State of New York Attorney General
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On September 3, my office announced the results of its investigation of the unlawful and improper trading practices of Canary Partners. Since that time, my office has worked closely with the Securities and Exchange Commission and others to uncover the extent to which mutual fund directors and managers breached their fiduciary responsibilities to the 95 million Americans who have invested $7 trillion in mutual funds.

Our continuing investigations reveal a systemic breakdown in mutual fund governance that allowed directors and managers to ignore the interests of investors. In fund after fund, what we have seen is the wholesale abandonment of fiduciary responsibilities. As Chairman Donaldson put it to this Committee on Tuesday, "the industry lost sight of certain fundamental principles, including its responsibilities to the millions of people who entrusted their confidence [and] the fruits of their labor . . . to this industry for safekeeping."

Earlier today, my office filed a lawsuit against the founders of the Pilgrim Funds, Gary Pilgrim and Harold Baxter. These individuals served as directors of the various Pilgrim mutual funds and as fiduciaries of their investors' money. Nevertheless, when offered an opportunity to personally profit at the expense of their investors, they grabbed it. Although the Pilgrim Funds' prospectus prohibited shareholders from making more than four trades a year and their internal policies prohibited market timing, Mr. Pilgrim and his partners in another investment fund were permitted to engage in frequent market timing trades. Those trades were enormously profitable to Mr. Pilgrim and his partners, but were costly and detrimental to his shareholders. When Mr. Pilgrim was confronted with the choice between his lawful duty to investors and an unlawful opportunity for personal profit, he chose personal gain over his investors.

That is the bad news. Unfortunately, there is certainly going to be more bad news to come as our investigations continue. But there is also good news.

The good news is that the process of addressing these systemic failures by considering system-wide reforms has begun. These reforms would alter the current governance structure of most funds by requiring them to have truly independent boards of directors. Seventy-five percent of directors, including the chairman, would be independent of the management companies that operate the funds. The independent directors would also oversee a compliance staff that will ensure that the fund's managers are acting in the best interests of the funds shareholders.

These reforms were all included in the package of proposals that I discussed when I testified before House and Senate committees two weeks ago. I certainly agree with Chairman Donaldson that they are good "first steps." Taken together, these reforms will hopefully foster board action that is for the benefit of shareholders and not managers.

At the same time, it is necessary for us to take the logical next step, which is to examine the fee arrangements between the mutual funds and their managers. As I have said before, the 95 million Americans from 54 million households paid more than $70 billion in advisory and management fees in 2002. That comes to an average of $737 in fees paid by each individual investor and $1292 paid by each household invested in mutual funds. These fees are in addition to the significant costs -- such as trading costs -- that are passed on to investors.

Investors who paid those fees -- via deductions from their account, often without full disclosure – are entitled to know whether they are fair.

Some have questioned whether there is a nexus between the inquiry into fees that I am proposing and the investigation into the trading activities permitted by fund managers. The answer is yes.

The improper trading and the exorbitant fees charged are both consequences of a governance structure that permitted managers to enrich themselves at the expense of investors. We know that directors and managers breached their duties to investors in every conceivable manner. As regulators and lawmakers, our duty to investors is to investigate every manifestation of that breach and to return to investors any and all fees that were improper or inappropriate. This includes the fees that the managers received during the very time that they were violating their fiduciary duties to investors.

Moreover, the nexus between fees and the improper trading that we have uncovered is demonstrated by the fact that the managers who permitted late trading and market timing in many instances did so in return for increased investments in other funds that they managed. Mutual fund managers get paid a percentage of the funds under management, and therefore seek to increase their funds' asset base to increase their compensation. As one mutual fund manager put it in a particularly memorable email: "I have no interest in building a business around market timers, but at the same time I do not want to turn away $10-20 million!"

Simply stated, the desire for increased fees led managers and directors to abandon their duty to investors and to condone improper and illegal activity. Common sense demands that we at least inquire whether the desire for increased fees also resulted in fee agreements and charges that were improper.

Common sense and a simple review of the numbers also dictate that the fees charged to investors by the Putnam funds continue to deserve scrutiny. In 2002, Putnam had approximately $279 billion under management. The $279 billion was divided between mutual fund money and institutional investors.

Our investigation has revealed that Putnam charged higher advisory fees for the mutual fund money that it managed, and charged lower fees for the advisory services that it provided to institutional investors. Here's what we have learned:

There was an extraordinarily large disparity between the rate of advisory fees charged to mutual fund investors and the rate paid by institutional investors. Mutual fund investors were charged 15 basis points -- or 40% -- more for advice than Putnam's other investors.

<u>In dollar terms, this fee disparity meant that in 2002, Putnam mutual fund investors paid $290 million more in advisory fees than they would have paid had they been charged the same rate that Putnam's institutional investors paid for advisory services.</u>

At a minimum, this disparity raises several fundamental questions: Why were mutual fund investors charged more than institutional investors for advisory services? What steps if any did the directors who negotiated these fee contracts take to protect the interests of investors and to ensure that they paid the lowest possible rate? Did managers take advantage of a conflicted and complacent board to extract unjustifiably large fees?

These questions demand answers, and I will continue to insist that funds answer these questions as part of any settlement with my office.

Perhaps the most important question that needs to be answered is this: What can be done to convince nervous and skeptical investors that the fees that they are charged in the future are fair and subject to the competitive pressures of the marketplace?

Let me offer a few possible answers.

First, mutual funds must be required to disclose the precise dollar amount of the fees charged to each investor in a quarterly or semi-annual statement sent to the investor. This disclosure should be itemized, and consist of the dollar cost to the investor of advisory, management, marketing and other administrative costs. Armed with this knowledge, investors can begin to engage in true comparison shopping among funds. There is no other industry that is exempt from informing their customers what they are being charged. It is an understatement to note that there is nothing about the manner in which the fund industry has conducted itself to warrant such an exemption.

Second, we must impose a fiduciary duty on fund directors that requires them to negotiate fee contracts that are reasonable and in their investors' best interest. To determine reasonableness, directors must consider what institutional investors are charged for similar services, and the actual cost of the service being provided. While mutual funds do need some services that institutional investors do not require, there is no reason that they should pay more than institutional investors for services such as core money management. Moreover, the directors should be obligated to make public a meaningful analysis that supports the fee agreements that they have approved.

Third, we should consider requiring funds to obtain "most favored nations" clauses in their fee contracts. These contracts are common in procurement contracts throughout industry, and should not be ignored by the mutual fund industry. We should also consider requiring funds to put certain contracts out for competitive bidding. This may be especially suitable for many of the back-office and administrative services for which mutual funds pay.

Some in the industry question whether competitive bidding is appropriate. Perhaps they should be reminded that many fund complexes already hire sub-advisors to perform the services that investor pay for. What happens to the money saved when management companies subcontract for the services that they are charging investors for? We believe that the cost savings should be passed along to investors and not pocketed by the managers.

These ideas are not meant to suggest an exclusive or exhaustive list of the mechanisms available to achieve the goal of reducing fees. Rather, they are aimed at beginning a dialogue that is necessary if we are to regain and retain the confidence of mutual fund investors.

Please permit me to make one final point. My office and the Securities and Exchange Commission have worked together cooperatively since the day I announced the settlement with the Canary hedge fund. Each day since then, there have been -- and will continue to be -- dozens of points of contact, coordination and cooperation. On rare occasions, we have disagreed. As is the nature of these things, those rare moments of disagreement tend to get far more attention than all of our weeks of cooperation.

I will continue to speak up for investors when necessary. But that should not obscure the productive and mutually beneficial relationship that my office has forged with the Commission. It is my desire and intention to continue to foster that relationship.