November 3, 2003

The Honorable William Donaldson
Chairman
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Dear Chairman Donaldson:

Last year, Senator Fred Thompson and I wrote to the SEC about our alarm regarding the failure of the SEC and the private sector financial watchdogs to guard against the wrenching corporate scandals that led to the loss of billions of investor dollars, much of which was retirement savings and college funds of hardworking, middle class families. We provided your predecessor with a copy of a report authored by the staff of the Senate Governmental Affairs Committee, of which I was then the Chairman and Senator Thompson was the Ranking Minority Member, detailing those failures. Now I am writing to the SEC again, this time about mutual funds, because once again, the working families of America fear that their savings are not safe and their trust is being abused. As with the scandal involving Wall Street analysts' conflicts of interest, the SEC was far too late to the table in addressing these problems, which were exposed only through the diligent work of the New York Attorney General. Now that the problems have come to light, I am once again left to wonder: why did the watchdogs fail to bark?

As the deceptions and conflicts of the Wall Street analysts were uncovered last year in the wake of the Enron scandal, the oft-heard advice to the average investor was to invest in mutual funds. The *Economist* wrote, "Instead of following the stock tips of Wall Street analysts, [retail investors] would be better advised to buy pooled investment vehicles such as mutual funds. Spread your risks, or risk losing your money."[1] Maria Crawford Scott, a representative of the American Association of Individual Investors, advised, "If you don't have the time or inclination to do the research, then you should definitely consider using mutual funds for your investing."[2]

Investors have taken that advice in droves. Ninety-five million Americans own shares in mutual funds, which claim a total value of $6.8 trillion.[3] Of that nearly $7 trillion, $2.1 trillion is invested specifically for retirement.[4] Perhaps investors have felt comfortable putting so much of their money in the hands of mutual funds because the mutual fund industry, through the Investment Company Act of 1940, offers one of the most highly regulated investments available.

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[1] "Thunderstruck," *Economist*, May 25, 2002.

[2] Guy Halverson, "When Brokers Talk, Should You Listen?" *Christian Science Monitor*, May 6, 2002.

[3] Neil Weinberg and Emily Lambert, "The Great Fund Failure," *Forbes*, September 15, 2003.

[4] Gretchen Morgenson, "401ks Are Grand, for Fund Companies Anyhow," *The New York Times*, October 26, 2003.

Mutual funds, their directors and their managers owe their investors a statutory fiduciary duty. Mutual funds are closely overseen by the SEC through a registration and reporting process as well as a regular examination and audit process. Moreover, as SEC Commissioner Harvey Goldschmid noted on February 4, 2003 at a Commission meeting regarding a proposal for greater oversight of the mutual fund industry, "The mutual fund industry has been blessed – and blessed is the only word – by being relatively free of scandal."[5] Until recently, that is.

The industry's good luck has run out, and the ugly truth has come to light. On September 3, 2003, the New York State Attorney General Eliot Spitzer announced his investigation into improper trading practices at large mutual funds, including those at Bank of America, Strong, and Janus. According to court filings, these funds had allowed at least one large hedge fund – Canary Partners -- to engage in "late-trading" and "market-timing." Late trading, which is illegal, involves trades following the close of the market at earlier, more favorable prices. Market-timing, which is not necessary illegal, involves quick redemption – "in and out" trading – and dilutes the value of long-term investors' shares. Most mutual funds have policies against market-timing, but these funds made exceptions for Canary, at the expense of other investors. Canary agreed to pay $40 million to settle the charges and to cooperate with the investigation.

When Attorney General Spitzer announced his investigation, some industry experts assumed these practices were unusual. For example, John Kline, a banking analyst with Sandler O'Neill & Partners, was reported to have said that "the Nations Fund situation sounds like an isolated incident that will blow over. . . ."[6] But we now know this is far from the case. A number of mutual fund and brokerage firm employees have been fired over the last two months for the very abuses charged in the Canary case. A hedge fund executive has pled guilty to securities fraud for late-trading.

And now we have a virtual avalanche of admissions by the mutual funds themselves. On October 25, 2003, *The New York Times* reported that the SEC had sent out letters to 88 mutual fund companies and brokerage firms, and in response, half of the fund companies acknowledged having arrangements with investors that allowed them to "market-time," despite the fact that many of those companies have explicit policies against such practices.[7] According to the *Times* report, responses to those 88 letters revealed other abuses. Many fund companies admitted providing portfolio information, unavailable publicly, to certain large investors to help them

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[5] Andrew Countryman, "SEC floats mutual fund ideas; Self-regulatory body among proposed rules," *Chicago Tribune*, February 5, 2003.

[6] "Brokers in Probe Leave BofA," *Business Journal*, September 12, 2003.

[7] Gretchen Morgenson and Landon Thomas, Jr., "SEC Finding Fund Abuses, Official Says," *The New York Times*, October 25, 2003.

make trading decisions.[8] This seems in clear contravention of the SEC's rule prohibiting selective disclosures. Also, a number of the brokerage firms indicated that they had allowed certain customers to engage in late-trading.[9] Perhaps most shocking, Stephen Cutler, Director of the SEC's Enforcement Division, has said that there is evidence that officials at fund companies profited *personally* at the expense of their customers by market-timing their own funds.[10]

But that's not all. Other abuses have come to light. In September, the NASD levied a $2 million fine on Morgan Stanley for enticing brokers into selling its funds with prohibited incentives such as golf lessons, auto racing courses, and tickets for events like the NBA Finals and Britney Spears concerts. Brokers are supposed to sell investments to their customers based on what is suitable for their customers, not for prizes. Having been frightened off using the guidance of Wall Street analysts to invest in individual stocks, average investors are now left to wonder about their mutual fund investments. Now that the rock has been lifted, what other scandals are lurking? How else have they been cheated? After all, as Bob Moon reported on October 28, 2003 on NPR's *Marketplace*, paraphrasing Mercer Bullard of the Fund Democracy Center: "so far we've been hearing mainly what the firms have admitted to, suggesting a wider breakdown in compliance with trading rules."

If, as appears to be the case, there has been a broad breakdown in the integrity of the mutual fund industry, two questions must be answered. First, why, if the SEC so closely oversees this industry, did the Commission fail to catch even a hint of the problem before New York's Attorney General and Massachusetts' Secretary of the Commonwealth took action? Second, what can be done to reassure working families, so many of whom have entrusted their retirement savings and children's college funds to mutual funds, that their trust is not misplaced? As the primary regulator of mutual funds, your agency must demonstrate that its vigilance against misconduct in this area will not waver, and that ordinary investors have reason to believe that their mutual funds are operating fairly and transparently. In this regard, please respond to my queries below.

How the widespread abuses were missed. After the New York State Attorney General filed his complaint regarding the wrongful practices by Canary Partners in concert with a number of mutual funds, many noted that once again, Eliot Spitzer had uncovered significant market abuses ahead of the SEC. At the time, the SEC intimated that Spitzer caught the problem because a whistleblower went to him, rather than the SEC. "The success of one regulator is not to the detriment of the SEC. God Bless Eliot Spitzer, he got a tip and pursued it," Director of

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[8] *Id.*

[9] *Id.*

[10] Brooke Masters and Carrie Johnson, "SEC Expands Market-Timing Probe; Mutual Fund Managers Profited Personally, Enforcement Director Says," *Washington Post*, October 24, 2003.

Enforcement Stephen Cutler said.[11]

According to recent reports, however, the SEC also got a tip. The only difference appears to be that the SEC, unlike Spitzer, *did not* pursue it. According to an October 24, 2003 report in the *Boston Globe*, a call center employee from Putnam Investments, Peter Scannell, went to the SEC on March 22, 2003 with internal documents evidencing market-timing "run wild" at Putnam.[12] According to the press account, an SEC attorney met with Mr. Scannell and his lawyer for an hour and promised to get back to him, but never did, despite several calls from Mr. Scannell's lawyer to follow up.[13] On September 11, 2003, Mr. Scannell and his attorney took their story to Massachusetts Securities Division in the office of the Secretary of the Commonwealth, William Galvin.[14] According to the *Globe*, Galvin acted immediately.[15] On October 28, 2003, the SEC announced that it was bringing an enforcement action in concert with Galvin against Putnam and two Putnam managing directors in connection with the improper trading activity and for market-timing trades by those managing directors for their own accounts. Please answer the following questions with respect to these events:

(1) What did the SEC do, if anything, in response to Mr. Scannell's tip in March?

(2) If the SEC did not open an investigation based on Mr. Scannell's tip, why did it fail to do so?

(3) When did the SEC open the investigation that culminated in the action announced on October 28, 2003?

(4) Director of Enforcement Cutler reportedly acknowledged that he received another tip alerting him to personal trading by Putnam executives.[16] When did this tip come in? Has the SEC reviewed its files to see if it received any other tips of mutual fund wrongdoing by Putnam or others? If not, why not? If so, what did the SEC find? Please provide specifics relating to each call received and what the SEC did to follow

[11] Leticia Williams, "Suddenly, Spitzer's a Hero in Washington," *CBS MarketWatch.com*, September 6, 2003.

[12] Steve Bailey, "Asleep at the Switch," *Boston Globe*, October 24, 2003.

[13] *Id.*

[14] *Id.*

[15] *Id.*

[16] Brooke Masters, "30 Firms Face NASD Fund-Trading Probe," *Washington Post*, October 29, 2003.

up.

(5) Has the SEC taken any action to make sure that future tips will be handled better than Mr. Scannell's? If so, please specify what the SEC has done. If not, please explain why not.

How the SEC can catch such widespread abuses in the future. The Investment Company Act of 1940 and the regulations promulgated by the SEC thereunder contemplate a rather involved scheme of oversight by the SEC of investment companies, which include mutual fund firms. As a part of that oversight regime, mutual funds must register with and regularly report to the SEC, and must submit to regular audits and examinations by Commission staff.

(6) What specific aspects of the current reporting requirements for mutual funds are useful for helping to uncover improper or fraudulent practices? Would any additional reporting requirements provide an additional mechanism for catching such improper behavior?

(7) What specific aspects of the audit and examination process are designed to help root out wrongful conduct? Is the SEC reviewing how it can enhance the audit and examination process in any way to facilitate detection of these practices?

How the SEC can prevent trading abuses. The current transaction window for mutual fund trades supposedly closes at 4 pm, but the meaning of that deadline is not so clear. For example, trading rules do not require that the order actually reach the mutual fund by that time, just that the order be called into the broker by that time. This rule seems too easy to manipulate. As John Bogle, founder and former CEO of Vanguard Group, has suggested, one way to help prevent trading abuses would be to impose a firm and actual deadline. Bogle believes it should be set as early as 2:30 pm.[17]

(8) Is the SEC considering changing the current rule to set a hard deadline for trades to be into the mutual fund by a time certain? What options is the SEC considering?

(9) If not, does the SEC have an alternative plan to prevent these practices?

[17] Yuka Hayashi, "Vanguard's Bogle Urges SEC to Adopt Market Timing Rules," *Wall Street Journal*, October 29, 2003.

How the SEC can restore confidence in mutual funds: accountability. While it is important to ensure that the SEC's oversight efforts are focused on deterring and rooting out abuses, it is perhaps even more important to make sure there is meaningful accountability from within the funds themselves. As John Bogle noted in a recent interview, "There's an old saying I heard a few years ago about corporate America, and that is, 'When you have strong managers, weak directors and passive owners, it's only a matter of time before the looting begins.'"[18] The looting has already begun; now we must prevent it from continuing. Strengthening boards will certainly help. While corporate governance is generally a matter of state law, the Investment Company Act of 1940 prescribes that at least 40 percent of mutual fund directors be independent, and the SEC conditions certain basic exemptions on a majority of such boards being independent. Given that this is an area that the SEC has addressed in regulation before, I would strongly urge the SEC to issue further regulations to enhance the effectiveness of mutual fund directors. Specifically:

(10) *The definition of independence*: Former SEC Chairman Arthur Levitt was recently quoted as saying, "Sadly, one of the most effective checks to these [mutual fund] abuses, I think needs fixing, and that's the independent directors."[19] Under the current definition of an independence, an independent director could be a board member of a fund who retired as an executive for that fund or a director who has served the fund for decades and sits on the boards of dozens of other funds within that mutual fund company. Will the SEC strengthen the definition of independence for mutual fund directors to avoid entrenchment and entanglement with management? If so, what is the timeline for doing so?

(11) *Overcommitted directors:* According to Edward Regan, President of Baruch College and a corporate governance expert, "There are plenty of fund family directors who have 80 or 90 funds. That seems too many."[20] Indeed, this appears to have been the case at the fund families involved in the Canary Partners scandal: The chairman of Bank of America's Nations Funds sits on the board of 85 funds; the chairman at Janus sits on 113 fund boards.[21] While many funds have similar structures and approaches, warranting some "economy of scale" in this regard, it is

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[18] *NOW With Bill Moyers,* Transcript, October 10, 2003.

[19] Martha Graybow, "Ex-SEC Chief Seeks Reform of Mutual Fund Boards," *Reuters News Service*, September 22, 2003.

[20] Yuka Hayashi, "Are Fund Directors Doing Enough?" *Wall Street Journal*, October 22, 2003.

[21] Mara Der Hovanesian, et al., "How to Fix the Mutual Funds Mess," *Business Week*, September 22, 2003.

hard to see how anyone can effectively monitor activity in so many different entities. Will the SEC issue guidelines for mutual funds to follow in deciding how much is too much?

(12) *More independent directors:* While the SEC, as noted above, has required a majority of directors to be independent, the widespread abuses and the lax oversight that allowed them suggest that we must have fewer insiders running the funds. Investors need more voices of authority challenging management. Has the SEC considered requiring that a significantly larger percentage of mutual fund directors be independent in order for those funds to qualify for certain basic exemptions? Does it plan to impose such a requirement? If not, why not?

(13) *Compliance officers reporting directly to the Board:* In order to reinforce the importance of matters of compliance, what are the SEC's views on requiring, as a qualifying condition for certain exemptions, that funds hire a compliance officer who reports directly to an independent compliance committee of the board of directors?

How the SEC can restore confidence in mutual funds: transparency and disclosure. The scandals in the mutual fund industry cry out for greater openness in the way mutual funds operate. And one of the most visible indications of transparency – or the lack thereof – is in the way that funds disclose the fees they charge investors.

(14) *Comparative Expense Information.* A recent study commissioned by Fund Democracy and Consumer Federation of America and conducted by Morningstar, Inc. looked at of index funds and money market funds – funds that are not actively managed and that would therefore be expected to have relatively low expenses. The study found that there was a huge variation in fees charged by these funds, with some investors paying expense ratios as much as 9 times higher than others.[22]

a) In light of these findings, do you believe that it would be helpful to investors to require funds to provide information on how their fees compare to those of similar funds?

b) Has the SEC previously considered requiring such information?

c) Is there a particular benchmark – an average or range, for example – that you

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[22] Gretchen Morgenson, "Market Watch: There's No Way to Justify These Fees," *The New York Times*, July 27, 2003.

believe would be particularly useful as a point of comparison?

(15) *Consumer Research*. Disclosure is fundamental to the Commission's regulatory mandate. In the mutual fund context, the Commission requires a great deal of information to be disclosed to investors in the fund's prospectus and in certain other documents. The Commission also recently amended its regulations governing mutual fund advertising, in order to help prevent investors from drawing unjustified conclusions about a fund's future performance based on past performance.[23] While these clarifications to mutual fund advertising may help investors, there appears to be little publicly available data on whether or how the average investor actually understands the mutual fund information required by the SEC.

Other federal agencies charged with protecting consumers rely on both qualitative and quantitative consumer research to understand how informational messages are understood by the public. The Federal Trade Commission, for example, makes frequent uses of surveys, copytests and focus groups to determine how consumers understand advertisements and whether an ad is deceptive or likely to mislead consumers. Similarly, the Food and Drug Administration did extensive consumer research in designing the format of and information in the nutrition labels on food to determine the design that would most effectively convey nutrition information to consumers.

a) How, if at all, has the SEC used consumer research, either qualitative or quantitative, to determine how the information or disclosures required in mutual fund advertising or in prospectuses or other documents provided to investors are understood by those investors?

b) If the SEC has not made use of consumer research, please explain why not. Do you believe it would be useful to conduct such research to determine and design disclosure requirements in the future as a way of ensuring that information is provided to investors in a meaningful, useful and comprehensible way?

(16) *Individualized Fee Information*. As you know, mutual funds must currently disclose their expense ratios – management and certain other fees as a percentage of the fund's net assets – in the prospectus sent to investors. The prospectus must also disclose the fees paid, in dollars, on a $10,000 investment. In December 2002, the Commission proposed a rule that would require that a similar disclosure be included in the shareholder reports sent to investors. But there is no

[23] Amendments to Investment Company Advertising Rules, 68 Fed. Reg. 57759 (October 6, 2003).

requirement that mutual funds disclose the actual costs paid by investors for their investment in the mutual funds for a given period.

> In this respect, mutual funds differ from many other types of financial products used by average consumers. Bank statements, for example, list fees assessed on the holders' accounts; credit card statements list actual finance charges and annual fees in dollar amounts on monthly statements; mortgage lenders are required to provide at the time of settlement information not only on the annual percentage rate but the cost of the loan in dollar terms; and even brokerage accounts provide investors with the dollar costs of each individual trade. Only in the case of mutual funds are investors left to try to calculate their own fees based on percentages listed in the prospectus; as a result, few investors have any idea what they are paying to own a mutual fund. This may be one reason that mutual fund expense ratios have been creeping up over the last five years.[24]

In a testimony before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Financial Services Committee on June 18, 2003, GAO recommended that the SEC consider requiring disclosure of the actual fees mutual fund investors pay in their account statements.[25] GAO concluded that additional disclosure could increase the transparency of fees and other mutual fund practices. In a report three years earlier, GAO also found that such disclosure could encourage greater price competition.[26] Nonetheless, in the SEC's December 2002 proposed rulemaking, the Commission specifically declined to propose that specific fees charged to an individual be disclosed to that individual in dollar terms.

a) Does the Commission continue to believe that mutual funds should not disclose the expenses an investor paid in that investor's quarterly or monthly statements? Please explain why or why not.

b) How do the recent scandals in the mutual fund industry affect your analysis of this issue? Does the resulting need for increased transparency and trust in the industry alter your assessment of the costs and benefits of requiring clearer disclosure?

c) What is the status of the December 2002 proposed rule?

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[24] Ian McDonald "Go Figure," *Wall Street Journal*, October 29, 2003.

[25] GAO-03-909T, "Mutual Funds: Additional Disclosures Could Increase Transparency of Fees and Other Practices," Testimony Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, House of Representatives, June 18, 2003; *see also* GAO-03-763, "Mutual Funds: Greater Transparency Needed in Disclosures to Investors, June 2003.

[26] GAO/GGD-00-126, "Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition," June 2000.

(17) *Trading Costs and Other Non-Disclosed Expenses*. Some fund expenses – despite the fact that they are paid for using investors' money -- are not disclosed directly to investors at all. Perhaps most significant among these are the brokerage commissions that the fund pays to buy and sell the shares in its portfolio. Variations in commission expenses have an effect on investors returns and may also suggest other characteristics of a fund's management, such as the extent of the turnover in the fund's portfolio or whether the fund has successfully negotiated low rates. These are disclosed only in documents filed with the SEC, and not in any document provided directly to mutual fund shareholders. Other trading costs are also not required to be disclosed (including, in some cases, not even to the Commission): brokers, for example, may be compensated not through commissions but through markups or by the spread between the bid and ask price of a security. Again, shareholders pay for these things, but they aren't told directly about them.

Other fund expenses are kept secret from both shareholders and the SEC, including so-called soft-dollar arrangements. In such arrangements, funds pay a larger-than-normal commission for trades, but in exchange receive research or other services. If the funds were paying directly for the research or other services, the costs would have to be disclosed to investors. As part of a soft-dollar deal, however, such payments may be kept altogether from investors.

a) Which, if any, of these expenses do you believe should be disclosed directly to investors? For any that you do not, please explain why not.

b) To the extent such expenses are required to be disclosed to investors, what do you believe is the best manner in which to disclose them? Should they be included in expense ratios or should they be disclosed separately?

Mutual fund investing is, for many Americans, the path to retirement. These working families look to the SEC, as the main federal agency charged with watching over that industry, to make sure that their investments are handled honestly and transparently. Please provide your response as soon as possible, but in any event, no later than November 24, 2003. If you have any questions, feel free to call me, or have your staff call Beth Grossman of my staff at (202) 224-2627. Thank you for your attention to this important matter.

Sincerely,

Joseph I. Lieberman
Ranking Minority Member

cc: The Honorable Susan Collins, Chairman