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Subcommittee on Financial Management
the Budget, and International Security

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Thank you for inviting me back to testify before this committee. This committee's hearing this past November played an important role in focusing attention on the conflicts inherent in an industry where directors were beholden to management. That hearing also started the process of crafting solutions to protect the $7 trillion Americans have invested in mutual funds.

Several of the proposals that seemed radical when I discussed them in November have already become conventional wisdom. Requiring mutual funds to have truly independent directors and an independent board chairman is now a centerpiece of every reform proposal. There is now also widespread recognition that mutual funds directors must be given the staff and resources needed to allow them to effectively oversee the management companies that run the funds' day-to-day operations.

Many reformers also recognize that mutual fund compliance officers should report to the fund's independent directors and not to the mangers whose activities are being monitored and reviewed. Perhaps most significantly, there is universal agreement that the disclosures provided to mutual fund customers are inadequate and several competing proposals address this problem. I continue to believe that the proper approach would be to provide each investor with an itemized statement of the actual costs charged to his or her account. This would provide mutual fund customers with the information necessary to engage in true comparison shopping.

That is the good news. The bad news is that the industry and many of its apologists are still opposing true reform in the area that most directly impacts investors: advisory fees.

As I indicated when I was here last November, in 2002 mutual fund investors paid advisory fees of more than $50 billion and other management fees of nearly $20 billion. That is in addition to the tens of billions of dollars in marketing fees and trading costs imposed by the fund industry.

The advisory fees that mutual funds charge their shareholders greatly exceed those charged to institutional customers. If mutual fund customers were charged the lower rate for advisory fees paid by institutional investors, they would save more than $10 billion each year.

The industry and its apologists have asked whether there is a link between the advisory fees charged to investors and the late trading and market timing practices that were the initial

focus of my investigation. As I stated to Senators Sarbanes and Shelby when I testified before their committee, the answer is yes.

Both the improper trading and the exorbitant advisory fees are a consequence of a desire by managers to enrich themselves at the expense of investors and an inability or unwillingness on the part of directors to protect investors. This can be 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. As one mutual fund manager frankly admitted in an email uncovered by my office: "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!"

Mutual fund directors and managers breached their duties to investors in every conceivable manner, and we must pursue every manifestation of that breach. This includes breaches of duty that allowed managers to overcharge investors.

When I was last before this committee I spoke in generalized terms about the advisory fee overcharges imposed on investors. Now that our investigation has progressed, I'd like to talk specifically about the advisory fees charged by two fund complexes, Putnam and Alliance.

In 2002, Putnam managed approximately $279 billion for mutual fund and institutional investors. Our investigation revealed that Putnam charged mutual fund investors significantly higher advisory fees than those charged to institutional investors. Here are the specifics:

Putnam's mutual fund investors were charged 40% more for advisory services than Putnam's institutional investors. In dollar terms, what this fee disparity means is that in 2002 Putnam mutual fund investors paid $290 million more in advisory fees than they would have paid had they been charged the rate given to Putnam's institutional clients.

There was a similar disparity in the advisory fees charged by Alliance. Once again, mutual fund investors were charged significantly higher advisory fees than institutional investors. Specifically, Alliance's mutual fund investors paid advisory fees that were twice those paid by institutional investors. In dollar terms, this means that Alliance investors paid more than $200 million dollars more in advisory fees than they would have paid had they been charged the rate given to Alliance's institutional clients.

Because of these findings, I refused to join in a settlement with Putnam that did not provide investors with some form of compensation for the advisory fee overcharges they incurred. Similarly, my office's settlement with Alliance requires them to return $350 million to investors by way of a five-year, twenty percent reduction in their advisory fees.

These actions have lead my critics to accuse me of engaging in "rate-setting." That charge is false. Requiring mutual funds to return to investors money that should never have been taken from them is not "rate-setting." It is what regulators across the country do every day when they uncover evidence that consumers have been ripped-off, and it is what I will continue to do

as I uncover more evidence that mutual fund investors have been cheated.

When the charge of rate-setting fell flat, the industry turned to a more audacious argument in defense of their advisory fees. Earlier this month, the Investment Company Institute issued a report that attempted to rebut the evidence showing that mutual fund investors pay more than institutional investors for advisory services. The report focuses significant attention on an academic article published in the Journal of Corporation Law by Professors Freeman and Brown.

Professor Freeman is testifying on a later panel and does not need my assistance to defend his work. But he is due our thanks for shedding light on an abusive practice that takes billions of dollars each year from the pockets of average families saving for a new home or their children's education. Thank you, Professor Freeman.

The ICI's conclusion that mutual fund investors don't pay more than institutional investors for advisory services was misleading or worse. It was not based on data showing what mutual funds charge for advisory services. Instead, the ICI relied exclusively on data concerning the fees that subadvisors -- the outside advisors occasionally hired by mutual fund managers to give investment advice -- charge management companies.

There are three reasons why it is inappropriate to rely on data concerning subadvisors. First, fewer than 20% of all mutual funds employ subadvisors. Indeed, after the ICI released its report, Business Week noted that as few as 7% of mutual funds employ subadvisors.

Second, unlike most mutual fund fees where directors rubber stamp their affiliated management company's request, the fees charged by subadvisors are the product of an arms length negotiation between disinterested parties.

Third, the few mutual funds that employ subadvisors often impose their own costs on top of those of the subadvisor. For example, if the subadvisor charges the fund thirty basis points, the fund will tack on its own "premium" of twenty or thirty basis points and charge investors the combined amount. The ICI report used the amount charged by the subadvisors, without accounting for the "premiums" tacked on by the mutual funds and passed on to shareholders. The result is that even in mutual funds that are subadvised, shareholders pay more for advisory services than the actual cost for that service incurred by the management company.

Thus, the ICI report takes a number that reflects a narrow slice of the industry and is the product of arms length negotiation, ignores the mark-up imposed by mutual funds and then attempts to pass that number off as representative of the entire industry. For shame.

I know that the ICI has a representative testifying on a later panel. I hope the committee will explore the issue of subadvised fees, particularly the premiums that the funds impose. My sense is that these "premiums" are often as much or more than the fees charged by the subadvisor itself. This raises the question of what service is being provided to justify these premiums. In the coming weeks, my office may take a closer look at that question.

When discussing advisory fees, the challenge is not in determining the scope of the problem but in crafting an appropriate solution. I would like to ask this committee to consider a proposal endorsed a few weeks ago by the treasurers of California and North Carolina and by the New York State comptroller.

This proposal that would require all mutual fund fee contracts to contain breakpoints providing economies of scale savings to shareholders, and would require mutual fund boards to justify the fees in an analysis published in the fund's annual report.

The analysis must include a comparison of the fees charged to institutional investors, a review of the management company's pre-tax profit and a detailed itemization of the costs of the various services, including investment advice, marketing and advertising, operations and administration.

I believe that this proposal, if enacted, would lead to savings of billions or more each year. I hope that the committee will give it serious consideration.