GARY GENSLER

Testimony on Mutual Fund Reform

Committee on Banking, Housing & Urban Affairs
United States Senate

February 25, 2004

Introduction

Chairman Shelby, Ranking member Sarbanes, members of the committee, thank you for the opportunity to testify today on how to better align the mutual fund industry with the interests of investors. Since I last appeared here during my tenure as Under Secretary of the Treasury, I co-authored a book, *The Great Mutual Fund Trap*, to present common sense investing advice to middle income Americans.

The recent mutual fund scandals have shaken the confidence of these very investors. They are now asking, what went wrong? How do they best protect their savings? What can their government do to better protect investors in the future?

I believe that, at its core, the scandals have revealed the need for substantive reform regarding how mutual funds are governed and operated in America.

In today's global economy we simply have no choice but to ensure that America has the fairest and most efficient capital markets in the world. Mutual funds are a dominant factor for a majority of American families trying to save for retirement. They are amongst the largest sources of capital for corporate America. If mutual funds were to truly operate in the best interest of investors it would increase investors' returns, increase retirement savings, and lower the cost of capital for the overall economy. This is ever more critical as we prepare for the retirement of the baby boom generation.

Congress long ago recognized the inherent conflicts of interest that exist between investors and those who mange investors' money. Responding to an earlier era's financial scandals, Congress passed the Investment Company Act of 1940 (the "1940 Act"). The 1940 Act set up a system of mutual fund governance whereby non-interested mutual fund directors ("independent directors") must independently review and approve all of the contractual relationships with the management company and the financial community. Congress understood that these relationships presented unavoidable conflicts and could significantly affect investors' overall returns.

It is largely that system - independent mutual fund directors acting as gatekeepers for the benefit of investors - which we have in place today. It is that system that I believe deserves serious review and reconsideration.

Only Congress can adequately address these issues through reform legislation. While the Securities and Exchange Commission (the "SEC") is pursuing an active agenda of reform, it can not act alone on all of the necessary reforms to best align the interests of mutual funds with those of the investors they are supposed to serve.

Background

The whole idea of a mutual fund is, as the name suggests, *mutuality*. Funds allow investors to share the costs of professional money management, in the nature of a cooperative. Mutual funds offer investors a chance at the superior long-term performance of equity investing, and a convenient way to buy bonds. They offer risk reduction through diversification as most funds own a broad spectrum of the market. Lastly, when compared with the full-service brokerage commissions of the time, at first mutual funds' costs were relatively attractive.

Legally, investors actually have collective control over their mutual funds. The company managing the assets is distinct from – and legally simply a contractor hired by – a mutual fund. Investors are represented by a board of directors which has a fiduciary duty to oversee their investments and hire the money management company (known as an "adviser") to invest it. In theory, the adviser works for investors to get the best returns for the lowest costs and risks. That is, at least in theory.

Mutual fund companies, as distinct from the funds themselves, however, have their own shareholders and profits to consider. They have a primary responsibility to their shareholders above any duties to the investors in the many funds they manage. They charge high management fees even though those fees come directly from investors' returns. They generally are willing to take added risks in an effort to attract assets in rising markets. And they trade frequently, even if that increases trading costs and investors' short-term capital gains taxes.

In practice, mutual fund investors have very little power over "their" company. Mutual funds are set up by advisers, not by individual investors. Funds have no employees of their own. All of the research, trading, money management and customer support staff actually work for the adviser.

Mutual fund directors serve part-time and rely on the adviser for information. The adviser initially selects directors for new funds and often recruits new directors for established funds. Approximately 80% of mutual fund boards are even chaired by someone affiliated with the adviser. Furthermore, fund companies generally set up a pooled structure, whereby fund directors serve on groups of boards for a fund family. The Investment Company Institute (the "ICI") recommends use of such 'unitary boards' or similar 'cluster boards' in the name of efficiency. Not surprisingly, mutual fund boards fire their advisers with about the same frequency that race horses fire their jockeys.

The Role of Fund Directors

The 1940 Act establishes specific roles for mutual fund directors. In particular, section 36 of the 1940 Act imposes a fiduciary duty on directors with respect to fees paid to advisers. Section 15 of the 1940 Act requires that the independent directors annually review and approve the contracts with the investment adviser and the principal underwriters. Rule 12b-1 requires a similar review of distribution contracts. According to the late Supreme Court Justice William Brennan, the 1940 Act was designed to place unaffiliated fund directors in the role of independent watchdogs, to furnish an "independent check upon the management of investment companies."[i]

In speaking to the inherent conflicts and potential for abuse and overreaching, SEC chairman Donaldson said just two weeks ago:

> "This problem is nowhere more in evidence than in the negotiations over the advisory contract between the manager and the fund. The money manager wants to maximize its profits through the fees the fund pays. The fund's shareholders want to maximize their profits by paying as little as they can for the highest level of service. The fund's board of directors serves as the shareholders' representative in this negotiation."[ii]

This duty, however, has never been interpreted very stringently. In the landmark case on the matter, the second circuit court of appeals ruled in 1982 that:

> "To be found excessive, the trustee's fee must be so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[iii]

Over the subsequent years, the Gartenberg standard has proved to be insurmountable. No shareholder has subsequently proved a violation of the Gartenberg standard. And while it was initially found with regard to the fiduciary duty of the adviser (under section 36(b)) courts have allowed its use as the standard for directors as well. The SEC also has never sued a fund director for failing to review adequately an advisory agreement.

In practice, fund directors have a difficult time striking a proper balance between working with the adviser and vigorously pursuing investors' interests. Directors, in essence, are recruited by the fund companies. Directors generally serve on a multitude of the fund family's boards. They naturally serve only part time and rely solely on the management company for all of their information. There are not even any direct employees of the fund or the board. The directors also have been informed of the legal standards and that until recently there has been only limited actions by the SEC and the courts. How many well meaning directors would wish to make waves in this environment?

***Why Governance Matters** – Excess Costs Lower Retirement Savings*

High mutual fund costs take a serious bite out of Americans' retirement savings. The SEC noted the potential effects on retirement savings when they stated: "a 1% increase in a fund's annual expenses can reduce an investor's ending account balance in that fund by 18% after twenty years."[iv]

Over a lifetime, results can be even more dramatic when compared with low cost passive index investing. Investing in low cost index funds can lead to nearly twice as much savings by retirement than with the same amount actively invested (based upon just 2 percent more earnings per year.)[v]

In total, investors can expect costs totaling close to 3 percent to disappear each year in an actively managed stock fund. Those investors who invest in a fund with sales loads (close to one half of all investors) can expect costs averaging over 4 percent per year. While fees for bond funds are modestly lower, they still overwhelm the expected returns on bonds, particular in today's low interest rate environment.

Mutual fund companies impose costs on investors approaching $100 billion annually. These mutual fund costs are disclosed to investors:

- Monthly management, administrative, and distribution fees averaging well over 1 percent per year. A review of the 2,297 actively managed stock funds in the Morningstar database shows an average expense ratio of 1.49 percent.[vi]

- Sales loads, charged by half of all actively managed mutual funds, averaging 3.9 percent.[vii] With an average holding period of just over three years, investors can pay an additional 1.2 percent per year.

While investors may not pay particular attention to these costs, at least they are disclosed. Also, fund directors are legally required to pay attention to them.

There are some very important costs, though, which go undisclosed. They are hard for investors to measure and they do not show up on any statement. Mutual fund directors also have a more limited legal role in these costs. As investors' representatives, however, I believe, they actually should be very engaged in these costs.

- Portfolio trading costs — the typical active equity fund manager turns over their entire portfolio once every 18 months, incurring brokerage costs and bid/ask spreads approximating 1/2 to 3/4 percent of assets each year.

- Excess capital gains taxes - adding costs of 1 to 2 percent of assets per year - are incurred as portfolios are rapidly traded. While helpful to the US Treasury, this pervasive triggering of short term capital gains tax is particularly costly for investors in the new 15% long term capital gains rate environment.

- The opportunity cost of holding idle cash lowers returns about 0.4 percent each year, on average, during the last ten years. (Though even more during the strong market of last year.)

Why Governance Matters - *Soft Dollars*

Hidden within portfolio trading costs is something Wall Street calls "soft dollars." This is where an adviser, with the acquiescence of the funds' directors, benefits itself at investors' expense.

The mutual fund industry's educational material on the role of directors has this to say about "soft dollars." (Emphasis added):

> Directors also review a fund's use of "soft dollars," a practice by which some money managers, including mutual fund advisers, use brokerage commissions generated by their clients' securities transactions to obtain research and related services from broker-dealers **for the clients' benefit**. Directors review their fund adviser's soft-dollar practices as part of their review of the advisory contract. They do this because **services received from soft-dollar arrangements might otherwise have to be paid for by the adviser.**[viii]

What's hard to figure out is how soft dollar payments can ever be "for the clients' benefits" when they "might otherwise have to be paid for by the adviser." A portion of every commission will be retained by the broker as payment for research advice or other services normally paid for by the fund company. Basically, any expense that the fund company can direct to the fund's broker adds to the fund companies' profits at the expense of individual funds and their investors.

Why Governance Matters - *The Sad Averages*

All of these costs have their effect. Looking at the results over the last ten years, Morningstar data shows that the average actively managed diversified US equity mutual fund fell short of the market by 1.4 percent annually. Annual fund returns of 9.2 percent compared to the overall market return of 10.6 percent annually, as measured by the Wilshire 5000.

Furthermore, currently reported performance results include only those funds that survived the entire period. The many funds which have been routinely merged or liquidated are not still included in industry statistics. Looking at ten-year returns of currently active funds in 2004 will by definition exclude all the unfit funds that closed up shop during the last ten years.

This phenomenon is known as survivorship bias. It is like judging the contestants on a reality TV show simply by looking at the last few people left on the island. If someone asked a viewer how interesting the contestants were, they would probably forget the ones who were voted off in the first few weeks. What were their names again?

The most comprehensive look at survivorship bias was conducted by Burton Malkiel, who concluded that such bias was considerably more significant than previous studies had suggested. For the ten-year period 1982-1991, survivorship bias inflated average industry returns by 1.4 percent per year.[ix] Furthermore, the number of liquidating funds is rising. With 4 to 5 percent of all funds disappearing each year, survivorship bias today is likely to be even greater than during this earlier period.

***Why Governance Matters** - Distribution & Revenue Sharing Arrangements*

The mutual fund industry increasingly relies on others – brokers, insurance companies, and financial planners – to sell its products. While initially hesitant to promote a competitor's products, brokers later developed 'revenue sharing arrangements' whereby they would get paid for every new sale they made. Most mutual fund families feel they have to pay, lest they lose access to new assets and market share.

Mutual fund companies don't eat the cost of paying these sales forces. They pass that cost along to investors, either through a 12b-1 fee, a sales load, or in the form of directed brokerage commissions. In certain recent cases, these arrangements have been in direct conflict with current SEC rules. In aggregate, 12b-1 fees cost investors approximately $10 billion per year while sales loads are in excess of $20 billion per year.

There is absolutely no reason, however, for investors to pay loads or 12b-1 fees. They are not like brokerage commissions, which are necessary to execute a trade on an exchange. Mutual funds are charging investors loads and part of 12b-1 fees to issue them new fund shares. The other part of 12b-1 fees goes to advertising. Brokers like both because they get to share in the action as additional compensation.

Sales loads don't even help offset other costs. Expense ratios for load funds are higher than for no-load funds, with an average of 1.89 percent per year.[x] And as a group, load funds actually earn lower average returns than no-load funds … *even without taking the loads into account.*

***Why Governance Matters** - Recent Scandals*

Mutual fund investors have had a series of wake up calls this past year. The series of scandals has helped to highlight the potential for investors to take a back seat to the inherent conflicts of interest lurking within the industry.

In a pursuit of assets, many mutual fund companies entered into questionable activities. Some sophisticated investors, such as certain hedge funds, were allowed to invest in mutual funds based upon stale prices. These practices, known as 'late trading' and 'market timing' were not readily available to the general public. With 'late trading,' intuitional investors were allowed to invest after the legally mandated 4:00 close, thus getting the benefit of further market developments while still paying the price as of 4:00. In 'market timing' sophisticated investors were allowed to trade in and out of funds on very short holding periods in an effort to take advantage of stale prices related to international stocks. Most of these funds had actually publicly stated to their investors that they forbade such activity. To allow this for the privileged few was disadvantageous to the vast majority of retail investors.

Another set of problems arose around brokers incorrectly charging investors when purchasing load funds. In many of these funds, discounts are advertised for larger purchases. Unfortunately, many brokers were lax in recognizing these discounts or 'breakpoints.'

There also have been questionable practices which have gotten less public attention, but are no less troubling. In particular, many mutual fund companies use 'incubator' funds and the allocation of initial public offerings ('IPO's') and other hot stocks to boost the reported results of new funds. Other fund advisers also have been advising hedge funds and potentially favoring those funds internally.

Market Breakdown

The mutual fund industry is certainly competitive, with significant disclosure of its costs. So why haven't markets worked better to protect investors?

I believe that this is due to a number of factors, including: (i) investors' collective willingness to put their faith in experts while chasing after recent performance; (ii) the effective advertising of the financial industry; (iii) the unique way the industry charges for its services; (iv) the many conflicts of brokers and financial planners; & (v) the practical day-to-day barriers in switching mutual fund families.

There are thousands of funds and hundreds of fund companies competing in the market. That does not mean, however, that the mutual fund industry competes on cost. There are hundreds of casinos in Las Vegas, but that doesn't mean that you'll find one where the odds are in your favor.

Mutual funds compete on service and the expectation of earnings performance. Most Americans tend to pick actively managed funds in the hope of relying on the experts to beat the market. Worse, they pick funds based upon last year's best performers or "hot" funds – expecting them to out perform the market once again next year.

Winning funds of the past, however, are unlikely to be the winning funds of the future. In perhaps the most important study of the factors affecting mutual fund performance, it was found that, basically, past performance does not predict future performance.[xi] If you take the top 10 percent of funds in a given year, by the next year, 80 percent of those funds have dropped out of that top 10 percent ranking. For the top 20 percent of funds, 73 percent drop out the next year. For the top 50 percent of funds, roughly 45 percent fall out the next year. That's not much different from what you'd expect from random chance.

Regardless, mutual fund companies spend significant advertising dollars luring investors to this loosing strategy. Advertisements are a poor guide, however, for investors trying to decide on a mutual fund. Researchers examined two years of mutual fund advertising in *Barron's* and *Money* magazine. [xii]

The study reached three conclusions:

- Not surprisingly, the advertised funds had performed well in the year *before* the advertisement was run. The *pre*-advertisement returns of those funds over the past year were 1.8 percentage points better than the S&P 500 Index.

- Second, the advertisements were extremely effective in attracting new money to the funds. Compared to a control group, advertising appeared to increase inflows 20 percent over what one would otherwise have expected.

- Third, and most significantly, the *post*-advertisement performance of the funds was quite poor. The funds' *post*-advertisement performance over the next year *trailed the S&P 500 by 7.9 percentage points*.

Mutual fund advertising is a classic example of closing the barn door once the horse has left.

Mutual funds also have constructed a unique system whereby costs are practically invisible - another reason why traditional market forces break down. We all have to write a check to our utility or mortgage company, but we never pay a bill for mutual fund management. Such costs are simply deducted from our monthly returns, or taken off the top if we buy a load fund. Other significant costs are not even adequately disclosed, such as portfolio trading costs. In addition, markets are volatile while trending up. This leaves most investors focused on total returns rather than how costs affect those returns.

Investors also are faced with brokers and financial planners touting suggestions and advice which often have the added benefit of lining that broker's or planner's pocket. When investors do consider changing mutual funds, they generally turn to these same brokers and financial planners. There are some practical barriers to switching funds, as well. A significant portion of mutual fund investors now have some savings in 401(k) or 403(b) plans. These plans and the fund options are selected by their employers. Many other investors are hesitant to make investments with a fund family other than where they might have a linked money market account.

Policy Recommendations

To promote retirement savings and the markets, I believe that Congress and the SEC should enact significant mutual fund reforms. While the SEC and other law enforcement agencies may be the first line of defense, I think that there is an important role for Congress to play. The SEC may go only so far under current statute. In addition, Congress can bolster the actions the SEC might take on their own.

In this regard, I recommend that this committee give serious consideration to (a) strengthening fund governance; (b) restricting payments of soft dollars and 12b-1 fees; (c) enhancing fund disclosures; and (d) adopting certain fixes directly raised by the recent scandals.

Mutual Fund Governance

The 1940 Act sought to address inherent conflicts of interest by relying upon independent directors to promote investors' best interests. The recent scandals and the persistence of high fees and other costs have revealed fundamental weaknesses in this system of governance. I believe that Congress and the SEC should now vigorously address these weaknesses by: (i) clarifying the duties of independent directors and the standards to which they are held; (ii) tightening the definition of independence; (iii) prescribing how independent directors are selected; and (iv) increasing their numbers and requiring the chair to be independent.

Governance *- Duties & Standards*

I believe that the most important thing that Congress can do in promoting reform is to make clear - in statute - the duties which independent directors hold to investors and tighten the standards to which they will be held. In essence, I believe that directors should act on behalf of the investors as if they were owners.

While the 1940 Act is specific as to the many duties of directors, until the recent scandals, the mood in the board room has been all too accommodating. In particular, there is significant evidence suggesting that fund directors do not actively pursue cost reductions or vigorously negotiate major contracts related to advisers, brokers or portfolio trading. These are the largest controllable costs of a mutual fund.

What if mutual fund directors were to vigorously negotiate fees and other costs? Could they not confer far more significant benefits to investors than they do under the current governance system? Would not retirement savings increase in America?

While I am not suggesting mandating 'request for proposals' by mutual funds, I do believe that the 1940 Act should be amended to include a general fiduciary duty for directors to act with loyalty and care and in the best interests of the shareholders. It may be appropriate, as well, to mandate that the SEC promulgate rules for directors in carrying out these fiduciary duties. This would provide impetus for independent directors trying to balance their relationships with the investment adviser and others with inherent conflicts of interest. For instance, the Act could require that the independent directors formally meet without interested parties while reviewing and discussing the material contracts. It could also spell out a list of issues which must be considered when approving contracts. Most significantly, the 1940 Act could require true arms length negotiations. Imagine any other board of directors fulfilling its fiduciary duties without requiring similar efforts related to its principal supply contracts.

I also believe that Congress should amend or repeal the Gartenberg Standard. This legal standard is at the very heart of the loose oversight currently evidenced by mutual fund boards.

Lastly, I believe that independent directors should be required to ask for and receive more relevant information prior to entering into major contracts, not just the advisory contract. Section 15 of the 1940 Act could be expanded, requiring that the SEC promulgate rules from time to time to best accomplish this. In particular, the SEC should require independent directors to consider the amounts that advisers charge pension plans and other parties for similar advisory services.

A study conducted in 2001 showed that the largest mutual funds pay twice the amount to their advisers than public-employee pension plans do for the same services.[xiii] In some cases, mutual fund advisory fees were 3 to 4 times higher than those of pension funds. While challenged by the ICI, the study still raises legitimate questions for policy makers and independent fund directors. Pension funds negotiate for lower fees, while mutual fund shareholders can only rely on their directors to do so. Trustees of public pension plans and corporate retirement plans switch asset managers on a regular basis, due to fee, performance or service issues. Mutual fund directors should at least benefit from the best direct comparisons on fees. I have no doubt that they could be made available, if required in law.

Governance *– Definition of Independence & Selection Process*

While the 1940 Act currently contains a definition of an independent director, I believe that it is prudent to tighten that definition and provide for an independent mechanism for the recruitment and selection of such directors. Sections 10 (and its related definitions) of the 1940 Act could be amended to assure that non-interested directors not have any material employment, business or family relationship with the investment adviser, significant service providers, or any entity controlling, controlled by, or under common control with such companies. In addition, the recruitment and selection of such directors should be by the independent directors or by an independent nominating committee.

Governance *– Independent Chair & Percentage of Independent Directors*

The 1940 Act currently mandates that at least 40% of mutual fund directors be independent. The SEC, in 2001, required mutual funds operating under a series of SEC exemptions to have at least 50% of their directors be independent. The SEC, in response to the recent scandals has proposed rules to move this percentage to 75% and require that the board Chair be independent, as well.

I support these changes as they should change the dynamics in the board room. In particular, the Chair sets the agenda and tone of board deliberations. There is no way that a Chair who also works for the investment adviser can satisfactorily serve two masters. By way of analogy, for those who might doubt the importance of the Chair, think of all the energy that goes into securing the Chairs of Senate committees.

I do believe, however, that it would be far better to incorporate these requirements directly in the 1940 Act. It is better for Congress to act on such a material provision of law, rather than have the SEC, a regulatory agency, to mandate its adoption particularly through indirect means. In addition, in a moment of future confrontation between an independent board and a fund company, the fund may avoid the SEC rule by declining the various exemptions.

To assure the necessary change in behavior of boards, however, more is needed than simply changing the number of independent directors and mandating an independent Chair. The great majority of funds already have a substantial majority of independent directors. In fact, approximately 20% already have independent Chairs, including some of those funds caught up in the recent scandals. While it would be a positive step, current law already requires that independent directors review and make the key decisions of the board. That is why I believe that the most important governance reform is to clarify the duties of independent directors and tighten the standards to which they are held.

Restricting Soft Dollars & 12b-1 Fees

Beyond changes to encourage better mutual fund governance, I believe that Congress should give serious consideration to restrictions on soft dollar arrangements and 12b-1 fees. Both of these practices exist as they do as a result of specific SEC actions. Both of these practices also have been associated with a long history of conflicts of interest, and may have outlived their purposes.

The use of soft dollars was significantly broadened under an SEC release in 1986 (interpreting Section 28(e) of the Securities Exchange Act of 1934, which allows paying more than the lowest available commission.) Mutual fund companies enter into soft dollar arrangements with brokers at the expense of the mutual funds which they manage. While soft dollar arrangements can be used to support independent research efforts, they are often used for other expenses as well. They also diminish fund managers' pursuit of best execution for portfolio transactions.

The SEC has put out a concept release seeking comments on soft dollar arrangements, but Congress may wish to significantly restrict or possibly prohibit the current practice. Short of an outright prohibition, mutual funds should be required to disclose the amount by which any soft dollar arrangement are picking up costs for the fund company and this amount should be added to expense ratios.

Rule 12b-1 was promulgated in 1980 in an effort to bring the benefits of economies of scale to investors. The theory originally was that by helping fund companies generate cash for marketing, funds could grow faster and share economies with investors. Unfortunately, investors have seen few benefits from scale in these funds. The evidence clearly shows that funds with 12b-1 plans simply have higher expense ratios and poorer performance than non 12b-1 funds. The time has come to look seriously at repealing rule 12b-1.

The SEC proposed an amendment to rule 12b-1 this month which would ban the practice by mutual funds of directing commissions from their portfolio brokerage transactions to broker-dealers to compensate them for distributing fund shares. I agree with these changes but would add that Congress might want to consider the effects of other revenue sharing arrangements, as well. These arrangements call into question the ability of investors to receive unbiased financial advice from their financial planners or brokers. By analogy, patients do not wish to see their doctors receive direct commissions when deciding on the appropriate medicine to prescribe.

Greater Disclosure

The mutual fund industry currently provides a considerable amount of disclosure to the investing public. Additional disclosures, however, may assist investors and further guard against inherent conflicts. While I think that the most important reforms relate directly to governance, I offer the following thoughts on additional possible disclosures to benefit investors.

First, while the direct costs of management fees and sales loads are disclosed, many of the indirect costs are not. In particular, portfolio trading costs are generally not disclosed. This is somewhat remarkable given their significance to investor returns. They are also one of the largest controllable costs of mutual funds. I believe that it would be beneficial to disclose total transactions costs, commissions as well as an estimate of the costs of bid/offer spreads. If pursued, this would be most helpful if disclosed along with management fees as a percentage of average assets.

Second, the mutual fund industry relies heavily on others — brokers, insurance Companies, and financial advisers — to sell its products. Additionally, fund companies actively compete to win 401(k) and 403(b) plans from large corporations and institutions. Recognizing their commercial leverage, brokers have developed revenue sharing agreements whereby they get paid handsomely for new sales. Large corporations and institutions have developed somewhat similar arrangements whereby they receive part of the mutual fund fees on plan assets. Consideration is appropriate to greater disclosure of these revenue sharing arrangements.

Third, bringing greater transparency in the area of governance may bring greater discipline. The SEC has this month proposed a rule to require improved disclosures regarding the reasons for a fund board's approval of investment advisory contracts. I believe that this rule could be extended – by statute - both as it relates to the negotiations with the adviser and to include other major contracts. In addition, disclosure of portfolio manager compensation and fund ownership would be helpful.

Fourth, given the natural desire of fund companies to ignore the poor results of liquidated or merged funds, it would be helpful to require fund companies to maintain such disclosure on their web sites. Survivorship bias has a perfectly innocent explanation. When investors are trying to decide with which mutual fund family to invest, however, they could benefit by seeing a firm's entire track record. Many outside services and publications would also summarize the information, once it was made publicly available.

Fifth, there is a significant relationship between risk and returns. Many observers focus on risk adjusted returns to compare investments. Based upon modern theories of investing, risk adjusted returns are a way of comparing investments of different risks. There are many services that compute such statistics. It may be worthwhile considering requiring fund companies to readily disclose such information on their web sites or with promotional material.

Sixth, while Congress took steps several years ago to require the disclosure of after-tax returns, the SEC does not require inclusion of this information in sales and promotional material unless a fund is claiming to be tax efficient. Investors wishing to know a fund's after-tax performance currently need to review the prospectus – something they should be doing, but generally are not. It may be appropriate to mandate broader use of after-tax performance data.

Recent Scandals

The SEC has had an active agenda addressing the specifics of 'late trading,' 'market timing,' and 'breakpoint discounts.' In particular, the SEC proposed a rule requiring that fund orders be received by 4:00 p.m. to address 'late trading.' To address 'market timing' problems, the SEC proposed a rule requiring enhanced disclosures including: (1) 'market timing' policies and procedures, (2) "fair valuation" practices and (3) portfolio disclosure policies and procedures. Regarding 'breakpoints' the SEC proposed enhanced disclosure regarding breakpoint discounts. In addition, the SEC adopted a rule on fund compliance policies and compliance officers and has proposed a rule on fund codes of ethics.

While the SEC has been able to move forward with these rules under current authorities, Congress could include in any comprehensive reform package an endorsement or enhancement of these rules.

Conclusion

In conclusion, I believe that the recent mutual fund scandals have revealed the need for substantive reform regarding how mutual funds are governed and operated. Most importantly, it is the system of governance – whereby independent mutual fund directors act as gatekeepers for the benefit of investors - which deserves serious review and reconsideration.

Mutual funds now play a central role in America's capital markets. As we, as a nation, face increasing global competition and prepare for the retirement of the baby boom generation, I believe that we simply have no choice but to ensure that America has the fairest and most efficient capital markets in the world. Even small annual savings can lead to enormous differences upon retirement. Thus, mutual fund reforms, with the goal to promote greater retirement savings and lower the cost of capital, are ever more critical.

Thank you. I would be happy to answer any of your questions.

[i] Burks v. Lasker, 441 US 471, 484 (1979).
[ii] SEC hearing (February 11, 2004)
[iii] Gartenberg v. Merrill Lynch Asset Management, Inc. 694 F.2d 923 (2d Cir. 1982), *cert. denied,* 461 U.S. 906 (1983).
[iv] SEC Report of the Division of Investment Management of Mutual Fund Fees and Expenses, (January 2001): 5
[v] For example, if a worker saves just $100 per month over a 40 year career and earns 8 percent annually, they can retire with a $348,000 nest egg. Invest in actively managed funds and the likely nest egg – $199,000 – fully 43 percent less money available for retirement.
[vi] Morningstar Principia Pro as of December 31, 2003.
[vii] Morningstar Principia Pro as of December 31, 2003. Search was for all US equity mutual fund share classes charging a sales load, excluding index funds, exchange-traded funds, and institutional funds—3,996 funds in all. The 3.9 percent came from adding the average front-end and back-end load.
[viii] Investment Company Institute, "Understanding the Role of Mutual Fund Directors" (1999): 16.
[ix] Malkiel, Burton G., "returns from Investing in Equity Mutual Funds 1971 to 1991," *Journal of Finance* 50 (June 1995): 549.
[x] Morningstar Principia Pro as of December 31, 2003.
[xi] Carhart, Mark M., "On Persistence in Mutual Fund Performance," *Journal of Finance 52* (March 1997): 57.
[xii] Jaij, Prem C., and Joanna Shuang Wu, "Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows," *Journal of Finance15*, (April 2000): 937.
[xiii] Brown, Stewart, and John Freeman, "Mutual Fund Advisory Fees: The Cost of Conflicts of Interest," *University of Iowa Journal of Corporation Law*, (August 2001): 609-73.