WRITTEN STATEMENT

of

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before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

"REVIEW OF CURRENT INVESTIGATIONS AND REGULATORY ACTIONS REGARDING THE MUTUAL FUND INDUSTRY: FUND OPERATIONS AND GOVERNANCE"

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Chairman Shelby, Ranking Member Sarbanes, distinguished members of the Committee: My name is David S. Pottruck, and I am the Chief Executive Officer of The Charles Schwab Corporation, one of the nation's largest financial services firms. Schwab was founded more than 30 years ago as a pioneer in discount brokerage. Today, we are a full-service firm serving more than 8 million client accounts with nearly $1 trillion in client assets. Through Schwab Corporate Services, we serve more than 2 million 401(k) plan investors.

I appreciate the opportunity to provide my thoughts this morning on vitally-needed reforms to the mutual fund industry. Let me begin by assuring you that we stand ready to help the Committee move forward in any way we can. We at Schwab share the Committee's disappointment over the recent events that have propelled mutual funds to the front pages. We fully support many of the reforms already undertaken by the SEC. But we also believe that more can and should be done. I applaud this Committee's efforts to put the interests of investors – not insiders – first.

Introduction – The Importance of Mutual Fund Supermarkets

Schwab is certainly no stranger to the needs of mutual fund investors -- mutual funds have long been at the core of our business. We launched the first mutual fund supermarket to focus on no-load funds some 20 years ago, and in 1992 we launched the first no-load, no-transaction fee supermarket, OneSource®. Today, Schwab clients can choose from among nearly 5,000 mutual funds from 430 fund families, including nearly 2,000 funds that have no loads and no transaction fees.

Our heritage is one of innovation, and I don't think I'm being too bold when I say that mutual fund supermarkets have revolutionized investing for millions of Americans. Supermarkets have helped provide investors with an array of investment choices unimaginable a decade or two ago, when investors were essentially held captive by their fund company. Supermarkets empower investors by facilitating comparison shopping among funds; they simplify investing by consolidating statements and allowing investors to move easily from one fund family to another; and they increase competition, driving down costs for individual investors.

We made the decision early on to focus our supermarket on no-load, no-transaction fee funds because we felt that investors should not be forced to bear these costs, and that they deserved access to funds without them. But, in response to client demand, we also make available more than 2,600 mutual funds that do carry either transaction fees or loads, or both. The goal of our supermarket is to make available to our clients the widest array of funds, and our customers have demanded the option of funds that carry additional costs. No two investors are the same. While the majority of our clients prefer funds without loads or transaction fees, that's a determination for each individual investor to make on his or her own, based on his or her own investment strategy, needs, and long-term goals. If a load fund offers superior service or performance, investors may determine that paying the load is worth those benefits. But fewer than 1 percent of all mutual fund purchases made at Schwab involve paying a load.

Our mutual fund supermarket is designed to make comparison shopping among funds as easy as possible. On our web site, Schwab.com, investors can compare literally thousands of mutual funds in a wide array of categories to find the one that best meets their investment goals. They can compare the performance of a no-load fund with that of a load fund, to determine whether loads help or hinder market performance. They can compare funds that have transaction fees with funds that don't have transaction fees. They can compare multiple funds across any number of key data points – past performance, fee structure, portfolio turnover rates, the tenure of the fund manager, risk, amount of assets in the fund, even the percentage of holdings that are from a particular sector of the economy. All of these tools are designed with the idea that what is most important to one investor may be least important to the next. At Schwab, we strive to make as much information as possible available to the investor prior to the transaction to help him or her make the most educated decision.

It is clear to us that our supermarket strategy was the right one. Our clients love this kind of freedom, convenience and flexibility, and they have voted with their wallets. Before the launch of our no-load, no transaction fee marketplace, our clients held about $6 billion in mutual funds. Today, our clients have more than $235 billion invested in literally thousands of mutual funds from more than 400 fund companies. We are proud to be one of the largest mutual fund supermarkets in the world.

And it's not just Schwab's supermarket that investors have responded to. The vast majority of mutual fund trades today are executed via a supermarket, whether it be Schwab's, or Fidelity's, or another competitor's. Only about 12 percent of mutual fund assets are purchased directly from a fund company. And, in the retirement plan context, an estimated 80 or more percent of all 401(k) investors have access to a fund supermarket that allows them to compare hundreds or even thousands of funds across hundreds of fund families to find the one that best meets their individual needs, goals and style.

Mutual fund supermarkets have also helped the industry remain extraordinarily competitive. In a time of growing consolidation in the financial services industry that has resulted in less consumer choice, mutual funds stand out as an admirable exception. Since 1990, the number of mutual funds available to investors has nearly tripled – from 3,000 to over 8,000. Many of these new funds are managed by smaller fund companies that didn't even exist a decade ago – and couldn't exist without the infrastructure provided by mutual fund supermarkets that helps them reach large numbers of individual investors.

In short, supermarkets are a crucial innovation that provide the link between millions of Americans and our equity markets. They are an indispensable tool that must be preserved and strengthened – not weakened by reform proposals, no matter how well-intentioned. As the Committee considers reform, I urge it to remember the very qualities that make mutual fund supermarkets so valuable to investors: choice, simplicity, convenience, transparency and competition.

Reforms Must Preserve the Strength of Supermarkets

Let me briefly outline a few suggestions for the Committee's consideration that underscore these principles.

First, it is clear that there is not enough transparency in the mutual fund business. Schwab supports many of the proposals under consideration in Congress and at the SEC to enhance disclosure to fund investors, but I think we can go further. There are three areas that I would recommend for additional disclosure:

- Investors have a right to know if their broker's representative has a financial incentive to push one mutual fund over another. No one at Schwab does. We voluntarily provide information on our web site today to investors about how our representatives are paid and rewarded. All investors deserve this sort of transparency.

- Investors need to know whether a fund company has paid a fee to be on a broker's preferred list. At Schwab, our OneSource Select List™ features the best performing no-load, no-transaction fee funds available through Schwab's supermarket. No fund can pay us for inclusion on the list, and we tell investors that. More light needs to be shed on how these lists are created.

- To bolster competition and lower prices, Congress should unfix sales loads, so that broker-dealers are forced to compete, just like back in 1974, when commissions were deregulated. Mutual funds should be allowed to set a maximum load, but not a minimum. This would put the burden on the broker to determine, disclose and defend their commissions. Investors could then shop around for the best price. Mutual funds already compete vigorously on the fees they charge investors; there is no reason that broker-dealers should not do so as well.

  Moreover, in 1992 the SEC's Division of Investment Management recommended that the Commission seek legislation to amend Section 22(d) of the Investment Company Act, which mandates retail price maintenance on mutual fund sales loads[1]. That recommendation was never adopted, and as a result, investors are faced today with a confusing array of load share classes that prevents too many investors from understanding how they are paying for their sales commission – via a front-end load, a back-end load or level load. The proliferation of Class A, B and C shares leads to conflicts, as brokers could push investors into a class that may not be appropriate for their situation. If Congress acted to unfix sales loads, the SEC should do away with the confusing proliferation of load share classes.

All of these steps would put investors in the driver's seat – helping them better understand what they are paying for and giving them better tools for making informed investment decisions.

It is critically important, though, that we focus on the quality not just the quantity of these disclosures. Mutual fund documents are already too complex. They are littered with legalese and fine print that too few investors can understand, when they bother to read it at all. There is a danger that additional disclosure will further overwhelm investors. The SEC has made important progress in recent years in its plain English initiatives – it should apply those principles here as well, ensuring that new disclosures are presented as simply and as conspicuously as possible, and that they facilitate comparability and clarity.

"Hard 4 p.m. Close" Will Harm Investors

Unfortunately, Mr. Chairman, one of the highest-profile proposals to emerge from the SEC would undermine all of these efforts. The so-called "4 p.m. hard close" represents a step backward for investors. While well-intentioned, it does nothing to increase transparency, minimize conflicts or maximize convenience. Instead, it undermines the goal of competition and would deprive investors of choice.

The SEC proposal would require all fund orders to be received by fund companies by Market Close, generally 4 p.m. eastern time, to receive that day's price. To accomplish that, intermediaries, such as Schwab, would have to impose an earlier cut-off time, perhaps at 2:30 or 3 p.m., to process, verify and aggregate those orders before submitting them to the fund company. Furthermore, because of the additional regulatory requirements surrounding the processing of retirement plan trades, an even earlier cut-off time would have to be imposed for retirement plan participants. The result is a confusing array of different rules depending on how the individual invests.

In considering the impact of the "Hard 4," it is important first to understand how mutual funds transactions currently work. At Schwab, we receive mutual fund orders throughout the day and night from individual investors, registered investment advisers, clearing firms, and Retirement Plan Administrators. Those orders come in to live representatives, via our web site, over the telephone, even via wireless communication devices. Close to 90 percent of our orders are received through the electronic channels with minimal or no human intervention. Whenever

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[1] See *Protecting Investors: A Half Century of Investment Company Regulation*, Division of Investment Management, SEC, at page 297.

and however those orders are placed, they are promptly entered into our system and electronically time-stamped. Our system automatically and in real time aggregates the order for the appropriate day's price. Orders received up until Market Close automatically receive today's price; orders received after Market Close automatically receive the next day's price.

Once the market closes, Schwab engages in a review process to ensure the accuracy and integrity of our aggregate omnibus orders prior to sending them to the funds. For the majority of our mutual fund business, orders are aggregated by order type and are transmitted as a single omnibus level order to the fund. Aggregating the orders provides real economic value and minimizes the expenses to us and the funds. We also use this small window of time to proactively notify fund companies of any large purchase and redemption orders from clients. This gives fund companies the time needed to contact their portfolio managers and make an informed decision regarding the order (taking into account client trading behavior, fund flows, and market conditions) and communicate back to Schwab. Schwab also needs time to cancel the order(s) if the fund elects to reject the purchase. Since a rejected order may involve multiple orders for hundreds of accounts managed by a registered investment adviser, the process of canceling a rejected order may take upwards of 30 minutes. This is important since we don't want to transmit orders that have been rejected by the fund. This ultimately protects the funds (and Schwab) from the operational and financial risks associated with canceling orders that have been rejected after they were transmitted to the funds.

Typically, this entire review process is completed within 60 to 90 minutes and our omnibus orders are submitted to the various fund companies between 5 and 5:30 p.m., eastern time. For many intermediaries, the process takes much longer, and orders are submitted to fund companies well into the night. It is, of course, this gap in time, between 4 p.m., when the market closes, and the time when orders are submitted to the fund company, that the SEC has identified as the period some have taken advantage of to engage in the prohibited activity known as "late trading." The "Hard 4" solution proposed by the SEC is an attempt to deal with this problem.

We at Schwab share the Committee's disappointment at the illegal late trading activity that has been uncovered in the industry, and we strongly support regulatory and legislative steps to ensure that this kind of activity is eliminated. We have a proposal, which we call the "Smart 4" solution, that I outline below. It's a solution that cracks down on late trading without disadvantaging different groups of investors. Before I detail that proposal, which we believe is the best solution, let me take a moment to walk the Committee through the impact of the SEC's "Hard 4" proposal on various groups of investors:

- *Impact on Individual Investors*. As the SEC acknowledges in its rule proposal, substantial changes would be required in the way fund intermediaries process fund purchase and redemption orders. Today, a mutual fund may accept an order after Market Close, provided the order was received by an intermediary prior to Market Close. However, under the Proposed Rules, investors investing through intermediaries would be required to submit purchase orders prior to an earlier cut-off time, such as 2 p.m., to allow the intermediary sufficient time to process the purchase and redemption orders before submitting them to the fund, its designated transfer agent, or a registered clearing agency by the 4 p.m. deadline. Significantly, that earlier cut-off time would likely be different for different intermediaries, depending on the business model and systems capabilities of the particular firm. In other words, an investor who uses Schwab might have a deadline of 2:30 p.m., but an investor that uses Firm ABC as an intermediary might have a cut-off time of an hour earlier. Of course, an investor would be able to place an order directly with a fund company right up until 4 p.m. Yet approximately 88 percent of mutual fund purchases today are executed via an intermediary. Undoubtedly, this variety of cut-off times would be confusing to investors, and it would create different classes of investors depending on which firms they used to execute their trades

Moreover, earlier cut-off times would particularly disadvantage investors on the West Coast and in Hawaii. For example, West Coast investors might be required to submit their mutual fund orders to the intermediary by 11 a.m. Pacific Time (and as early as 8 a.m. in Hawaii) to receive that day's current price (assuming a 2 p.m. Eastern Time early cut-off time).

Let me also make an observation about the nature of pricing mutual funds. Forward pricing in the fund industry has been necessary to protect existing shareholders, but the reality is that it is not a particularly consumer-friendly feature. Where else does a consumer make a decision to buy something without knowing the exact price he/she will pay? Mutual fund investors are promised only that they will get the appropriate price at the next calculated time. Investors don't like this uncertainty and they take steps to minimize it by placing orders later in the day when there is less time between when their order is entered and the pricing time. In fact, over 40 percent of mutual fund orders are received by Schwab during the last 2 hours prior to market close. Sadly, the Hard 4 p.m. Close will create increased investor dissatisfaction by increasing the time between order placement and pricing. We owe it to investors to do better, not worse.

- *Impact on Retirement Plan Participants*. More significantly, retirement plan participants, because of the increased complexity of aggregating and pricing orders at the individual and plan levels, would have even earlier, less convenient cut-offs than ordinary retail investors. The latest order cut-off a retirement plan could administer likely would be 12 p.m. Eastern Time. In practice then, as acknowledged by the SEC in its proposal, almost all retirement plan participants would as a result receive next-day pricing, not same-day pricing.

  The proposal would have other unfortunate consequences for retirement plans. Under the proposed rules, retirement plans will face strong pressure to offer choices only from a single fund family, which would allow orders to be placed up until the market closes. In this way, retirement plans will be able to take participant orders later than if the orders were first routed through an intermediary such as a broker-dealer. However, limiting plan participants to a single fund family will be a detriment for 401(k) plan participants. It will reduce choice and the ability to diversify retirement assets across multiple fund families. Reducing participant choice will encourage higher operating expense ratios and other costs. As a result of reduced choice and increased costs, plan participants could face increased risk and decreased returns.

Forcing retirement plan participants to get next-day pricing would also raise serious fiduciary issues for retirement plan sponsors as to whether they should offer mutual funds as an investment option at all, when other pooled investment vehicles (such as bank collective trust funds and insurance company separate accounts) with same-day pricing are available as alternatives. It would be unfortunate if the "Hard 4" proposal created an incentive for 401(k) plan participants, who include less sophisticated investors, to receive investment choices with a lower level of investor protection.

One of the issues that frustrates me most in this context is the claim that retirement plan participants are, or at least should be, long-term investors, for whom the price of a mutual fund on a particular day is not that important. While the effect of next-day pricing on a single investor may be small, the aggregate effect on all investors is large. SEC statements over time on best execution (in the equities context), for example, make clear the SEC's view that it is a serious breach of fiduciary duty to short-change investors by a few pennies per share. In the aggregate, especially over long periods of time, pennies matter.[2] Long-term investors should be fully invested; systematically having money uninvested for a day will increase long-term tracking error and disadvantage investors (especially since significant market events will occur on some of the uninvested days). Furthermore, it will undermine 401(k) plan participants' confidence in mutual funds if they are forced to wait an extra day to sell in a falling market, or to buy in a rising market. The government should not be in the business of determining what is and is not an "appropriate" investing strategy for a retirement plan participant.

- *Impact of an Early Order Cut-Off on Investors' Use of Intermediaries*. Another disadvantage of the "Hard 4" proposal is that it will create a strong disincentive to invest in mutual funds through intermediaries, which benefit investors in many ways. As I have already detailed, intermediaries are more convenient for investors. They allow clients to see all of types of assets, including mutual funds from different fund families, equities, bonds, and other investments, on a single web page and/or a single statement; enhance clients' ability to comparison shop among different fund families and make more informed decisions; foster more robust competition in the industry; and allow investors to move money more easily from one fund family to another. The SEC staff has repeatedly noted the benefits to investors of fund supermarkets, as recently as in a letter to the House Financial Services Committee last summer.[3]

- *Impact of Early Order Cut-Off on Funds—Cost and Competition.* By discouraging the use of intermediaries and encouraging direct investment with funds, the proposed "Hard 4" would result in all funds having to build more infrastructure for handling customer

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[2] See Remarks of Chairman Arthur Levitt, Best Execution: Promise of Integrity, Guardian of Competition (Nov. 4, 1999); Order Execution Obligations, Securities Exchange Act Release No. 37619A (Sept. 6, 1996).

[3] See Memorandum from Paul F. Roye Re: Correspondence from Chairman Richard H. Baker, House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, June 9, 2003, at 73; Investment Company Institute, 1998 SEC No-Act LEXIS 976 at *6 (publicly available Oct. 30, 1998).

service and orders. Today, most fund companies receive a relatively small number of orders – the work of aggregating thousands of customer orders (and doing all of the attendant sub-accounting) occurs at the broker-dealer, not at the fund company. Many intermediaries, such as broker-dealers, find it more efficient to build this infrastructure, where they can leverage the infrastructure they already have for handling orders for other types of securities.

Requiring an early order cut-off for mutual fund orders through intermediaries will create additional competitive distortions. Newer, smaller, more entrepreneurial mutual funds primarily reach clients through intermediaries and typically do not have the scale to reach clients directly. If the SEC adopts regulations that discourage the use of intermediaries, the result may be higher barriers to entry for new funds and fewer choices for investors. As a result, the mutual fund industry will move towards an oligopoly of large fund complexes with the size and scale to be able to reach investors directly. The inevitable result of lessened competition will be higher costs and fewer choices for investors.

Moreover, mutual funds are just one choice among many other types of investments. An earlier cut-off time that applies only to mutual funds would disadvantage these funds compared to investors in competing products that will continue to have later cut-off times. Equities, exchange-traded funds (ETFs), closed-end funds, bank collective trust funds, insurance company separate accounts, and managed accounts will continue to accept orders up until 4 p.m. A “Hard 4” for mutual funds would encourage investors to prefer those products to mutual funds. Many of these other products are less regulated and have less robust disclosure.

“Smart 4” – A Strong Alternative That Will Protect, Not Harm Investors

Mr. Chairman, the term “Hard 4” is accurate – it will make investing harder. We prefer an alternative, a “Smart 4,” if you will. It would utilize the best technology, enhanced compliance and audit requirements, and vigorous enforcement to stamp out late trading. The SEC included in its recent rule proposals an alternative proposal that incorporates several of our suggestions, but we would recommend going even further. Our “Smart 4” proposal would allow a fund intermediary to submit orders after Market Close, provided that the intermediary adopts certain protections designed to prevent late trading:

- Immediate electronic or physical time-stamping of orders in a manner that cannot be altered or discarded once the order is entered into the trading system;
- Annual certification that the intermediary and the fund has policies and procedures in place designed to prevent late trades, and that no late trades were submitted to the fund or its designated transfer agent during the period; and
- Submission of the intermediary to an annual audit of its controls conducted by an independent public accountant who would submit their report to the fund's chief compliance officer.
- SEC inspection authority over any intermediary that seeks to submit orders it has received prior to 4 p.m. to the fund company after the market closes; and

- Enhanced compliance surveillance policies and procedures that would ensure that orders were in fact received prior to 4 p.m.

We believe that any intermediary that seeks to submit orders that it received from its customers prior to 4 p.m. to the fund company after that hour should be required to adopt the five protections set forth above. Intermediaries should have the option, however, to avoid adopting these protections if they elect to submit their orders to the fund company prior to 4 p.m. This approach will be more effective in preventing instances of late order trades, while avoiding the many hardships that forcing an earlier cut-off time would impose on millions of mutual fund investors.

Schwab believes that the most effective way to stop late trading at both the fund level and the intermediary level is to make the time that a customer submits an order transparent to the fund, its independent auditors, and SEC examiners, and subject the order process to strict compliance controls, certification requirements, and independent audit and examination. This verifiable, "Smart 4 Close," provides a greater level of protection because it applies to all mutual fund orders, while avoiding the hardship on individual investors imposed by the "Hard 4 Close." Let me set forth further details about each of the five elements of this plan:

- *Electronic Audit Trail.* The mutual fund industry should work together to establish an enhanced electronic audit trail for mutual fund orders. Ideally, this audit trail should document the time of receipt of the order from the client, the time of transmittal within a firm (for example, from a branch or call center to a mutual funds operations group), the time of transmission among intermediaries (for example, from a retirement plan Third-Party Administrator to a broker-dealer), and the time of transmission from the intermediary to the fund or its transfer agent. At an absolute minimum, however, the time of receipt of the order from the client should be captured electronically with the order secured from being altered. In addition, the time stamping should be accompanied by information about the actual individual who handled or observed that step in the process. Material modifications would require the cancellation of the original order and the entry of a new order with a new and updated time stamp.
- *Annual Certification of Procedures.* Entities that handle mutual fund orders – including fund companies and their transfer agents, as well as intermediaries such as brokerage firms and retirement plan third-party administrators – should issue annual certifications that they have procedures reasonably designed to prevent or detect late trading, and that those procedures have been implemented and are working as designed. Intermediaries would make these certifications available to any mutual fund on behalf of which it accepts orders for purchase or sale of shares of the fund. As is typically the case for certifications under the Sarbanes-Oxley Act of 2002, each entity would be responsible for designing a process to give the individuals signing the certification a reasonable basis for believing it to be correct. As with the SEC's recent proposal for investment company and investment adviser compliance programs, the annual certification process would address whether changes are needed to assure the continued effectiveness of the late-trading procedures.
- *Enhanced Auditor Review.* All entities that handle mutual fund orders should be required to conduct an annual auditor review of their late-trade prevention and detection

procedures. For registered intermediaries such as broker-dealers or banks, we suggest, at a minimum, a standardized SAS 70 or similar review by independent auditors. An audit review would be based in part on the annual written compliance certification by the intermediary's management discussed above, which would in this context serve as the equivalent of a management representation letter for an auditor review. Both the management certification and the results of the auditor review should be provided to the funds on behalf of which the intermediary accepts orders. Further, if the auditors discover any material control weaknesses, and management does not promptly correct those weaknesses, the auditor should be required to escalate that information to the SEC, similar to the requirement for independent audit escalation under Section 10A of the Securities Exchange Act of 1934.

- *Consent to SEC Inspection Jurisdiction.* The SEC should be able to inspect any intermediary to review whether its late-trade prevention and detection procedures are adequate and are working as designed. The SEC already has jurisdiction to inspect broker-dealers who process mutual fund orders; but there should be consistency in oversight. The SEC should require banks and trust companies to "push out" mutual fund order processing activities to an affiliated broker-dealer registered with the SEC. The Gramm-Leach-Bliley Act contemplated that these types of securities processing activities (a core part of the definition of broker-dealer activity in the Exchange Act) would be handled by broker-dealer affiliates; however, regulations implementing this portion of Gramm-Leach-Bliley do not exist. Alternatively, the SEC could require that banks register as transfer agents to engage in this type of mutual fund order aggregation and processing.

  Unregistered intermediaries should consent to SEC inspection on the grounds that they are acting as an agent of an SEC-registered mutual fund when they accept orders for that fund. Indeed, some third-party administrators are already subject to SEC jurisdiction as registered sub-transfer agents for fund companies. To the extent intermediaries decline to consent to SEC jurisdiction for inspections, they should be required to submit all trades to a registered intermediary (or directly to the fund or transfer agent) prior to Market Close.

- *Enhanced Compliance Surveillance.* Even with an electronic order audit trail, there may be situations where the electronic version of the order is entered shortly after the market closes (for example, when a client calls just before 4 p.m. but the registered representative does not finish inputting the order until shortly after 4 p.m., or when a computer systems problem delays electronic input of the order). A robust compliance surveillance process can address the potential for abuse of this process. Firms should require surveillance for suspicious patterns of potential late orders by a single client, orders entered by related clients (such as clients of a single adviser), or orders entered by a single registered representative. Where suspicious patterns exist without adequate contemporaneous explanations, firms should take prompt actions to investigate and respond appropriately.

In addition, each intermediary's handling of late orders should be transparent to the regulators. Funds and intermediaries who accept customer orders up until 4 p.m. should file annually with the SEC a report of trade activities including reporting of any "late trades" with explanations. This reporting would allow visibility and oversight by the SEC without overwhelming the agency with the need to inspect or examine each firm: the SEC could target firms where the late trading filings indicate unusual activity. This process already exists for transfer agents in the current TA-2 filing. Finally, funds and intermediaries should be required to review late trading policies and procedures with their employees in their annual compliance continuing education meetings.

Mr. Chairman, this "Smart 4" proposal is, we believe, the most effective way to combat the pernicious problem of late trading. It's a tough, sensible solution that will prevent illegal activity but without disadvantaging legitimate investors who want nothing more than to make sound investment decisions on a level playing field.

Other Issues

With the Committee's indulgence, I'd like to conclude by offering specific comments on two other issues that have been under the spotlight recently.

Fees

There has been considerable discussion in the media and at the Senate Governmental Affairs hearing last month about the subject of mutual fund fees. Some believe that the government should be mandating fee rates or capping fee rates. I strongly disagree. This is an extraordinarily competitive industry, which puts tremendous pressure on companies to keep fees low. As an investor, if you believe the fees a particular fund charges are too high, you have literally thousands of other funds to choose from. Every investor is different and should be allowed to make his or her own choices – if a particular fund has a high fee but offers tremendous performance and tremendous service, then an investor can make the decision to pay for that. Neither Congress or the regulators should be in the business of mandating fee levels in such a competitive environment.

The other point I want to raise is the issue of how best to disclose fees. In both the legislative and regulatory context over the past few months, there has been considerable discussion of what kind of disclosure is most appropriate and useful to investors. One idea under consideration is mandating personalized, actual-dollar disclosure of the fees each unique investor pays. I am not convinced that this kind of individualized disclosure is actually helpful to investors. First of all, it would be enormously expensive, and firms would just pass that cost on to investors, increasing the fees. More importantly, I don't believe individualized disclosure facilitates the kind of apples-to-apples comparisons that investors need. Apparently, the SEC agrees, for Commissioners approved a rule earlier this month requiring that funds disclosure, via a standardized example, what the fees are on an investment of $1,000. This was a sensible decision by the Commission, as it allows for quick side-by-side comparison of different funds, would be a much better solution. We applaud the Commission for moving so quickly on this rule.

Mutual Fund Governance

On the issue of mutual fund governance, we support the SEC's proposal for mutual fund boards to have a 75% majority of independent directors. We have concerns, however, about mandating an independent chairman. We believe the independent directors should be empowered to choose whomever they want as a chairman, and that person can be independent or interested. There does not seem to be a correlation between behavior and having an independent chairman. Indeed, many of the funds that have had the worst problems over the last few months had an independent chairman. Finally, let me say that Charles R. Schwab is the chairman of our mutual fund board. We believe the expertise and experience he brings to the table is unparalleled. Moreover, we believe his integrity cannot be questioned, and that his long history of championing the individual investor speaks for itself.

Conclusion

As we move forward we must remember the lessons we have learned from the evolution of mutual fund supermarkets. We must empower investors by promoting competition and choice; requiring clear, simple disclosure; and minimizing conflicts. Investors have given us a roadmap that should guide our reform efforts. We should also look ahead to solutions that may be further down the road, such as examining ways to use technology to improve pricing and, perhaps ultimately, to get to more frequent, even real-time, pricing.

I applaud this Committee for its deliberate approach on this issue. Mutual funds are the great democratizing force in our markets. They are the vehicle that allows millions of Americans to participate fully in our nation's economic prosperity. However, any reform that confuses investors or erects new barriers for those who want to participate in mutual funds – including well-intentioned proposals such as the "4 p.m. hard close" – will be a step backward, not forward.

Finally, Mr. Chairman, let me conclude by saying that we in the mutual fund industry bear the ultimate responsibility for acting in the best interest of our clients. Legislation and regulation can only do so much. Most of the failures that have been publicized were not about inadequate rules, but a failure to follow the letter and spirit of the rules we have. At Schwab, we are committed to living by the principles I have outlined for you today.

I appreciate the opportunity to share my views on this critical issue and I would be happy to answer in writing any follow-up questions members of the Committee may have. Thank you.

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