.9* | 15.4* | 3.0 | 44.5* | 25.0* | 5.6 |
| 1.5 | 10.3 | 2.23* | 0.22 | 23.0* | 7.5* | 2.3 | 29.2* | 13.8* | 5.7 |
| 2 | 5.8 | 2.74* | 0.33 | 15.7* | 4.2* | 1.9 | 13.2* | 1.7 | 5.8 |
| 2.5 | 3.7 | 2.98* | 0.48 | 11.0* | 1.8 | 1.8 | 0.3 | −9.0 | 5.7 |
| 3 | 1.9 | 4.03* | 0.73 | 7.5* | 1.9 | 1.3 | 13.9* | 8.3 | 6.3 |
| 3.5 | 1.0 | 4.59* | 0.93 | 4.7* | 1.1 | 1.0 | −3.7 | −7.2 | 4.1 |
| Europe stock | | | | | | | | | |
| 0 | 54.2 | 0.75* | 0.08 | 40.8* | 40.8* | 4.5 | 40.6* | 40.6* | 4.5 |
| 0.25 | 46.7 | 0.90* | 0.08 | 42.1* | 30.4* | 3.8 | 41.4* | 29.7* | 4.5 |
| 0.5 | 31.1 | 1.11* | 0.10 | 34.5* | 18.9* | 3.1 | 37.0* | 21.4* | 4.6 |
| 0.75 | 19.6 | 1.30* | 0.13 | 25.5* | 10.8* | 2.5 | 29.3* | 14.6* | 4.6 |
| 1 | 12.1 | 1.41* | 0.17 | 17.1* | 5.0* | 2.0 | 19.2* | 7.2 | 4.7 |
| 1.5 | 4.4 | 1.92* | 0.30 | 8.4* | 1.8 | 1.3 | 8.6* | 2.0 | 4.7 |
| 2 | 1.4 | 2.32* | 0.46 | 3.2* | 0.4 | 0.6 | −3.8 | −6.6 | 3.8 |
| Small growth | | | | | | | | | |
| 0 | 50.8 | 0.73* | 0.13 | 36.8* | 36.8* | 6.6 | 36.5* | 36.5* | 6.5 |
| 0.25 | 42.9 | 0.83* | 0.13 | 35.5* | 24.8* | 5.7 | 34.9* | 24.1* | 6.6 |
| 0.5 | 25.0 | 1.04* | 0.19 | 26.1* | 13.6* | 4.8 | 37.9* | 25.4* | 6.6 |
| 0.75 | 14.4 | 1.22* | 0.28 | 17.6* | 6.8 | 4.0 | 19.5* | 8.7 | 6.7 |
| 1 | 8.5 | 1.65* | 0.35 | 14.0* | 5.5 | 2.9 | 10.9 | 2.4 | 6.5 |
| 1.5 | 2.6 | 2.03* | 0.60 | 5.2* | 1.4 | 1.6 | 11.3 | 7.5 | 5.9 |

This table examines the effect of short-term trading fees on arbitrage excess returns. The multi-index predictive model from Table 1 is estimated for each asset class and applied out of sample. Arbitrageurs are assumed to trade when expected excess returns are greater than 50% of the short-term trading fee. Expected excess returns are adjusted for the fact that out-of-sample actual returns tend to be slightly less than predicted returns, as described in the text. The table first reports an estimate of the excess returns on the day following trading signals. The next set of columns uses this estimate to construct an estimate of annual excess returns, assuming that returns are symmetrically distributed and that excess returns on days when there is no trading signal are zero. The final set of columns report excess returns from the simulated trading strategy that does not make this assumption.
*Significant at 5%.

where *Own&B* means that the arbitrageur bought the fund yesterday, *Own&WB* means the arbitrageur would have bought the fund if she did not already own it, and *Own&NotS* means that the arbitrageur owns the fund but would not have bought or sold it.

If the distribution of future returns in the fund beyond the next day is independent of past fund or market returns and if fund returns are distributed symmetrically, then

$$\overline{R}^{fund}|Own\&NotS = \overline{R}^{fund} \tag{9}$$

$$\overline{R}^{fund}|Own\&WB - \overline{R}^{fund} = \overline{R}^{fund} - \overline{R}^{fund}|NotOwn\&WS \tag{10}$$

$$s(Own\&WB) = s(NotOwn\&WS), \tag{11}$$

and Equation (8) can be written as

$$\overline{R}^{fund}|Own\&B \cdot s(Own\&B) - \overline{R}^{fund}|NotOwn\&S \cdot s(NotOwn\&S), \tag{12}$$

where $NotOwn\&S$ means that the arbitrageur sold the fund yesterday and $NotOwn\&WS$ means that the arbitrageur would have sold the fund if she owned it. Note that in a large sample, $s(Own\&B)$ and $s(NotOwn\&S)$ will be approximately equal and will both equal the rate at which round-trip trades are made in the fund.

The intuitive interpretation of Equations (12) and (8) is that the excess returns to an arbitrage strategy per round-trip trade is the difference between the returns following buys and the returns following sells plus a "drift" that is zero if returns are symmetric and independent of market changes more than one day old.

Table 6 reports excess returns with and without "drift" for different levels of short-term trading fees. Since excess returns are more precisely estimated without drift, I will focus on those results. Next-day excess returns remain positive for Pacific stock, Europe stock, and small growth funds even with short-term trading fees of 3.5%, 2.0%, and 1.5%, respectively. Returns are statistically significant and greater than 5% per year even with fees of 2.0%, 1.0%, and 0.5%, respectively. Results including drift imply higher returns for Pacific stock funds and lower returns for Europe stock and small growth funds than those without drift, although in the latter case the difference is not statistically significant.

The results in Table 6 also suggest the ability of arbitrageurs to "wait out" short-term fees. In order to accommodate legitimate investor demand for liquidity and to avoid being accused of using short-term fees to "trap" money in their funds, many funds have limited fees to the sale of shares within 30 or 90 days of purchase.[16] Table 6 suggests that arbitrageurs can earn annualized gross excess returns of approximately 10%, 6%, and 4% in the three asset classes by making three round-trip trades per year.

To summarize, the 2% short-term trading fees currently allowed by the SEC are sufficient to eliminate arbitrage opportunities in asset classes other than Asian stock, so long as they are of sufficient duration to prevent arbitrageurs from waiting them out. They are also certainly large enough to reduce arbitrage profits enough to divert activity to funds without short-term fees, so long as there are some remaining.

16. As of November 2001, of the funds that had imposed short-term trading fees, 42% and 92% did not charge fees when the investors had held the shares for at least 30 and 90 days, respectively.

### 5.2 Trading Frequency Restrictions and Monitoring

Another popular device for controlling arbitrage is to either explicitly limit the number of round-trip trades an account may engage in or to monitor accounts for frequent trading. This approach can be effective in diverting arbitrage activity to other funds, but it has some of the same shortcomings as short-term trading fees.

First, like short-term trading fees, frequency restrictions and monitoring cannot be applied across all channels. Many existing variable annuity contracts do not allow fund companies to limit trading frequencies. Limiting trading through channels such as fund supermarkets or retirement plans is difficult, and investors can to some extent evade monitoring by moving between accounts or trading multiple funds. In addition, monitoring conducted on a case-by-case basis is even more subject to the selectivity criticism than short-term trading fees that are applied consistently according to predetermined rules. As with short-term trading fees, there is a trade-off between limiting arbitrage and the attractiveness of the fund along other dimensions. Frequency restrictions can be made more effective by restricting access to only investors who trade directly with the fund family, but this obviously has significant costs to investor convenience and the competitiveness of the fund.

Second, the evidence in Table 6 shows that frequency restrictions do not eliminate dilution opportunities, since arbitrageurs can earn excess returns of up to 10% by making just three round-trip trades per year. In addition, no amount of monitoring will prevent investors who are knowledgeable about the NAV arbitrage issue from timing their purchases and redemptions so as to earn extra returns at the expense of investors who are not knowledgeable about the issue.

### 5.3 Partial Fair-Value Pricing

Two types of partial fair-value pricing have been proposed or adopted by fund management companies. One is using fair-value pricing only on days with extreme market movements. The other is using one of a variety of partial fair-value pricing methodologies. These partial methodologies often have some intuitive appeal, but they remove only part of the arbitrage opportunity, for reasons discussed below.

5.3.1 Fair-Value Pricing on Extreme Days. The idea of using fair-value pricing only on extreme movement days is appealing to fund companies. Currently most do not have a system in place for calculating fair-value prices, and fair valuing involves convening a valuation subcommittee of the board of directors and calculating fair-value prices in a nonautomated fashion. Given the seniority of the people involved, this is, of course, extremely expensive.

Often, fair valuing only on extreme days is justified by arguing that the difference between calculated and fair-value NAVs on other days is not material. Unless the postclose change in markets is extreme, funds argue that a "significant event" has not occurred, and thus they are under no obligation to fair-value price. An executive from a large fund complex recently announced in a public conference that his funds used fair-value pricing when the Japanese market was believed to be 2% different from its closing level or when individual Asian markets were believed to be 3% different.

Table 6 indirectly provides evidence about whether such a fair valuation approach is likely to prevent a significant amount of the arbitrage opportunity. Assume that the fund in question fair values much more often than the fund discussed above; assume they fair value whenever the fair-value NAV is more than 1.5% different from the stale-price NAV. An arbitrageur who faced a 3% short-term trading fee would trade precisely on the days fair-value and stale-price NAVs were more than 1.5% different when a fund's fair-value NAV was 1.5% different from its actual NAV. Table 6 suggests that an arbitrageur trading a Pacific stock fund only on such days would earn annualized gross next-day excess returns of 4.3% compared with the total annualized returns of 50.6% that they would earn from trading every day. Likewise, if fair-value pricing eliminated the excess returns on these extreme-move days, a maximum frequency trader would earn excess returns of 50.6% less 4.3%. In this example, fair valuing only on extreme days removes less than 10% of the arbitrage opportunity.

Another issue with fair valuing infrequently using valuation committees is that it potentially introduces discretion into the decisions of whether and how to fair value. Zitzewitz (2002) reports evidence that discretion already enters into fair-value decisions: the few funds that were occasionally fair valuing between January 2001 and December 2002 were much less likely to do so on Friday evenings, when the effort costs of fair valuation are presumably higher. Conceivably discretion could also be abused to provide dilution opportunities to those with inside knowledge of fair-valuation procedures.

5.3.2 Mark-to-ADR Pricing. Another partial fair-value pricing methodology that has been proposed is pricing foreign assets using the prices of comparable assets that trade when the U.S. market is open. The most common version of this is mark-to-ADR pricing, where the most recent ADR price is taken to be a "readily available" market price.

The issue with mark-to-ADR pricing is foreshadowed by the high NAV predictability for U.S. small-cap stock funds. Three-quarters of ADRs had lower trading volumes in 2000 than U.S. stocks in NYSE/AMEX decile 6 (most U.S. small-cap funds have holdings in deciles 6–8). As with small-cap stocks, ADR prices do not instantly reflect changes in the general market, but high round-trip trading costs prevent arbitrageurs from taking advantage of this phenomenon. The last traded price for a relatively illiquid ADR, like the last traded price for a small-cap equity, will be systematically below that which would prevail in a liquid market when the U.S. market is rising, and systematically too high when the U.S. market is falling.

Table 7 reports regressions of the next-day change in an ADR price on the current-day change in the S&P 500. The average slope for all ADRs is 0.12. This result suggests that the predictability for a mutual fund priced entirely using ADRs is about 40% of that of a mutual fund priced using local closes (as suggested by the coefficient of 0.32 reported for the average international fund in Table 3). Interaction regressions suggest that the predictability coefficient is greater than 0.3 for the least-liquid and smallest-cap ADRs and not significantly different from zero for the most-liquid, largest-cap ADRs, which is consistent with illiquidity being the source of predictability of ADR prices.

Some in the industry have advocated the use of exchange-traded foreign index funds, or iShares, in fair-value pricing. All but the Japanese iShares are fairly illiquid and thus, like ADRs, have predictable next-day price

Table 7. Predictability of Next-Day ADR Returns, 1995–2000

| ADRs<br>Observations | 666<br>579,116 | 666<br>579,116 | 666<br>579,116 |
|---|---|---|---|
| dS&P(*t*) | 0.12*<br>(0.03) | 0.34*<br>(0.07) | 0.38*<br>(0.07) |
| dS&P(*t*)*ln(market cap) | | −0.018*<br>(0.005) | |
| dS&P(*t*)*ln[daily volume in $] | | | −0.020*<br>(0.006) |
| ln(market cap)/100 | | 0.010*<br>(0.005) | |
| ln(daily volume in $)/100 | | | −0.007<br>(0.005) |
| *Quartiles for interaction variables* | | ln(market cap) | ln(volume) |
| 0 | | 0.6 | 1.8 |
| 25 | | 10.7 | 11.3 |
| 50 | | 11.9 | 13.1 |
| 75 | | 13.3 | 14.8 |
| 100 | | 18.6 | 22.1 |
| *Predictability slope at quartiles* | | | |
| 0 | | 0.33 | 0.35 |
| 25 | | 0.14 | 0.16 |
| 50 | | 0.12 | 0.12 |
| 75 | | 0.09 | 0.09 |
| 100 | | −0.01 | −0.06 |

Dependent variable: log returns($t+1$).

The predictability of next-day returns using current-day change in the S&P 500 is examined for securities identified as ADRs in the CRSP dataset. Interaction regressions suggest less predictability for large-cap and more heavily traded ADRs. Tests for nonlinearities in the interaction terms do not reveal statistically significant quadratic or cubic effects (not reported). Average predictability is not significantly different in different years (not reported). Standard errors are adjusted for clustering within trading days.

changes. iShares prices, like ADR prices, may be a useful input into a fair-value pricing formula, especially if their liquidity improves, but a mark-to-iShares fair-value pricing methodology will have the same shortcomings as a mark-to-ADRs methodology.

The evidence on ADR pricing also suggests issues with another argument sometimes made by practitioners, that fair-value pricing will become moot once exchanges move to 24-hour trading. The ADR evidence suggests that unless foreign issues are liquidly traded at 4:00 P.M. ET, their next-day price changes will still be predictable. A test of whether after-hours trading in foreign markets is likely to be liquid can be conducted using the German market, which extended trading until 2:00 P.M. ET (8:00 P.M. German time) in June 2000. A regression of the next-day change in the DAX index on the change in the S&P futures before 11:30 A.M. ET, between 11:30 A.M. and 2:00 P.M., and between 2:00 and 4:00 P.M. yields coefficients of 0.00, 0.15, and 0.62 (with standard errors of about 0.09), suggesting that German stocks are not sufficiently liquid after regular trading hours to fully incorporate changes in the U.S. market. If German stocks are not sufficiently liquid from 6:00 to 8:00 P.M. German time to exhibit no price predictability, it is hard to believe that Asian stocks will be in the middle of the night Asian time.

### 5.4 True Fair-Value Pricing

Given the number of partial solutions to the NAV arbitrage problem that have been adopted or at least proposed by the industry, one might expect that a full solution was impossible or prohibitively expensive. This is actually not the case. Goetzmann, Ivkovic, and Rouwenhorst (2001) outline a simple methodology that estimates a top-down correction to a fund's NAV based on historical relationships between its NAV and market indices. Ciampi and Zitzewitz (2001) advocate a related bottom-up methodology that estimates fair-value prices at the security level. The idea behind both methodologies is that a reasonable fair-value price is the statistical expectation of the price that would prevail in a liquid market, given all information reflected in market indices as of 4:00 P.M. ET.

Fair-value pricing at the security level is likely to be more accurate given that the median international fund has holdings turnover of 80% per year, but either methodology is substantially better than the alternative solutions discussed above. Properly constructed fair-value pricing should completely eliminate dilution and should substantially reduce market timing activity and the associated costs to funds. At least two third-party pricing services are currently offering to provide fair-value prices for international equities calculated using a bottom-up methodology. Out-of-sample tests of one service's prices suggest that it removes more than 95% of NAV predictability, yet neither has been widely adopted as of mid-2002. The pricing information I have obtained from one of the services implies a cost to the median-size fund complex of 5 basis points of international assets.

## 6. SEC Guidance and Industry Response

The most recent formal guidance given by the SEC to funds on this issue is their letter to the Investment Company Institute of April 30, 2001. The letter states that "with regard to a foreign security, a fund *must* evaluate whether a significant event (i.e., an event that will affect the value of a portfolio security) has occurred after the foreign exchange or market has closed, but before the fund's NAV calculation. If the fund determines that a significant event has occurred ... then the closing price for that security would not be considered a 'readily available' market quotation, and the fund *must* value *the security* pursuant to a fair value pricing methodology." It further states that "significant fluctuations in domestic or foreign markets *may* constitute a significant event" and that "funds should continuously monitor for events that might necessitate the use of fair value prices" and should "evaluate the appropriateness of their fair value methodology for foreign securities by reviewing next-day opening prices" (all emphasis added). The letter motivates these requirements by specifically mentioning that "the failure to determine the fair value of portfolio securities following significant events may result in dilution."

Although the SEC's formal guidance emphasized that fair valuing individual securities is a requirement, it leaves funds the latitude to make their own determinations in good faith as to when significant events have occurred and what constitutes an appropriate fair valuation methodology. An examination of recent NAV changes suggests that the vast majority of international funds have not fair valued on even a single day in the May 2001–September 2002 period, a sustained period of high market volatility (Zitzewitz, 2002). This implies that these funds have thus far used this latitude to define a significant event such that they essentially never occur or that they are using fair-value prices that are statistically indiscernible from local closing prices, even on high-volatility days.[17]

The formal response from industry groups to the SEC guidance has tended to defend a broad interpretation of "good faith." A March 2002 white article by the Investment Company Institute (2002) argues that "even if *future* prices in a foreign market tend to be correlated with either a particular financial instrument or the U.S. market, this does not necessarily mean that prices in the foreign market *as of the close of the U.S. market* are similarly correlated" (second emphasis added).[18] A June 21, 2001, letter to the SEC from the Committee on Investment Management

17. Surveys in late 2001 by Deloitte and Touche, PriceWaterhouseCoopers, and Capital Market Risk Advisors revealed that 20–40% of funds did not monitor for significant events, as required by the April 2001 letter, and only 4% of funds made fair-value adjustments to account for time zone differences (Dodds, 2001; Sahoo, 2001a, b).

18. Note that this statement is positing an extreme violation of market efficiency: that, for example, *all* of the correlation between the 11:30 A.M. to 4:00 P.M. ET change in the U.S. market and the 11:30 A.M. to 11:30 A.M. next day change in the price of a European security is due to post-rather than pre-4:00 P.M. changes in the true value of the European security. While we do not observe the 4:00 P.M. values of most foreign securities, the evidence for the most

Regulation of the Association of the Bar of New York City states that "we are skeptical of the premise that, if one market moves after another closes, there is necessarily a change in value," that "any fair value is but one value within a range of possible fair values" and that "this inherent uncertainty is not a basis to contest the good faith of directors in making fair value determinations." It adds that "the dilution issues raised in the 2001 Valuation Letter are better addressed by redemption fees, limitations on exchange privileges and other trading controls."

The SEC normally avoids being overly proscriptive, preferring to allow the industry the latitude to develop innovative ways of addressing the SEC's concerns. In this case, however, many fund companies appear to be abusing that latitude to essentially not respond to the SEC's concerns about shareholder dilution, and some have called for the SEC to become more proscriptive, particularly on the definition of a significant event and on the standards for the appropriateness of fair-value prices.[19] But the SEC has been subject to considerable political pressure on the issue from an industry that opensecrets.org ranks as the second largest political donor.[20] On one particular issue, the question of whether funds can substitute top-down adjustments for security-level valuation, some have interpreted Paul Roye, head of the SEC's Investment Management Division, as backing away from comments by Doug Scheidt, chief counsel of the division and author of the 2001 letter, that making only top-down adjustments is inadequate (Investment Company Institute, 2002; Sahoo, 2001d, f). According to industry sources and Sahoo (2001e), the SEC has placed more emphasis on fair valuation in its recent compliance visits to mutual funds, but it is unclear whether they plan to require funds to fair value often and fully enough to substantially limit dilution or whether they will simply require funds to "monitor for significant events."

## 7. Who Cares About Shareholders?

The fact that the mutual fund industry is lobbying aggressively to avoid being forced to adopt a fairly low-cost solution to rather substantial shareholder dilution is suggestive of a conflict of interest between fund managers and their shareholders. An alternative hypothesis offered by some in the industry is that the funds' resistance is motivated by legal concerns, particularly the fear of shareholder lawsuits based on the ex post difference between fair value and future prices. There are reasons to doubt the legal

liquid ADRs (Table 7) and the Nikkei future suggests that essentially all of the correlation is due to pre-4:00 P.M. changes in the value of the foreign securities, consistent with market efficiency.

19. For example, Ciccotello et al. (2002) and industry sources cited in Sahoo (2001c).

20. The SEC has also received other political pressure. An example is a September 13, 2001, letter from Congressman Thomas Tancredo (R-CO) expressing "alarm" at fair-value pricing and at restrictions being imposed on international market timers. Congressman Tancredo specifically complained that he had had trading restrictions imposed on his personal account by a fund family. This letter and the Bar Association letter were obtained from the SEC via a Freedom of Information Act request.

explanation, particularly the fact that the SEC's position provides some cover for funds and that, arguably, continued dilution provides even greater grounds for shareholder action, but further light can be shed on these competing hypotheses by examining the relationship between fund governance and aggressiveness on the arbitrage issue.

Although the industry response to the arbitrage problem has been slow in aggregate, there are some exceptions. About 30% of international funds have short-term trading fees by the end of 2001, mostly adopted by funds in 2000–2001. As discussed above, short-term trading fees have limitations in their effectiveness in preventing arbitrage, but having them offers more protection to shareholders than not having them. In addition, a very limited number of funds have started either full or partial fair-value pricing. Using a method for measuring the degree to which predictable future changes in foreign closing prices are incorporated in current-day NAVs described in Zitzewitz (2002), I find that the average fund incorporated 5% of predictable next-day NAV changes from January 2001 to December 2002.[21] Most of this came from funds valuing ADR holdings using their ADR rather than their local prices; only five international funds incorporated more than 80% of predictable stale price changes without having significant ADR holdings.[22] But fair valuing via ADRs is better than not at all, and therefore it seems reasonable to include it in a measure of investor protection. In some cases, funds shift their holdings toward ADRs to reduce NAV predictability, the most extreme example being ProFunds Europe, which limits itself to holding 35 very liquid ADRs, since it caters to high-frequency traders.

If protecting funds from dilution is in the interests of long-term shareholders, but most fund managers view it as not being in their interest, then one would expect to see better protection in funds where governance gives greater weight to shareholder interests. This appears to be the case. Table 8 reports regressions predicting the adoption of short-term trading fees and fair-value pricing. Funds with a lower share of the board that are "interested parties" (who are indicated as such by an asterisk in a fund's

21. In brief, the method is to first estimate a predictive model for next-day returns in the (stale-price) Morgan Stanley Capital International (MSCI) index relevant for each Morningstar category, where the predictive variables are the three used in Table 1 (the pre- and post-11:30 A.M. changes in the S&P 500 and the CME Nikkei future less its local close). Second, regress a fund's current-day NAV change on the current-day MSCI index change and the difference between today and yesterday's predicted next-day changes in the appropriate MSCI index. The second coefficient divided by the sum of the two gives the extent to which predictable changes in stale prices are incorporated in current-day NAVs.

22. The five are AMIDEX 35 (AMDEX), Rydex Europe (RYEUX), Rydex Japan (RYJPX), ProFunds Japan (UJPIX), and Vanguard Pacific Stock Index (VPACX). It is unsurprising that Rydex and ProFunds fair value, given that they specialize in accommodating high-frequency traders. Rydex and ProFunds Japan index the Nikkei 225, so they can "fair-value price" using the 4:00 P.M. ET Nikkei future price from the CME. An additional group of funds, including American and Delaware's international funds (e.g., AEPGX and DEGCX) began fair valuing fully during 2002.

Table 8. Determinants of Arbitrage Countermeasures by International Equity Mutual Funds

| Specification | Probit regression | | OLS | | Summary statistics of RHS variables | |
|---|---|---|---|---|---|---|
| Dependent variable | Fund has short term fee? | | Fair valuing coefficient | | | |
| Mean of dependent variable | 0.31 | 0.33 | 0.051 | 0.040 | | |
| Observations | 1003 | 720 | 1309 | 676 | | |
| Pseudo/adjusted $R^2$ | 0.09 | 0.12 | 0.25 | 0.34 | Mean | SD |
| Expense ratio (in percent) | −0.18* | −0.14 | −0.045* | 0.011 | 1.9 | 0.7 |
| | (0.09) | (0.11) | (0.012) | (0.013) | | |
| Percent of board that are "interested parties" | | −2.26* | | −0.086* | 0.2 | 0.2 |
| | | (0.43) | | (0.032) | | |
| ln(median market cap of holdings) | −0.18* | −0.23* | 0.055* | 0.054* | 9.2 | 1.2 |
| | (0.09) | (0.05) | (0.006) | (0.006) | | |
| ln(fund assets) | 0.03 | 0.04 | 0.001 | 0.005 | 3.4 | 2.1 |
| | (0.02) | (0.03) | (0.003) | (0.003) | | |
| Load fund dummy | −0.13 | −0.04 | 0.076* | −0.006 | 0.6 | 0.5 |
| | (0.11) | (0.14) | (0.014) | (0.016) | | |
| ln(brokerage networks distributed through) | 0.65* | 0.40* | −0.015* | −0.008 | 2.8 | 0.8 |
| | (0.09) | (0.14) | (0.007) | (0.014) | | |

Regressions measure the correlation between the adoption of countermeasures against arbitrage (short-term trading fees and fair valuing) and proxies for independent fund governance (expense ratio and share of insiders on the board). The short-term trading fee variable captures whether a short-term fee was mentioned in the prospectus at the end of 2001. The fair valuing coefficient captures the extent to which the predictable next-day return in the MSCI index for the region covered by the fund is captured in the current-day fund NAV change (0 implies pricing using stale prices; 1 would imply completely removing the predictability from next-day returns; see footnote 21 in the text for the estimation procedure). Annualized dilution is the dilution of a specific fund in percent, measured as in Table 4. Regressions include fixed effects for Morningstar fund categories. Standard errors are adjusted for clustering within fund families.
*Significant at 5%.

Statement of Additional Information) and lower expense ratios are more likely to have adopted short-term trading fees and fair-value pricing. The magnitudes of these relationships are large: for example, a standard deviation reduction in expense ratio increases the likelihood of a short-term trading fee by 3 percentage points, while a standard deviation reduction in the insider share of board seats increases it by 16 percentage points.

These relationships are robust to control for characteristics of a fund's holdings (asset class, portfolio size, and median market cap) and distribution (load/no load, number of supermarkets distributed through). The control variables enter the regression in a logical fashion: widely distributed funds are more likely to have fees. Funds with small capitalization holdings are more likely to have fees but appear to be doing less fair valuing, probably because they are less likely to have ADRs. Analyzing fair-value pricing using a discrete variable (does a fund fair value make more than $x$% of a full adjustment, where $x$ is between 20 and 80) yields qualitatively similar results, with less statistical power. I also examined whether fund-level dilution varied with governance, but with dilution measures only available for 10% of funds, the sample size was too small to yield meaningful results.

It is important to note that since we observe no source of exogenous variation in fund governance, these correlations are not necessarily causal.[23] For example, the fact that low-expense-ratio funds are more likely to have fees or fair value may be the result of these funds having previously attracted proportionately more arbitrage activity, since arbitrageurs are presumably more sophisticated than average mutual fund investors, and thus may be more sensitive to expenses. Anecdotally, Vanguard, a low-expense-ratio fund family, was among the first fund families to implement fees and fair-value pricing. But a similar alternative causal story is more difficult to construct for board composition, since once expense ratios are controlled for there is little reason an arbitrageur should be attracted to a fund with a more independent board.

## 8. Conclusion

This article makes several points. First, NAV arbitrage is a widespread problem, and the resulting dilution of long-term shareholders has roughly doubled since 1998–99 to more than $4 billion per year. Second, the solutions adopted and advocated to date by the fund management industry have serious shortcomings, and most funds appear willing to defy regulators to avoid adopting fairly low-cost full solutions. Third, while the industry has been surprisingly slow in moving to close the NAV arbitrage loophole, funds that appear to be better governed seem to be moving faster.

23. This is, of course, a common problem with empirical work on corporate or fund governance.

This set of facts is consistent with fairly severe agency problems in delegated fund management. The fact that funds are unwilling to spend 5 basis points per year to eliminate annual dilution of more than 100 basis points suggests that they care less than 5 cents on the dollar about shareholder welfare.[24]

A similar estimate can be made using the fact that Daly (2002) reports that at least three fund families that discourage market timing at daily frequencies are willing to allow it at monthly or quarterly frequencies in order to increase the size of their funds. From Table 6, one can infer that 12 and 4 well-timed round-trips per year yield excess returns of 15–25% and 8–12% in international and small-cap funds without fees. The size-weighted average expense ratio of international funds is 115 basis points, and most asset management costs are fixed, so for simplicity assume that marginal fund company profit from additional assets is 100 basis points. By allowing an additional $1 of market timing, average annual assets increase by 50 cents and fund company profits by 0.5 cents, but shareholders lose 8–25 cents. This suggests that fund companies that consciously allow monthly or quarterly market timing to increase their asset base care less than 2–6 cents on the dollar about shareholder assets.

But a simple back-of-the-envelope calculation suggests that fund management companies actually have greater incentives to prevent dilution than these calculations imply. Recent research on the slope of the inflow-performance relationship (e.g., Chevalier and Ellison, 1997) suggests that $1 of dilution reduces future inflows by roughly another $1, thus reducing the future size of the fund by $2. If one again assumes that margin profit from additional assets is 100 basis points, then $1 of dilution costs a fund company 2 cents in flow profit per year. Applying a net discount rate of 10% (cost of capital less average future fund growth rate) in perpetuity suggests that $1 of dilution costs the fund management 20 cents in reduced NPV of flow profits. Although these exact assumptions may be debatable, reasonable alternatives are unlikely to change the conclusion that fund management companies have a substantial interest in reducing dilution.

Taken together, these calculations imply that there is another layer of agency problems inside the management companies. One might expect that fund managers would have high-powered incentives based on the performance of their funds and thus have a strong interest in eliminating dilution, but in many management companies, decisions about fair-value pricing are not made by fund managers, but rather by functional experts who could conceivably face strong incentives to maintain the status quo. Even if this is the case, one would need to explain why functional experts' incentives are determinant in this case.

24. This assumes that none of the 5 basis points could be passed onto shareholders in the form of higher expense ratios. It also ignores any additional costs of implementing fair-value pricing other than fees paid to the data provider, but since fair valuing would eliminate the need for the monitoring that many funds were engaged in as of 2001, net of this saving, the additional cost may be minimal.

Two other possibilities exist. One is the legal risk argument mentioned above, although as discussed, it is far from clear that funds minimize their legal risk by allowing dilution, especially given the SEC position. Another possibility, which one would hesitate to even suggest until all others are exhausted, is that fund management company employees directly benefit from allowing arbitrage. This might also explain why short-term trading fees and monitoring have been the dominant responses thus far, since these can be applied (or not applied) selectively. Even if this is not, in fact, the explanation, one might expect that the perception that it could be will be sufficient to spur action in the future, as NAV arbitrage becomes more widely understood.

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