

STATEMENT BY SENATOR CARL LEVIN (D-MICH)
BEFORE
U.S. SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
ON
ENDING CONFLICTS OF INTEREST AT MUTUAL FUNDS:
THE MUTUAL FUND REFORM ACT
March 31, 2004

Chairman Shelby, Ranking Member Sarbanes, other members of the Banking Committee, thank you for inviting us here today to testify about what needs to be done to tackle the abuses associated with the recent mutual fund scandals. Your series of hearings shows the same thoughtfulness and thoroughness that this Committee displayed in response to the corporate scandals of 2002, and, I hope, will also result in sensible and meaningful reforms this year.

When Enron, WorldCom, Global Crossing, and other scandals exploded onto the scene in late 2001 and early 2002, this Committee acted with deliberation, but it also didn't let these scandals fester. Within a year, you produced a bipartisan bill, and moved it through the Senate. Enactment of the Sarbanes-Oxley Act of 2002 was a proud moment for this Committee, for the Senate, and for the country.

With respect to mutual funds, seven months have now passed since abusive practices and allegations of wrongdoing came to light. Late trading, market timing, hedge fund favoritism, hidden fees, and other abuses have sullied an industry. These mutual fund abuses should not be allowed to infect investor confidence. With your leadership, Congress will again act decisively to restore investor confidence in what has been a powerful source of investment capital for the markets and a critical source of savings for millions of average American families.

I want to recognize and acknowledge the important enforcement and regulatory actions already taken by the SEC. These actions have sent a message to wrongdoers seeking to take advantage of mutual fund investors. But as much as the SEC has done, it doesn't have the authority to undertake certain key mutual fund reforms. Congress should strengthen the hand of the SEC by taking a stand on these issues and placing mutual fund reforms in statutory law.

Over 95 million Americans now invest more than \$7 trillion in mutual funds. These investors deserve complete and accurate information about mutual fund costs so they can make informed decisions and comparison shop to find well-run, efficient mutual fund products. They need to have confidence that the fees they pay are legitimate. They also deserve to know that the persons advising them relative to their investments are exercising independent and objective judgments.

Unfortunately, significant conflicts of interests in the industry today have undermined confidence in some of the investment advice being offered on the market. It is essential that we act to eliminate these conflicts.

The Mutual Fund Reform Act, which was introduced in February by Senators Fitzgerald, Collins and me, zeroes in on, among other things, the conflicts of interest problem. And it takes the approach of banning rather than simply disclosing unacceptable conflicts of interest that undermine public confidence in the mutual fund market.

Disclosure is not enough to address the conflicts problems in the mutual fund field. Complicated disclosures of such practices as revenue sharing and directed brokerage would, I'm afraid, confuse and overwhelm average investors. Just look at what disclosure has done to our telephone bills -- there are pages of information, but the sheer length and amount of unfamiliar data make it virtually impossible to decipher.

Mutual fund data is even more complex than long distance and local call data, and it unlikely that meaningful disclosures can be designed to educate investors and stamp out conflict of interest abuses.

The conclusion our bill reaches is that a disclosure-only regime isn't enough. Mere disclosure also blurs a key point: the conflicts aren't acceptable - period. Instead, we prohibit those practices that embody conflicts of interest and undermine confidence in the market. I'd like to briefly touch on a few of the conflicts of interest that our bill has determined need to be ended, not continued under a cloak of disclosure, if we are to act forcefully to restore confidence in the mutual fund industry.

Revenue Sharing

A key conflict of interest targeted by our bill is a practice known as revenue sharing. Revenue sharing occurs when a mutual fund manager pays a broker to promote the mutual fund to the broker's clients. This payment creates a clear conflict of interest by throwing in a new factor for an investment advisor to consider -- his or her company's own financial profit -- when deciding which mutual funds to recommend to an investor. The SEC recently conducted a review of the 15 largest Wall Street brokerage firms to determine the extent of revenue sharing between those firms and various mutual funds. It found that 14 of the 15 brokerage firms received payments from mutual funds in exchange for steering their clients toward those funds.

The SEC and the National Association of Securities Dealers (NASD) have proposed addressing this issue by requiring brokers to disclose revenue sharing payments to their clients at the time of purchase. But disclosure isn't enough. Even if an investor is clearly told that his or her broker is getting paid to promote a mutual fund, the investor is left wondering whether the broker's recommendation is based on the mutual fund's merits or the broker's financial benefit. Disclosure does not resolve the conflict; it allows revenue sharing payments to continue to undermine objective investment advice. The better course of action is to ban revenue sharing from the mutual fund marketplace.

Directed Brokerage

A second conflict of interest targeted by our bill is directed brokerage. In directed brokerage, a mutual fund typically promises to buy a certain amount of brokerage services from a broker-dealer who agrees to promote that mutual fund to investors. Like revenue sharing, this practice undermines objective investment advice, to the detriment of average investors. To its credit, the SEC has already proposed prohibiting, rather than just disclosing, directed brokerage. Our bill would provide the SEC's proposed ban with a statutory basis, helping the SEC to remove another cloud over the objectivity of investment advice.

Independent Directors

A third conflict of interest I want to mention today involves mutual fund directors. Recent scandals have disclosed a number of problems with mutual fund boards of directors. In some cases, the same person is the chairman of the board of both the mutual fund and the fund manager, meaning that when fees are negotiated the same person is on both sides of the table. In other cases, close relations between a mutual fund's board members and its management company leads to lax oversight and a misplaced reliance on the managers to protect shareholder interests. Shareholders are best represented when board members engage in active oversight and arms-length negotiations with management over expenses and investment decisions. The SEC has already proposed requiring that 75% of each mutual fund board members be independent from the fund's management, i.e. the people who set up the fund, and that an independent chairman sit at the helm. Our bill would, again, strengthen the SEC's position.

Mutual Fund Expense Disclosures

I want to mention one other topic, the importance of enacting legislation establishing a standard for calculating and disclosing mutual fund expenses that includes all material costs. The current "expense ratio" calculation allows funds to leave out key transactional expenses like brokerage commissions, which means that investors can't accurately comparison shop to find well-run, low-cost mutual fund products. Just like grocery shelf price tags give a "price per ounce" so shoppers can assess the price savings between different brands and sizes, investors should have access to a cost ratio that includes all expenses and allows easy and accurate comparisons between mutual funds. Expense disclosures that are comprehensive, easy to understand, and easy to compare are critical to creating a vibrant and fair mutual fund market and guaranteeing investors access to the information they need to make informed choices.

Mutual funds are a \$7 trillion engine of growth for our economy and investment of choice for many average Americans. I urge this Committee to act decisively and to act this year so the Senate can consider meaningful investor protections and help restore the confidence needed to keep this mutual fund engine humming.