Statement of Don Phillips

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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 mutual funds and other investments. Morningstar was founded in 1984, and today we cover more than 100,000 investments worldwide. Over 150,000 individual investors and 80,000 financial planners subscribe to our services. In addition, there are more than 2 million registered users of our investment Web site, Morningstar.com.

As the leading provider of mutual fund information to both individual investors and their financial advisors, Morningstar has had a front-row seat to witness both the rapid rise and the recent missteps of this important industry. We've seen a generation of American investors embrace mutual funds for their compelling combination of convenience, instant diversification, and professional management. The industry's rise has not solely been due to these merits, however. The mutual fund industry has also been the beneficiary of considerable good fortune. Numerous legislative acts, such as those allowing Individual

Retirement Accounts, 401(k) plans, and 529 college savings plans, have encouraged investors to place billions of dollars into funds, greatly enriching those companies that offer them. As a result, mutual funds now occupy a central position in the long-term savings plans of more than 90 million Americans.

Given the privileged and highly important role that mutual funds now play, it would behoove the industry to redouble its commitment to the effective stewardship of the public's assets. Most individuals who work for mutual fund companies embrace this challenge, but the recent scandals make it abundantly clear that too many people in this industry were willing to forsake their responsibility in exchange for short-term personal profit. Sadly, these were not the acts of a few, low-level employees, but instead were violations of trust that took place at the highest levels, including company founders, CEOs, portfolio managers, and several current or former members of the Investment Company Institute's Board of Governors.

Investors are angered and confused by these scandals. Moreover, those institutions, such as pension plans, the financial press, and even the U.S. Congress, who steered investors toward funds have reason to feel betrayed. While few question the inherent benefits of mutual funds, it's clear that the industry has foolishly jeopardized its greatest asset—the public's trust. Investors need reassurances that their trust will not be further betrayed. In particular, they need to know:

A) That mutual funds operate on a fair and level playing field

B) That checks and balances exist to safeguard investor interests

C) That adequate information will be available to allow investors or their advisors to make intelligent decisions about their funds

D) That mutual funds offer a reasonable value proposition

While market forces can and will do much of the work, the industry and regulators can take steps to ensure that mutual funds meet their obligations to the American public. Here are Morningstar's suggestions on each of these fronts:

A) Mutual Funds Must Operate on a Fair and Level Playing Field

One of the most disturbing aspects of the recent scandals has been the revelation that not all fund shareholders have been playing by the same set of rules. Too often, rules imposed upon ordinary investors have been ignored by insiders or waived for high rollers, such as hedge funds. These breaches violate the core democratic promise of funds, which, after all, are designed to be mutual. Moreover, the loosening of these rules allowed for rapid trading of fund shares that created economic penalties for shareholders who played by the rules. It's time for the industry to define what constitutes abusive market-timing and then take meaningful steps to eliminate it. It goes without saying that whatever standards are set must be applied uniformly to all shareholders in a fund. It's also essential that late trading and the possibility of time-zone arbitrage in mutual funds be curbed immediately. We suggest a combination of redemption fees, fair-value pricing standards, and, until a better solution can be determined, a hard 4:00 p.m. close that would require all fund transactions to be at the fund company by 4:00 p.m. Eastern time in order to be transacted at that day's price.

Compounding the problems of mutual fund trading abuses has been disturbing evidence surrounding fund sales practices. When brokerage houses demand special payments or directed brokerage arrangements in exchange for including a fund on their preferred lists, they tilt the playing field and raise questions about the objectivity of the advice their brokers give. Investors deserve to know that the funds chosen for their portfolios are done so on the basis of their investment merit, not on their willingness to pay for shelf space at the brokerage house. It's time to eliminate directed brokerage deals and, at a minimum, better disclose pay-to-play arrangements.

Another area that warps the playing field is how different fund companies account for basic fund expenses. Investors currently pay a management fee to the fund management company to cover the cost of investment research. In addition, a host of operational expenses, such as custodial costs or the cost of trading securities, are charged directly to the fund. Two activities muddy the water. First, soft-dollar arrangements allow the fund's manager to dip into shareholder assets to pay for research, trading systems, office furniture, or other services. While funds clearly need these things, one would assume that these expenses would be included in the fund's management fee, not embedded in artificially high trading costs. Simply put, soft dollars provide a bigger profit margin for the fund's manager made possible by a hidden charge to shareholders. The opportunity for such double dipping should be eliminated.

12b-1 fees further muddy the waters. Fund companies use these charges in part to promote the sale of new fund shares. Investors may benefit to a small extent from fund asset growth, but the advantages of a bigger fund are typically far greater for the asset manager. To the extent that 12b-1 fees compensate brokers for selling funds or for the services of fund supermarkets, we concur that these services help investors, but feel that the charge would be more properly paid directly to those parties, rather than through the expense ratio where all investors, not just those receiving the benefits of an advisor or a discount brokerage house, foot the bill.

While industry advocates will praise 12b-1 fees as a means of allowing investors greater choice in how (but not necessarily how much) they pay for advice, there's a danger to these fees that goes unspoken. When distribution costs are bundled into a fund's expense ratio, they begin to affect fund manager thinking. Unlike upfront sales charges, which are not included in the performance calculations investors see in places like *The Wall Street Journal*, the costs of 12b-1 fees directly lower a fund's total return and its yield. Managers who are saddled with high 12b-1 fees on their funds are at a distinct disadvantage to those who are not. If they simply buy the same securities as their lower-cost competitors, they are guaranteed to trail their rivals. Because fund managers are competitive people, it's not surprising that managers of higher-cost funds adjust their behavior in order to avoid this fate. Morningstar studies have shown that managers of funds saddled with high 12b-1 fees systematically take on greater risk than do managers of funds with lower expense ratios. For bond fund investors, this often means lower-quality bonds or added exposure to the risk of rising interest rates. For investors in equity funds, it may mean more concentrated portfolios or more speculative stock choices. In short, 12b-1 fees offer investors both insult and injury—the illusion of cost savings and the likelihood of added risk.

At Morningstar, we think it's time to eliminate soft-dollar payments and to eliminate or seriously reconsider the role of 12b-1 fees in funds. Investors deserve a clear account of how their money is being spent. Allowing fund managers to dip into shareholder assets to promote asset growth or to offset research costs distorts the picture and makes it difficult for investors to align costs and benefits. Let's keep things clean and clear: Costs whose benefits flow primarily to the fund's advisor should be on the advisor's tab, not passed off as an investor expense. Moreover, distribution costs should be paid directly to distributors, not run through the fund's expense ratio where they tempt managers to take risks they otherwise would avoid. Pricing schemes should not compromise the integrity of the investment management process.

B) Checks and Balances Must Be in Place to Safeguard Investors

It's not just the venality of the misdeeds in mutual funds, but the sheer number of offenses that's so disturbing to investors. It seems that every day another fund company is drawn into this mess. It's hard to fathom how so much wrongdoing could go undetected for so long. Sadly, these scandals raise obvious questions about the regulators who are supposed to safeguard investors. We support the increased funding for the Securities and Exchange Commission and would urge the Commission to continue to prioritize mutual fund regulation among the numerous important tasks it handles. Mutual funds are too important to the country's savings to be a back-burner issue with regulators.

Moves to put all fund regulation under the SEC strike us as inappropriate. The New York Attorney General's Office has demonstrated the significant benefits of a fresh set of eyes looking at the industry. We support the continued ability of individual states to bring actions against mutual fund companies when they see abuses. Mutual funds have been embedded into government-sponsored savings plans for both retirement and college savings. It's valuable to have multiple agencies serving as checks and balances to safeguard investor interests, but we'd ask that these groups coordinate their efforts. The public bickering between agencies in the recent investigations does nothing to reassure investors that their interests are paramount.

Ultimately, much of the burden of fund oversight must fall to the funds themselves, particularly to the fund directors. Much has been made of the importance of independent directors and an independent chairman. While these moves may be largely superficial, we think they are potentially beneficial. While in U.S. operating companies the chairman and the CEO are often the same person, such an arrangement presents 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 firm's stockholders. In a mutual fund there are two parties to which the non-independent directors owe their allegiance—one is the fund shareholder, the other is the stockholder in the fund management company. Only independent fund directors have a singular fiduciary responsibility to fund shareholders. Accordingly, we believe that fund shareholders may be better served when an independent chairman oversees their fund.

Of course, independence alone is no guarantee of good governance. We think a far more important issue is the visibility of the board. 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 the role of the board of directors, often relegating the names and biographical data of fund directors 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 represent 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, where it belongs.

If directors are to represent shareholders, they need to hear from them. However, most fund directors have far more contact with the fund's manager than they do with fund shareholders. 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. Fund boards have been out of sight and out of mind. It's telling that the whistle-blowers at groups like Putnam didn't even think to go to the fund boards. Fund boards must be more visible if they are to be an effective check for shareholders.

They must also be accountable. We suggest that the independent chairman 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 management company. 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. We'd also 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 should effectively explain the fund's investment strategy and the potential risks it may incur. By helping to establish rational performance expectations, fund boards would do a real service for both current and future shareholders.

C) Investors Must Have the Information to Make Intelligent Decisions about Funds

Transparency is the hallmark of the American financial system and one of the reasons that U.S. investors have put so much trust in mutual funds. Indeed, the amount of disclosure on funds in the United States is superior to that of any other country. Yet, at the same time, the disclosure requirements for funds fall well behind the standards set by publicly traded stocks in the United States. Given the rising importance of funds to so many Americans' financial security, we think it would benefit the industry to strive for the highest standards possible. While transparency can be a burden, it is also a tremendous asset in establishing and retaining trust, the very quality upon which mutual funds are based.

All investors deserve to know if their interests are aligned with management's. 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. That's why institutional equity managers have long demanded and received detailed information about senior corporate executives' compensation and their holdings of company stock. In fact, stock investors would protest loudly if this information were denied to them. Why, then, are fund shareholders not given the same insights into their investments?

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 several Putnam portfolio managers or Strong Funds' 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 their inappropriate trading activities would become public information? Disclosure can be a powerful deterrent.

Even the aggregate investment that managers have in their funds is shielded from fund shareholders' view. While any equity investor can see exactly how many shares of Microsoft Bill Gates owns, 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 about corporate insiders not be available about fund insiders?

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. 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 manager compensation.

Fund investors do not know if their manager's bonus is tied to short-term returns or to rolling five-year returns, to pre-tax or to aftertax profits. If the manager's pay is linked to pre-tax returns, surely a manager will be less 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 to the 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? If mutual funds are indeed investment companies, let's treat them as companies and give fund investors the same level of disclosure that stock investors have long enjoyed.

Finally, there's the issue of funds disclosing their portfolio holdings in a uniform and timely fashion. Such disclosure allows investors to see how their money is being managed and to more intelligently deploy funds within their portfolio. Many of the funds sold to the public as “diversified” growth funds during the late 1990s held more than half their assets in technology stocks. An investor who thinks he has a diversified portfolio, but who in fact has a massive sector bet, is a disaster waiting to happen—a fate that too many fund investors learned the hard way when the tech bubble burst in 2000.

The only way to intelligently troubleshoot a portfolio of funds is to have accurate and timely data on the securities within the funds. While most investors won’t sort through detailed lists of fund holdings, there are financial advisors and research companies who will. In addition, the press and academics would be better able to research the fund management industry if they had access to such information. We see no need for instantaneous disclosure of fund holdings, but full portfolio disclosure at monthly intervals with an appropriate lag time to protect the manager’s trading would greatly facilitate the research process and increase the odds that the right investor ends up in the right fund. If funds are not deployed wisely, they can’t possibly meet their obligations to investors. Barriers to quality research that would help investors make better use of their funds need to be removed wherever possible.

D) Mutual Funds Must Show that They Offer a Compelling Value Proposition

Ultimately, mutual funds must demonstrate to investors that they offer a compelling value proposition. While the market will be the final arbitrator, fund companies can and should disclose fund costs in a fashion comparable to other professional fees, so that investors can make informed choices and the market can operate efficiently. Investors have moved their assets toward lower-cost funds over time, but they’ve done so not because funds clearly disclose costs, but because investors ultimately see the debilitating effect of high costs on long-term performance. Why should we continue to subject investors to these damages when there are easy steps that can be taken to alert investors up front to the true cost of their funds?

Funds currently 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 likely gain—potentially a far more relevant number. For example, an investor with $300,000 in a bond fund is 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 his investment. While establishing expected returns for asset classes is problematic, it's clear that the way fees are currently reported to shareholders dramatically understates their impact on returns (1.5% versus 30%).

The U.S. government has established a fine precedent for the fund industry to follow in how it states, in dollars, the exact amount that a worker has deducted from his paycheck for federal taxes, state and local taxes, Social Security, and Medicare. Workers can decide for themselves if they think the payments they make represent reasonable value for the services provided because they are allowed to see the exact cost in dollars of the services. Wouldn't the same basic level of disclosure be helpful to investors making decisions about funds?

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 his house to shave a few pennies from his electric bill is apt to let these far greater fund costs go completely unexamined. Stating these fees 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 amount a homeowner will pay in interest on his mortgage. It's time for truth-in-investing rules that would bring the same common-sense solution to mutual funds. Of course, in fairness to mutual funds, the same standards should be applied to all investment services, including exchange-traded funds, variable annuities, and separately managed accounts.

Conclusions

Given the central role funds now play in the retirement savings of our country, it makes sense to debate the rules governing this industry. At the same time, we don't believe that legislative solutions alone can safeguard investors. Public scrutiny and market forces also play a crucial role. In the wake of the recent fund scandals, we've seen Larry Lasser, Putnam's longstanding CEO, resign his position in disgrace. We've seen Strong Funds' chairman Richard Strong forced to sell his business for a price possibly less than half what he had been offered just four years ago. And, finally, we've seen James Connelly of the Alger Funds sentenced to prison for his role in covering up evidence surrounding these scandals. The message to every fund executive is clear: If you violate the public's trust you can lose your reputation, your fortune, and your freedom. That's a lesson that will guide this industry for years to come.

Still, we believe that there are additional steps that can be taken to protect the investing public. Specifically, we endorse these 10 steps:

#1 Close the door to timing and late-trading abuses.

#2 Eliminate directed brokerage deals and better disclose pay-to-play arrangements.

#3 Eliminate soft-dollar payments.

#4 Eliminate or seriously reconsider the role of 12b-1 fees.

#5 Maintain vigilant and appropriately funded regulatory oversight.

#6 Make fund directors more visible and accountable to shareholders.

#7 Disclose fund manager trading in their funds.

#8 Disclose fund manager compensation.

#9 Improve portfolio holdings disclosure.

#10 State actual fund costs in dollars, so the market can work more efficiently.

Mutual funds have a proud history, but the recent scandals have badly damaged the industry's credibility. Collectively, legislators, regulators, and industry leaders must rebuild the public's trust in mutual funds. Investors need assurances that the playing field is level, that safeguards exist, that their manager's interests are aligned with theirs, and, ultimately, that funds represent good value. By addressing these concerns, the industry can get back on track to helping investors meet their goals and secure a safer future for their families.

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