STATEMENT BY SENATOR PETER G. FITZGERALD
Before the Senate Committee on Banking, Housing, and Urban Affairs
On S. 2059, the Mutual Fund Reform Act of 2004
March 31, 2004

Good afternoon, Chairman Shelby, Ranking Member Sarbanes, and members of this distinguished committee. Thank you for including me as a witness today during your hearing on mutual fund fees. I would like to commend you and the Banking Committee for the series of in-depth hearings you are holding on the mutual fund industry.

Today I would like to discuss S. 2059, the Mutual Fund Reform Act of 2004, that I introduced on February 10, 2004. I was pleased to be joined in introducing this legislation by my distinguished colleagues on the Committee on Governmental Affairs, Senator Carl Levin and Senator Susan Collins, the committee's chairman, from whom you also will hear today. I am grateful for the extensive and important input both Senators provided in the drafting of this bill, and appreciate the invaluable perspective Senator Collins provided based on her first-hand experience as Maine's Commissioner of Professional and Financial Regulation.

Since we introduced MFRA, we have been joined by a solidly, bipartisan group of Senators who are cosponsors. We welcome the support of Senators Lugar, Voinovoich, Hollings, Lautenberg, Durbin and Kennedy.

The Mutual Fund Reform Act, referred to as MFRA, would make fund governance truly accountable, require genuinely transparent total fund costs, enhance comprehension and comparison of fund fees, confront trading abuses, create a culture of compliance, eliminate hidden transactions that mislead investors and drive up costs, and save billions of dollars for the 91 million Americans who invest in mutual funds. Above all, MFRA strives to preserve the attraction of mutual funds as a flexible and investor-friendly vehicle for long-term, diversified investment.

I would like to take this opportunity to recognize the work of a number of our colleagues in this area. Last year, I was pleased to cosponsor S. 1822, introduced by Senator Daniel Akaka, the Ranking Member of the Senate Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security, which I chair, to address mutual fund trading abuses. Senators Corzine, Dodd, and Kerry also have sponsored mutual fund bills from which I drew, as well as legislation introduced by Congressman Richard Baker last summer and overwhelmingly passed by the House of Representatives at the end of the last session.

Mr. Chairman, MFRA reflects extensive testimony that was presented during oversight hearings of the Financial Management Subcommittee that I chaired on November 3, 2003, and January 27, 2004. The general consensus of the panelists at the November hearing was that illegal late trading and illicit market timing were indeed very serious threats to investors but that excessive fees and inadequate disclosure of those fees posed a much more serious threat to American investors. Witnesses at our hearing in January testified regarding the propriety and the adequacy of the disclosure of mutual fund fees, specifically hidden costs such as revenue sharing, directed brokerage, soft money arrangements, and hidden loads such as 12b-1 fees. The subcommittee also heard from two whistleblowers who were responsible for the initial revelations regarding Putnam Investments and Canary Capital Partners, LLC.

MFRA also reflects the constructive input from a number of key organizations and leaders of mutual fund reform. I especially appreciate the extensive contributions of Mr. John Bogle, the founder and former CEO of the Vanguard Group, who has been a champion of reforms in the mutual fund industry for many years. In his letter of endorsement of February 6, 2004, Mr. Bogle indicated that he viewed MFRA "as the gold standard in putting mutual fund shareholders back in the driver's seat."

In addition to Mr. Bogle, the following individuals and organizations have endorsed MFRA: Massachusetts Secretary of State William Galvin, the Coalition of Mutual Fund Investors, Fund Democracy, Consumer Federation of America, U.S. Public Interest Group, Consumer Action, Consumers Union, and the Government Accountability Project.

I ask consent from the committee that letters of endorsement from these leading individuals and organizations be made a part of the record following my statement.

As members of this committee know well, in 1980 only a small percentage of Americans invested in mutual funds and the assets of the industry were only $115 billion. Today, roughly 91 million Americans own shares in mutual funds and the assets of all the funds combined are now more than $7 trillion. Mutual funds have grown in popularity in part because Congress has sanctioned or expanded a variety of tax-sheltered savings vehicles such as 401(k)s, Keoghs, traditional IRAs, Roth IRAs, Rollover IRAs, and college savings plans. Given that mutual funds are now the repository of such a large share of so many Americans' savings, few issues we confront are as important as protecting the money invested in mutual funds.

Overview of the Mutual Fund Reform Act of 2004

The Mutual Fund Reform Act of 2004 puts the interests of investors first by:

- Ensuring independent and empowered boards of directors;
- Clarifying and making specific fund directors' foremost fiduciary duty to shareholders;
- Strengthening the fund advisers' fiduciary duty regarding negotiating fees and providing fund information; and
- Instituting Sarbanes-Oxley-style provisions for independent accounting and auditing, codes of ethics, chief compliance officers, compliance certifications, and whistleblower protections.

The Mutual Fund Reform Act of 2004 empowers both investors and free markets with clear, comprehensible fund transaction information by:

- Standardizing the computation and disclosure of (i) fund expenses and (ii) transaction costs, which yield a total investment cost ratio, and tell investors actual dollar costs;
- Providing disclosure and definitions of all types of costs and requiring that the SEC approve imposition of any new types of costs;
- Disclosing portfolio managers' compensation and stake in the fund;
- Disclosing broker compensation at the point of sale;
- Disclosing and explaining portfolio turnover ratios to investors; and
- Disclosing proxy voting policies and records.

The Mutual Fund Reform Act of 2004 vastly simplifies the disclosure regime by:

- Eliminating asset-based distribution fees (Rule 12b-1 fees), the original purpose of which has been lost and the current use of which is confusing and misleading — and amending the Investment Company Act of 1940 to permit the use of the adviser's fee for distribution expenses, which locates the incentive to keep distribution expenses reasonable exactly where it belongs — with the fund adviser;
- Prohibiting shadow transactions--such as revenue sharing, directed brokerage, and soft-dollar arrangements — that are riddled with conflicts of interest, serve no reasonable business purpose, and drive up costs;
- "Unbundling" commissions, such that research and other services, heretofore covered by hidden soft-dollar arrangements, will be the subject of separate negotiation and a freer and fairer market;
- Requiring enforceable market timing policies and mandatory redemption fees — as well as provision by omnibus account intermediaries of basic customer information to funds to enable the funds to enforce their market timing, redemption fee, and breakpoint discount policies; and
- Requiring fair value pricing and strengthening late trading rules.

The Mutual Fund Reform Act also would perpetuate the dialogue and preserve the wisdom gathered from hard experience. MFRA directs the SEC and the General Accounting Office to conduct several studies, including a study of ways to minimize conflicts of interest and incentivize internal management of mutual funds; a study on coordination of enforcement efforts between SEC headquarters, SEC regional offices, and state regulatory and law enforcement entities; and a study to enhance the role of the internet in educating investors and providing timely information about laws, regulations, enforcement proceedings, and individual funds, possibly by mandating disclosures on websites.

The Essential Role for Congress in Putting America's Investors First

Mr. Chairman, some people now inquire whether this institution has any role to play in cleaning up an industry that controls so much of America's savings. I believe it would be a serious mistake if we fail to enact meaningful reform legislation. This is an historic opportunity to do right by 91 million Americans who trusted too well.

I certainly commend the many recent regulatory initiatives from the Securities and Exchange Commission. They are collectively a step in the right direction and a demonstration of our seriousness in Washington about putting the interests of America's mutual investors first. But the SEC does not have the statutory authority to take all of the needed steps to restore integrity and health to the mutual fund industry. The current scandals demand that Congress take a comprehensive look at an industry still governed by a 64-year-old law.

For example, the SEC cannot tighten the definition of what constitutes an "independent director." The definition of "interested" — in contrast to "independent" — appears in the 1940 Act, and the SEC is normally not empowered to make law around acts of Congress. (I say "normally" because the SEC *has in fact done precisely that* in several areas, through its so-called "exemptive rules," which I will discuss in a moment.)

As we aim to empower a truly independent board of directors to act as the "watchdogs" for investor interests that they were intended to be, it is critical that we tighten the statutory definition of what constitutes "independence." The SEC itself has made this point persuasively in testimony before the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises. Mr. Paul Roye, Director of Investment Management at the SEC, testified before that subcommittee on June 18, 2003 about H.R. 2420, the bill that ultimately overwhelmingly passed the House, as follows:

> Finally, section 4 of the Bill would amend section 2(a)(19) of the Investment Company Act to give the Commission rulemaking authority to deem certain persons to be interested persons as a result of certain material business or close familial relationships. We strongly support this amendment, which would permit us to close "gaps" in the Investment Company Act that have permitted persons to serve as independent directors who do not appear to be sufficiently independent of fund management. For example, currently a fund manager's uncle is permitted to serve on the fund's board as an independent director. In other cases, former executives of fund management companies have served as independent directors. Best practices guidelines of the Advisory Group provided that former fund management executives should not serve as independent directors because their prior service may affect their independence, both in fact and in appearance.

I could not have said it better than the SEC itself has testified about the need for Congress to step up to the plate — even if the SEC remains absolutely committed to doing what it can to clean up the industry.

Mr. Chairman, I will give you a few more examples of what the SEC cannot do. Of the various nefarious transactions that have become commonplace in the industry, few match soft-dollar arrangements for sheer anti-competitive and anti-investor brazenness. With soft dollar arrangements, investment advisers essentially get to finance their office overhead with investors' money — and that's on top of the substantial adviser's fee they collect, also from investors' money. Investment advisers cause investors to pay an artificially inflated commission on every transaction in the fund's portfolio — and investment advisers thereby obtain "soft dollar credits," which they can use for research, computer terminals, and other office overhead. In section 28(e) of the Securities Exchange Act, Congress permits soft-dollar arrangements. MFRA prohibits soft-dollar arrangements — and only Congress can do that. Through rulemaking, the SEC can interpret the "safe harbor" in section 28(e) narrowly or broadly — and it has done both — but it cannot eliminate the safe harbor. It is time for Congress to correct the error of that safe harbor.

As for the SEC view, I am pleased to quote again from Mr. Roye's testimony on June 18, 2003:

> Our current regulatory regime primarily relies on disclosure by advisers of their soft dollar policies and practices. The Staff Responses submitted last week suggested that disclosure alone might not be adequate and suggested the need for Congressional reconsideration of section 28(e).

Congress should act to eliminate this indefensible and anti-competitive confiscation of shareholder money.

Further, Congress must act to strengthen and clarify what it truly means to be a fiduciary in the mutual fund industry. A "fiduciary duty" is supposed to entail much more than mere honesty and good faith, but it has too often meant much less. The Investment Company Act of 1940 refers to the fiduciary duty of both fund directors and fund advisers — but in both cases, the duty has been relatively empty and virtually unenforced. Indeed, the investment adviser's fiduciary duty with respect to fees is so weak — as interpreted by federal courts — that I am advised that not a single plaintiff has ever prevailed in an excessive fees case. MFRA amends the Investment Company Act to strengthen these twin fiduciary duties of directors and advisers to make abundantly clear that the interests of investors are always paramount. In the case of advisers, MFRA makes clear that their fiduciary duty extends not only to fair fees, but to providing all material information to directors in the directors' exercise of their fiduciary duties — a statutory and regulatory lapse that has made it very difficult for good-faith directors to wrangle essential information out of advisers.

A level playing field is critical to the proper resolution of market forces. Arm's-length negotiations over fees are supposed to be the key market dynamic that keeps state and federal regulators out of the board rooms. But both directors and advisers need a clearer and more specific statement of their fiduciary duties, and MFRA provides it.

For a final example, MFRA shifts the fund distribution dynamic from its current anti-investor and anti-competitive posture to a fairer and more rational market-based dynamic — a change that only Congress can make. MFRA directs the SEC to repeal its Rule 12b-1 — but simultaneously makes it clear that distribution expenses may be incurred by fund advisers, and thereby (1) gets funds out of the distribution business; and (2) imposes the incentive to keep distribution expenses reasonable exactly where it belongs — with the investment adviser.

The SEC cannot amend the 1940 Act to prohibit asset-based fees for distribution of fund shares. The SEC cannot amend the 1940 Act to make it clear that distribution expenses may be incurred out of the management fee paid to investment advisers. These fundamental changes embodied in

MFRA would rationalize a system that has become a mockery of the 1940 Act's Preamble declaration that the interests of investors are always paramount. Consider carefully what happens as a consequence of the SEC's Rule 12b-1. While funds themselves have some incentive to "grow" (primarily, for example, to ensure sufficient liquidity to meet redemptions), the overwhelmingly more powerful incentive to swell net assets is with the fund adviser, whose fee is a percentage of those assets. The current incentive and fee structure is accordingly troublesome: individual investors typically gain nothing from growth, except in the very unusual circumstance of sustained net redemptions, in which portfolio holdings must be sold disadvantageously to meet redemptions. Yet the industry forces these very investors to pay for promotion and growth. And it gets worse. Investors pay for promotion and growth that do not directly benefit them (and may often actually hurt them if the fund grows so large as to make strategic portfolio transactions unwieldy or impossible) — and they pay a fixed percentage for the "privilege" of doing so, regardless of fund size (*i.e.*, Rule 12b-1 — in conspicuous contrast to its founding theoretical framework — has been almost entirely impervious to economies of scale).

Free market principles would typically discipline excessive distribution costs as a direct bite out of profits — but fund advisers are (1) collecting their substantial fees as a percentage of fund assets; *and* (b) financing the sustained swelling of those very same assets with investors' money. Put another way, the King compels the cook to buy the food that fattens the King. Does the King worry about his food budget? Unlikely. MFRA rearranges this incentive structure — without dictating any specific diet. Fund advisers will now bear distribution expenses — and if, as appears virtually self-evident, some of these expenses are excessive, we can be certain that fund advisers, spending their own money, will discover the cost discipline that has been elusive to date.

Only Congress can rationalize the fund distribution system that its own Act of 64 years ago created — and that the SEC complicated with its well-intended but injuriously-perpetuated Rule 12b-1.

Finally, Mr. Chairman, I'd like to say a word about the SEC's so-called "exemptive rules." I am struck, given our system of separation of powers, that the SEC has managed, for example, to require a majority of independent directors on mutual fund boards, when Congress said quite clearly in the 1940 Act that only 40% of the directors need be independent. You won't learn about that kind of power in any basic civics textbook, because it seems to run directly counter to what the Framers established. I happen to believe the SEC is right on the merits about independent directors — but I am concerned that Congress appears to have abdicated its essential legislative power to an unelected agency of the Executive Branch.

The SEC accomplishes this legislative function through "exemptive rules" — rules that essentially create carrots for funds, and then oblige the funds to abide by certain additional rules of they wish to take advantage of the carrots. Perhaps the best known example of an exemptive rule is Rule 12b-1 — which allows funds to pay for distribution expenses *if* they comply with certain fund governance rules.[1] Apart from the separation of powers concerns triggered by reliance on such exemptive rules, I believe the system has spiraled into unacceptable complexity. Congress should make the essential policy determinations that have driven the SEC's exemptive rules. And Congress should make those policy directives independently binding — *not* dependent upon use of an agency-conferred benefit. It is one obvious weakness of reliance on exemptive rules that funds *may* — though it is rare for obvious reasons — opt out of the agency-conferred benefit, and thus decline to be bound by the requirements in the exemptive rules.

These are a few of my concerns with abdication of our congressional role to the SEC. There are more. I believe, however, the foregoing examples well illustrate the essential role of Congress in giving the mutual fund industry back to its owners — the 91 million American investors who will rely on mutual fund investment for their college and retirement security. They would be big winners under this legislation — and the big losers would be high-cost funds that cannot compete in a fair market.

Thank you again, Mr. Chairman, for the opportunity to testify today. I look forward to continuing to work with this Committee as it considers reporting the Mutual Fund Reform Act to the full Senate for consideration.

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[1] Other examples include Rule 10f-3 (permitting the purchase of securities in a primary offering where a fund affiliate is a member of the underwriting syndicate); Rule 15a-4 (permitting the approval of interim advisory contracts without shareholder approval); Rule 17a-7 (permitting securities transactions between a fund and certain affiliated persons of the fund); Rule 17a-8 (permitting mergers of certain affiliated funds); Rule 17d-1(d)(7) (permitting funds to purchase joint liability insurance policies with affiliates); Rule 17e-1 (addressing when funds may pay commissions to affiliated brokers); Rule 17g-1(j) (permitting joint insured bonds); Rule 18f-3 (permitting funds to issue multiple classes of shares); and Rule 23c-3 (permitting closed-end funds to repurchase shares periodically from investors and thereby operate as interval funds).