STATEMENT OF THOMAS O. PUTNAM

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FENIMORE ASSET MANAGEMENT, INC. / FAM FUNDS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ON

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

FUND COSTS AND DISTRIBUTION PRACTICES

MARCH 31, 2004

EXECUTIVE SUMMARY

- I am deeply disappointed about the recent mutual fund scandals. In an industry based on fiduciary principles, there is simply no place for this kind of behavior.

- I am pleased that regulators have moved swiftly to investigate and punish those responsible. I also strongly support SEC reforms aimed not only at remedying immediate problems affecting mutual funds, such as late trading, but also addressing potential conflicts of interest, strengthening fund governance, and enhancing standardized fund disclosures. These reforms will benefit investors for years to come.

- As the founder and chairman of a small fund group, however, I have serious concerns about the possible scope of the changes facing the industry. Small fund groups, with their smaller asset bases and thinner profit margins, may find that the considerable costs associated with those changes are prohibitive.

- Small fund groups provide greater choice for investors and help to foster competition. In addition, a small fund group typically can provide its shareholders a level of individual service and attention that is simply beyond the reach of a large fund group. It is also important to note that many of the most innovative fund products and services, such as money market funds, were introduced by entrepreneurs new to the industry.

- No proponent of mutual fund reform wants to damage the long-term competitiveness and creativity of this industry. If the regulatory restrictions and costs of managing mutual funds are made to outweigh the possible rewards, however, there could be a "brain drain" as the best and brightest portfolio managers leave the fund industry for more creative and lucrative forms of money management. New firms might bypass the fund industry altogether, choosing instead to limit their investment offerings to less regulated products.

- Our differences aside, small fund groups and large fund groups agree that the merits of any reform proposal should be measured against a single standard, one that has been the hallmark of our industry throughout its history: Will the proposed reform benefit the interests of long-term mutual fund investors?

- Fund Governance: Requiring that all fund groups have an independent chair would impose an unnecessary, one-size-fits-all approach. Instead, I believe that fund boards should have the ability to choose between having an independent chair and a lead independent director. I also support other measures to enhance the role of independent directors, such as requiring that they constitute a supermajority of each board and meet in executive session at least quarterly.

- Ban on Joint Management of Mutual Funds and Hedge Funds: Many small fund groups are concerned that such a ban could drive their top portfolio managers out of the mutual fund industry. In addition, the ban could have harsh, anti-competitive effects for small investment management firms, which may not have the resources to maintain different

managers for different types of accounts.

- Rule 12b-1: I am pleased that the SEC has initiated a thorough review of fund distribution practices and the role of Rule 12b-1. Many small fund groups have been able to remain competitive because they were able to gain access to a wider array of distribution channels than they otherwise would have through traditional sales load structures.

- Directed Brokerage: I support the SEC's proposal to prohibit directed brokerage arrangements, as also recommended by the Investment Company Institute ("ICI"). I would urge the SEC to modify its proposal, however, so that a fund executing portfolio transactions through selling brokers would have the protection of a safe harbor if it had procedures to ensure that the direction of brokerage was not intended as a reward for fund sales but was based solely on a broker's execution capabilities.

- Revenue Sharing: I support the SEC's proposal to require a broker to provide its customers with point of sale information about any revenue sharing payments the broker receives for its sale of fund shares. I do not agree, however, that such arrangements should be eliminated or that fund boards should be required to make value judgments about whether such arrangements are in the best interests of fund shareholders.

- Soft Dollars: I support a recommendation by the ICI that would significantly narrow the existing soft dollar safe harbor, which allows soft dollar credits to be redeemed for products and services that have attributes of traditional overhead expenses and lack intellectual content.

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I. INTRODUCTION

My name is Thomas O. Putnam. I am the Founder and Chairman of Fenimore Asset Management, a small investment advisory firm in rural upstate New York. Fenimore has been in business for 30 years and currently has 30 employees and more than $1 billion in total assets under management. At Fenimore, we manage structured portfolios for about 400 individual and institutional clients throughout the United States.

Fenimore also serves as investment adviser to the FAM Funds, a registered mutual fund company offering two investment portfolios with combined assets of approximately $700 million. Each fund has two classes of shares: the investor class, which is no load and is sold directly by Fenimore, and the advisor class – new as of July 2003 – which is sold through intermediaries. I serve as co-portfolio manager for each of the mutual funds and also as Fenimore's Director of Research. In addition to my varied duties at the firm, I also serve as Chair of the Small Funds Committee of the Investment Company Institute ("ICI").

I am honored to participate in today's hearing on regulatory actions regarding the mutual fund industry and, in particular, fund costs and distribution practices. My testimony will focus on the role of small fund groups in the mutual fund industry and the impact of regulatory reforms on small fund groups. I will also offer the Committee my thoughts on some of the specific reform proposals that have been advanced.

Let me begin, however, by expressing my deep disappointment about the events that have brought us together today. Investors' trust in the entire mutual fund industry has been shaken – and rightly so – by the revelations of wrongdoing that have unfolded over the past several months. That some industry participants would so blatantly disregard their fiduciary duties is both shocking and abhorrent to me. Clearly, there is no place in our industry for this kind of behavior, and I am pleased that the SEC and state regulators have moved quickly to investigate and punish those responsible.

Enforcement actions are just part of what is needed to ensure that the interests of mutual fund investors are fully protected going forward. I applaud the SEC's swift action on regulatory reforms to address the abuses we have seen with respect to late trading and market timing and to place much greater emphasis on fund compliance efforts, which will help to detect and prevent future wrongdoing. I am particularly pleased that certain of the SEC's proposals build in flexibility that may be useful to small funds, rather than taking a one-size-fits-all approach (*e.g.*, ensuring that independent directors have the authority, but are not required, to hire staff).

This Committee also has played an important role by thoroughly examining the recent scandals and thoughtfully considering what steps are necessary in response. Finally, mutual fund firms themselves must continue to embrace reforms that will protect investors, who have placed both their savings and their trust in the industry.

With all that said, however, I must tell you that I have some serious concerns about the possible scope of this reform effort. Several of the pending legislative

proposals, for example, contain provisions that go well beyond the abuses that have been uncovered and, if enacted, could substantially change the face of the industry. Even reforms that are more squarely focused on the abuses could, if drafted too broadly, impose considerable costs on individual fund groups and, ultimately, on fund shareholders. Such reforms also could prove to be cost prohibitive for smaller fund groups, especially those who allow access at a lower minimum (*e.g.*, at FAM Funds, the minimum initial investment is $500).

As this Committee considers what steps are necessary to respond to the recent scandals, I respectfully request that you bear in mind the law of unintended consequences. No proponent of mutual fund reform wants to damage the long-term competitiveness and creativity of this industry, the health of which is so vitally important to millions of lower- and middle-income investors. Yet if the scales are tipped too far, so that the regulatory restrictions and costs of managing mutual funds outweigh the possible rewards, there could be a "brain drain" as the best and brightest portfolio managers are drawn away from the mutual fund industry to more creative and lucrative forms of money management. New firms – which historically have developed many of the most innovative fund products and services, such as money market funds – simply might not enter our industry at all, choosing instead to limit their investment offerings to less regulated products. Any departure of top talent could well be followed by an adverse effect on long-term shareholders, including diminished returns and a departure of investors, which would leave fewer investors to shoulder an increased share of their funds' expenses. Finally, the creativity to provide new investment funds that would be advantageous to lower- and middle-income investors might be stifled, if not lost, if a

proposal creates a barrier to entry for a mutual fund entrepreneur. That would be tragic.

I hope that these observations about the potential threat of overregulation are taken by the Committee in the spirit in which I offer them – as constructive commentary, based upon my 30 years of experience in this industry and my strong belief that a vibrant, competitive mutual fund industry serves our nation's interests and the interests of all mutual fund investors, which represent more than half of all U.S. households.

II. THE ROLE OF SMALL FUNDS IN THE MUTUAL FUND INDUSTRY

To appreciate concerns about the impact that some of the reform proposals could have on small funds, I believe that it is important for the Committee to understand this segment of the mutual fund industry.

Many, if not most, investors are familiar with the larger mutual fund groups, such as Fidelity and Vanguard. It's no surprise that people often think of these fund groups first – they enjoy immediate name recognition because of their size and their ability to advertise widely. It would be a mistake, however, to think that these groups are representative of the entire mutual fund industry.

In fact, a large part of our industry is comprised of small fund groups. This point was very well articulated in recent testimony to this Committee by a fellow small fund

executive, Mellody Hobson of Ariel Capital Management and the Ariel Mutual Funds.[1] Ms. Hobson noted that more than 370 U.S. mutual fund companies have assets under management of $5 billion or less. This is out of a total of approximately 500 fund companies. To put this fact further into perspective, Ms. Hobson explained that if you were to combine the assets managed by all of these firms into a single firm, the amount under management would be less than half that managed by the single largest mutual fund company.

If you were to ask ten small advisory firms how they got into the business of managing mutual funds, you would probably get ten different answers. Here is mine. I was working with my father in the family manufacturing business in the early 1970s. At the same time, my father and I began managing some family money, and we did not suffer losses on our investments despite the bear market of 1973-74. Word got around, as it usually does in a small town, and we learned that people were interested in what we were doing. We started Fenimore Asset Management and slowly built a client base, largely through referrals by existing clients. Over time, we had many clients who wanted us to manage small sums for them – an account for the benefit of a child or grandchild, for instance. The most cost-effective way to manage small sums is through a pooled investment vehicle, so in 1987 the firm launched its first mutual fund. Almost a decade later, Fenimore launched its second mutual fund, an equity income fund, in order to meet the needs of clients who wanted an income stream from their investments.

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[1] *See* Statement of Mellody Hobson, President, Ariel Capital Management, LLC and Ariel Mutual Funds, *Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Operations and Governance*, Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 108th Cong., 2nd Sess. (Feb. 26, 2004), at 1-2.

Small fund groups such as FAM Funds play an important role in the mutual fund industry. They provide greater choice for investors and help to foster competition. In addition, a small fund group can typically provide its shareholders a level of individual service and attention that is simply beyond the reach of a large fund group with its millions of shareholders. At FAM Funds, for example, we do not contract any shareholder service activities to outside vendors. Instead, we provide these services through our own team of registered representatives. We also make our portfolio managers available to address shareholder questions and concerns, and we hold shareholder meetings annually at the local high school. In ways such as these, we seek to facilitate dialogue, educate, and create understanding between our shareholders and those of us at FAM Funds to whom they have entrusted their savings.

Many small fund groups specialize in one or more investment styles. At FAM Funds, our specialty is long-term, value-oriented investing. In other words, we are old-fashioned stock pickers. Our investment philosophy is based on the teachings of Benjamin Graham from his classic 1934 book, *Security Analysis*, which outlines the key elements to value investing. Using Graham's methodology, we have developed our own proprietary investment criteria to identify undervalued securities with good long-term growth potential. We consistently apply a thoughtful and disciplined approach to investing that will grow and preserve capital over the long term. In this way, we are able to achieve our overall purpose of providing financial peace of mind to our shareholders.

Unlike a large fund group, which typically offers funds covering a wide spectrum of investment objectives, small fund groups such as FAM Funds find a niche and stick with it. We are not trying to be all things to all investors or to change our investment offerings to capitalize on hot trends in investing, like the technology stock craze of a few years back. Rather, small funds tend to succeed by staying within their circle of competency.

A corollary to this is that a small fund group has to be able to communicate effectively with investors, so that they understand both the benefits *and* the limitations of what the fund group has to offer. A growth-oriented investor, for example, is simply not going to be happy with an investment in my firm's value-oriented mutual funds. Nor would that benefit my firm, since we depend upon the referrals of satisfied clients in order to grow. For this reason, we put a great deal of energy into helping our investors understand our process for selecting stocks and our long-range investment horizon.

III. THE IMPACT OF REGULATORY REFORMS ON SMALL FUNDS

In my 30 years as a money manager, I cannot recall another time in which the SEC has proposed so many sweeping changes to the regulatory scheme for mutual funds in such a short period of time. I fully support the SEC's efforts, and I commend the agency for proposing reforms that are aimed not only at remedying the immediate problems that have been found in the industry but also addressing potential conflicts of interest, strengthening fund governance, and enhancing standardized fund disclosures.

These reforms will benefit investors for years to come. As I stated at the outset of my testimony, however, these reforms – if enacted – would come with a hefty price tag.

It should not be surprising that the aggregate cost of these regulatory changes will have a proportionately larger impact on small fund groups. Small funds have smaller asset bases to absorb these costs, so their shareholders are hit harder than those in large fund groups, where the costs can be more spread out.

In addition, profit margins tend to be much thinner at smaller fund groups, which do not have the economies of scale enjoyed by large fund groups. Consequently, we must be extremely vigilant about controlling costs and keeping our fees at a reasonable level. If we don't, our shareholders can always move their money elsewhere. While this is true for all mutual funds, the costs associated with shareholder defections are more difficult for small funds to absorb. Put another way, small funds must be competitive not only to attract investors in the first instance but also to retain their business.

An example might be helpful. My firm is working to come into compliance with the SEC's newly adopted rule that requires each mutual fund to have in place a comprehensive compliance program and to designate a chief compliance officer to oversee that program. We are just able to think about bringing on board an in-house counsel at Fenimore who will also serve as the chief compliance officer for each of the FAM Funds. That is because the costs associated with hiring this new employee would be partially subsidized by our private client business. For fund groups smaller than

ours, or whose investment adviser does not manage other accounts, that approach will simply be too expensive. I expect that such fund groups will have to designate an existing employee to take on the additional – and not insignificant – responsibilities that are required of a chief compliance officer. I offer this example not as a criticism of the new requirement, but merely as an illustration that even worthwhile reforms can stretch the limited resources of small fund groups.

IV. COMMENTS ON SELECT REFORM PROPOSALS

Our differences aside, small fund groups and large fund groups agree that the merits of any reform proposal should be measured against a single standard, one that has been the hallmark of our industry throughout its history. That standard is this: Will the proposed reform benefit the interests of long-term mutual fund investors? While well intentioned, some reforms that have been proposed fall short of this mark. Such proposals include, among others, requiring each fund board to have an independent chair and barring a portfolio manager from jointly managing a mutual fund and a hedge fund. In addition, I will offer my observations with respect to certain other areas in which reform proposals have been advanced: mutual fund fees, Rule 12b-1 under the Investment Company Act of 1940, directed brokerage, soft dollars, and revenue sharing arrangements.

A. Independent Chair

Several legislative proposals and the SEC's proposed package of fund governance reforms would require that each fund board of directors have an

independent chair.[2] While this requirement may sound good in theory, I do not think that a one-size-fits-all approach is necessary. A requirement like this one would cause many fund groups – including my own – to choose a new board chair even though their current structure works well for them.

At FAM Funds, I serve as Chairman of the Board of Trustees, and the remaining trustees are independent. As a practical matter, they already have the power to replace me at any time with a new board chair if they feel that such a change would benefit the Funds and our shareholders. The Independent Trustees also have appointed a lead Independent Trustee, who serves as a point of contact with Fenimore and plays a major role in preparing the agendas for our Board meetings. This Independent Trustee also chairs the separate meetings held by the Independent Trustees before each Board meeting.

I would favor an approach that gives fund boards the ability to choose between having an independent chair and a lead independent director. It is important to note that the appointment of a lead independent director also is consistent with recommended industry best practices.[3] As an alternative to giving fund boards the choice between an independent chair and a lead independent director – or perhaps even in addition to such a choice – the SEC could consider requiring a fund board to elect its

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[2] *See, e.g., Investment Company Governance*, SEC Release No. IC-26323 (Jan. 15, 2004) ("Fund Governance Release"). Other reforms proposed by the SEC include requiring that: independent directors constitute at least 75% of a fund's board; fund boards perform annual self-assessments; independent directors meet in separate sessions at least once each quarter; and funds authorize their independent directors to hire staff.
[3] *See Enhancing a Culture of Independence and Effectiveness*, Report of the Advisory Group on Best Practices for Fund Directors (June 24, 1999) ("Best Practices Report"), at 25.

chair annually, by a majority vote of both the independent directors and the entire board.[4]

By focusing so much attention on whether fund boards should have an interested or an independent chair, we may well be missing the forest for the trees. What I think persons on both sides of this debate really want are board chairs who are knowledgeable about business, investment, finance, and the fund industry, and who are both capable and willing leaders. Obviously, who fits the bill will depend upon the composition of a particular fund board. For this reason, I feel strongly that board members themselves are in the best position to select their chair.

I also want to share the following observation. Contrary to their portrayal in some recent news stories, fund directors are not lemmings that blindly follow the lead of management. It has been my experience, both at FAM Funds and in the industry, that fund directors take their responsibilities seriously. They recognize their fiduciary obligations and they try to use their best judgment in fulfilling the many duties assigned to them by the Congress and the SEC. If fund directors are charged with such important responsibilities, they certainly should be treated as responsible enough to choose their own chair.

I support other measures to enhance the role of independent directors, because I know from experience that a strong board is an important partner in protecting the

[4] The SEC requested comment on whether it should require the annual election of the board chair. *See* Fund Governance Release, *supra* note 2. The ICI also supports this approach. *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated Mar. 10, 2004 ("ICI Fund Governance Letter").

interests of fund shareholders. In particular, I believe that each fund board should be required to have a supermajority of independent directors, as we do at FAM Funds. I do not believe, however, that requiring a three-fourths supermajority for all fund boards – rather than the two-thirds supermajority recommended by industry best practices[5] – would provide any additional benefits to shareholders. On the other hand, such a change would cause significant disruption for many fund boards, most of which already comply with the recommended two-thirds standard. I also support strengthening fund boards by requiring independent directors to meet in executive session at least quarterly, authorizing independent directors to retain their own staff members (although we at FAM Funds believe that our Independent Trustees already have this authority), and having fund boards annually assess their performance.

B. Joint Management of Mutual Funds and Hedge Funds

Pending legislative proposals would prevent an individual from managing both a mutual fund and any other type of unregistered investment company, most notably a hedge fund. Although they purport to give the SEC the authority to make exceptions, the authority would be so narrow in scope that the proposals effectively would ban the practice. Fenimore itself does not manage hedge funds, but some of my colleagues on the ICI's Small Funds Committee are very concerned about the possible impact on their firms of such a ban.

My colleagues fear that a ban on joint management would result in reduced access for mutual fund investors to skilled investment professionals who, if forced to

[5] *See* Best Practices Report, *supra* note 3, at 10-12.

choose, likely would opt to manage less regulated and more lucrative types of investment accounts such as hedge funds. In addition, the prohibition could eliminate important operating efficiencies for investment management firms. My colleagues also believe that it could have harsh, disruptive and anti-competitive effects for smaller investment management firms, which have fewer employees and might not have the resources to maintain separate staff for different types of accounts.[6]

The potential conflicts of interest associated with joint management of mutual funds and hedge funds do not seem to call for such a drastic all-or-nothing approach. Rather, it should be possible to address these potential conflicts and protect the interests of fund investors by requiring advisers who manage both types of products to adopt appropriate policies and procedures. It's important to note that, under the SEC's new compliance rule, such policies and procedures would be subject to continuing oversight by the fund's chief compliance officer and the fund board.

C. Mutual Fund Fees

Notwithstanding statements by members of Congress and federal regulators that they are not interested in rate setting for mutual funds, some proposals have been floated that would seem to move in that direction (*e.g.*, requiring specific SEC approval before a fund may charge its shareholders for any new service). Such government intervention with respect to fees has no place in an industry that is as dynamic and competitive as ours.

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[6] The negative effects of a joint management ban were well articulated in recent testimony before this Committee. *See* Statement of Michael S. Miller, Managing Director, The Vanguard Group, Inc., *Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Operations and Governance*, Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 108th Cong., 2nd Sess. (Mar. 2, 2004).

I firmly believe that discipline with respect to mutual fund fees and costs comes from two things, and two things alone: competition in the marketplace, which is fostered in part by the creation and success of smaller fund groups, and transparency, which is fostered by clear and meaningful disclosure to investors about the costs associated with investing in a particular mutual fund.[7] I am pleased that the SEC has taken steps to provide more meaningful fee disclosure to fund investors, in particular by its recent adoption of a rule that will require shareholder reports to include more detailed information about fund expenses and to present such information in a standardized way, thus facilitating comparisons across funds.

D. Rule 12b-1

Adopted more than twenty years ago by the SEC, Rule 12b-1 under the Investment Company Act permits payments for distribution from fund assets, subject to several safeguards, which include ongoing board oversight of Rule 12b-1 plans. There is widespread agreement that fund distribution practices have evolved significantly since 1980 and that a thorough review of such practices, and the role of Rule 12b-1, is overdue. I am pleased that the SEC has initiated such a review and has solicited comments from the public on possible reforms to the rule.[8]

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[7] Contrary to the assertions of some industry critics, fund boards are *not* charged with negotiating the lowest possible management fee. Rather, fund directors, acting in an oversight capacity, must ensure that fees are within a reasonable range. They also must evaluate the continuing propriety of fees in light of any material change in circumstances. *See* ICI Fund Governance Letter, *supra* note 4.

[8] *See Prohibition on the Use of Brokerage Commissions to Finance Distribution*, SEC Release No. IC-26356 (Feb. 24, 2004) ("Rule 12b-1 Release").

One of the pending legislative proposals calls for the outright repeal of Rule 12b-1, and the SEC also specifically requested comment on whether it should repeal the rule. The rule should be updated to reflect today's realities but should not be repealed. Rule 12b-1 continues to serve an important function by giving investors choice on how to compensate the intermediaries whose assistance they sought in making their investment decisions. Moreover, many small fund groups have been able to remain competitive because they were able to gain access to a wider array of distribution channels than they otherwise would have through traditional sales load structures.

E. Directed Brokerage

In keeping with its commitment to acting in the best interests of fund shareholders, the mutual fund industry must be willing to re-examine practices that give even the appearance that a fund's adviser may be putting its own interests before those of the fund's shareholders. One such practice is "directed brokerage," in which an adviser may take sales of fund shares into account when selecting brokers to execute portfolio transactions for the fund. Although the NASD strictly regulates this practice, and prohibits any type of *quid pro quo* between the adviser and the broker, directed brokerage involves potential conflicts of interest that could easily be avoided by simply banning the practice altogether.

In December, the industry called on the SEC to put an end to directed brokerage arrangements.[9] Consistent with the industry's recommendation, the SEC has issued a proposal that would prohibit any consideration of broker sales efforts in allocating fund brokerage.[10] I would urge the SEC to modify its proposal, however, so that funds executing portfolio transactions through selling brokers would have the protection of a safe harbor if they put procedures in place to ensure that the direction of brokerage in each instance is based solely on the broker's execution capabilities and is not intended as a reward for its sale of fund shares.

F. Revenue Sharing Arrangements

Several reform proposals, both in Congress and at the SEC, seek to address the criticism that revenue sharing payments by a fund adviser to a broker selling the fund's shares are not sufficiently transparent to investors. This criticism is a valid one, and I do think reform is needed in this area. An investor buying fund shares through a broker needs to be made aware of any incentives the broker may have to sell those shares. Armed with that information, the investor would be able to evaluate the broker's recommendation in light of those incentives. Knowledge is power, and providing this type of information to investors at the point of sale – as the SEC has proposed[11] – would

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[9] *See* Letter from Matthew P. Fink, President, Investment Company Institute, to the Honorable William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, dated Dec. 16, 2003 ("ICI Letter to Donaldson").

[10] *See* Rule 12b-1 Release, *supra* note 8. The NASD also has filed with the SEC a proposal to amend its rules to prohibit broker-dealers from selling the shares of any mutual fund that considers fund sales in making its brokerage allocation decisions. *See Proposed Amendment to Rule Relating to Execution of Investment Company Portfolio Transactions*, File No. SR-NASD-2004-027 (Feb. 10, 2004).

[11] *See Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds*, SEC Release Nos. 33-8358, 34-49148, IC-26341 (Jan. 29, 2004).

empower investors to make more informed decisions about how to invest their hard-earned savings.

At the same time, I do not agree that revenue sharing arrangements should be eliminated or that fund boards should be required to make value judgments about whether such arrangements are in the best interests of fund shareholders, as some legislators have proposed. The revenue that is being shared under such arrangements belongs to the adviser, not the fund, and there are already protections in existing law to ensure that an adviser is not indirectly using fund assets to finance distribution. The fact that revenue sharing arrangements exist simply reflects a basic economic principle that transcends the mutual fund industry – that is, competition for access to available distribution channels.

G. Soft Dollar Arrangements

The use of soft dollars by investment advisers is another area worthy of reform. Current law contains a safe harbor that in effect permits a fund's adviser, in certain circumstances, to pay for brokerage and research services using commissions generated by the fund's portfolio trades. The potential conflicts of interest are clear: an adviser may be tempted to (1) select a broker based on such services rather than on the broker's ability to deliver best execution or (2) pay too much in commissions or engage in unnecessary trading to generate soft dollar credits. In my view, these potential conflicts have been exacerbated by the SEC's broad interpretation of the safe harbor, which allows soft dollar "credits" to be "redeemed" for products and services that have attributes of traditional overhead expenses and lack intellectual content.

The SEC could easily stem the potential for abuse in this area by narrowing its interpretation of the safe harbor. I support a recommendation made by the ICI in December that would significantly narrow the safe harbor – and thus the use of soft dollar credits.[12] Requiring advisers generally to pay for research services directly would also promote transparency, making it easier for investors to compare the fees charged by different investment advisers. It is important to note that any reforms relating to the use of soft dollars should apply to all investment advisers, not just those managing mutual funds. Otherwise, not all investors would benefit from the additional protections that would flow from curbing the use of soft dollars.

V. CONCLUSION

In closing, I would like to reiterate my support for the SEC's regulatory actions to address the problems that have been uncovered in the mutual fund industry. Going forward, however, I would urge policymakers to be mindful of the potential impact of further changes on small fund groups. As I hope I have demonstrated, small fund groups play a vital role in spurring competition and innovation in the mutual fund industry.

In the same way that mutual fund investors benefit from the competitiveness and creativity of our industry, they also bear the costs associated with legislative and regulatory changes affecting the industry. For this reason, it is imperative that any such

[12] *See* ICI Letter to Donaldson, *supra* note 9.

changes be guided by this single standard: what is best for our nation's mutual fund investors.

I thank the Committee for the opportunity to present my views, and I offer my continuing assistance as you continue your thoughtful consideration of these important issues.