Testimony of Mercer E. Bullard

President and Founder

Fund Democracy, Inc.

and

Assistant Professor of Law

University of Mississippi School of Law

before the

Subcommittee on Financial Management, the Budget,

and International Security

Committee on Governmental Affairs

United States Senate

November 3, 2003

Chairman Fitzgerald, Ranking Member Akaka, members of the Subcommittee, thank you for the opportunity to appear before you today to discuss alleged trading abuses in the mutual fund industry and actions needed to mitigate such practices in the future. It is an honor and a privilege to appear before the Subcommittee today.

I am the Founder and President of Fund Democracy, a nonprofit advocacy group for mutual fund shareholders, and an Assistant Professor of Law at the University of Mississippi School of Law. I founded Fund Democracy in January 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments. Toward this end, Fund Democracy has filed petitions for hearings, submitted comment letters on rulemaking proposals, testified on legislation, published articles on regulatory issues, educated the financial press, and created and maintained an Internet web site.

I. Introduction

Last June, I introduced my testimony before a House subcommittee with the following statements:

> More than 95 million Americans are shareholders of mutual funds, making mutual funds America's investment vehicle of choice. These shareholders have made the right decision. For the overwhelming majority of Americans, mutual funds offer the best available investment alternative.[1]

[1] Testimony of Mercer Bullard, Fund Democracy, Inc., before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, at p. 2 (June 18, 2003) at http://financialservices.house.gov/media/pdf/061803mb.pdf.

More than 95 million Americans still own mutual funds today, but they are no longer certain that they made the right decision, or that mutual funds offer the best available investment alternative.

Recent allegations of fraud have fundamentally altered Americans' perception of mutual funds. These allegations do not involve isolated instances of individual wrongdoing by low-level employees – the proverbially "few bad apples." These allegations appear to involve the majority of mutual fund complexes, and wrongdoing by a large number of employees, including, in some cases, the executives at the highest levels of management.

The usual ways in which we respond to such crises do not apply here. When frauds occur that could not reasonably have been anticipated, perhaps because of some previously unidentified legal loopholes, we can close the loopholes and forgive the stewards of the industry. Structural reform generally is not needed.

The alleged frauds in this case, however, were open and notorious and violated express legal requirements. Fund stewards were on notice and failed to take action. There are no significant legal loopholes to close or grounds to excuse a fundamental failure of compliance. These systemic frauds have exposed a compliance system that is not working and is in dire need of structural reform.

In this testimony, I have described the recently alleged frauds – stale pricing, late trading, market timing, and commission overcharges -- in Section II. Section III discusses the systemic nature of these frauds and explains why structural reform in the way mutual funds are regulated is necessary. Section IV describes specific actions that I

believe are necessary to protect investors and restore Americans' confidence in the mutual fund industry.

II. Description of the Alleged Frauds

A. Stale pricing

Stale pricing refers to the practice of pricing a fund's shares based on prices of portfolio securities that no longer reflect their market value. For example, consider a Hong Kong fund that holds securities traded on the Hong Kong Exchange. The Exchange closes at 3:00 am EST, but the fund prices its portfolio securities at 4:00 pm EST, at the close of the U.S. markets. If the fund manager prices the fund using closing prices on the Hong Kong Exchange, and nothing has affected the value of the securities during the 13 hours since the Exchange closed, then the fund's price reflects current market value. If events have occurred that affect the value of those securities, however, then the price will not reflect current market value.[2]

A number of academic studies have shown that such events often occur after the close of foreign exchanges, and that the effect of these events is very predictable.[3] The effect is so predictable, in fact, that professional and retail investors alike routinely

---

[2] Stale pricing also can occur in domestic funds that hold illiquid or infrequently-traded securities whose most recent trading price may be hours or days old.

[3] See, e.g., Conrad Ciccotello, Roger Edelen, Jason Greene & Charles Hodges, Trading at Stale Prices with Modern Technology: Policy Options for Mutual Funds in the Internet Age, 7 Va. J.L. & Tech. 6 (Fall 2002); Jacob Boudoukh, Matthew Richardson, Marti Subrahmanyam & Robert Whitelaw, Stale Prices and Strategies for Trading Mutual Funds, 58 Financial Analysts Journal (July/August 2002) at http://www.aimrpubs.org/faj/issues/v58n4/full/f0580053a.html; Eric Zitzewitz, Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds (October 2002) at http://faculty-gsb.stanford.edu/zitzewitz/Research/arbitrage1002.pdf; and William Goetzmann, Zoran Ivkovich & Geert Rouwenhorst, Day Trading International Mutual Funds (October 2000) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=217168.

purchase shares of foreign funds in the knowledge that the funds are undervalued and that their share prices will rise the next day when the higher value of the securities is reflected in closing prices on foreign exchanges.[4]

This is precisely what occurred, for example, in October 1997, when a sharp drop in Asian markets was followed by a rebound in the U.S. market. According to the Securities and Exchange Commission ("SEC"), "fairly large numbers of investors attempted . . . to take advantage [of stale prices] which promised potential gains in double digits."[5] The SEC has not disclosed the results of its investigation of the effect of stale pricing on this occasion, but Fund Democracy has estimated, applying the methodology used by the SEC, that some funds lost in excess of 2% of net assets.[6] This means that a shareholder with a $100,000 account would have lost more than $2,000 to traders ***in a single day***.

Stale pricing is a violation of the Investment Company Act. The Act expressly requires that when market quotations are not readily available, funds' portfolio securities must be fair valued "in good faith by the board of directors."[7] Market quotations are not readily available, for example, when events occurring after the close of a foreign

---

[4] Although prices that are too high can also be exploited by selling fund shares and then buying them back the next day, this is less frequent because traders typically prefer to have cash available to exploit trading opportunities as they arise, and therefore prefer not to have cash tied up in a single fund that can be used to exploit trading opportunities only in that fund.

[5] Address by Barry Barbash, Director, Division of Investment Management, Securities and Exchange Commission, before the ICI Securities Law Procedures Conference, Washington, D.C. (Dec. 4, 1997).

[6] Mercer Bullard, Your International Fund May Have the Arbs Welcome Sign Out, TheStreet.com (June 10, 2000); see also Mercer Bullard, International Funds Still Sitting Ducks for Arbs, TheStreet.com (July 1, 2000).

[7] Investment Company Act Section 2(a)(41)(B); see Investment Company Rule 2a-4(a)(1).

exchange have affected the value of the securities.[8] In that event, funds must update the value of the affected securities. Some fund firms routinely update their portfolio securities' prices, but as evidenced by the pervasive exploiting of stale prices uncovered by recent investigations, many do not.

B. Late Trading

Late trading refers to purchase and sales that occur after the fund has been priced, which is typically at 4:00 pm EST. It is similar in effect to exploiting stale prices. After a fund has been priced, that price may quickly become stale as events occur that affect the value of the fund's portfolio. For example, companies often announce their quarterly results after the close of the U.S. markets at 4:00 pm EST. If the announcements are positive and they involve companies held in a fund's portfolio, the 4:00 pm EST price will then be lower than the actual value of the portfolio after the announcements are made.

The Investment Company Act prevents traders from exploiting post-4:00 pm EST information by requiring that all purchases of fund shares be executed at their next calculated net asset value.[9] An order received by a fund at 3:59 must receive that day's 4:00 price. An order received by a fund at 4:01 must receive the next day's price.

The SEC has permitted orders to be received after 4:00 pm EST in certain situations. As a practical matter, brokers, pension administrators and other intermediaries

---

[8] See Investment Company Institute, SEC No-Action Letter (Apr. 30, 2001) ("If the fund determines that a significant event has occurred since the closing of the foreign exchange or market, but before the fund's NAV calculation, then the closing price for that security would not be considered a 'readily available' market quotation, and the fund must value the security pursuant to a fair value pricing methodology.").

[9] Investment Company Act Rule 22c-1.

often receive orders before 4:00 pm EST but are unable to transmit the orders to the fund until after 4:00 pm EST. In these cases, the fund receives the order after legal deadline.[10] Of course, the SEC has permitted such "backward pricing" on the condition that orders received by the fund after 4:00 were received by the intermediary before that time.[11]

Further, the SEC position assumes that orders received before 4:00 cannot be cancelled after 4:00. Otherwise, a trader could exploit positive information released after 4:00 by placing an order every day and then canceling the order each day that there was no post-4:00 information affecting the value of the portfolio or the post-4:00 information was negative.

Recent investigations have found that traders, in direct contravention of existing rules and SEC positions, have routinely submitted orders and/or cancelled fund orders after the time the fund was priced.

C. Market Timing.

Market timing is a term of art that, with respect to mutual funds, refers to frequent purchases and redemptions based on the trader's views about the relative short term performance of certain market sectors, asset classes or other broad categories of investments. [12] For example, there are market timing newsletters that make

---

[10] According to a complaint filed by the New York Attorney General, some funds have given the same day price to orders received as late as 9:00 pm EST, State of New York v. Canary Capital Partners, LLC (Sep. 3, 2003), and some press reports suggest that some funds do so for orders received as late as 11:00 pm EST.

[11] Charles Schwab & Co., Inc., SEC No-Action Letter (July 7, 1997).

[12] Recent news reports have used the term "market timing" to describe frequent trading conducted for the purpose of exploiting stale prices. This use of the term is inaccurate and risks confusing and thereby improperly limiting the ultimate responsibility of fund managers for using stale prices. For example, some fund managers have stated that they intend to compensate funds for any harm resulting from "market timing" but have said nothing about compensating funds for dilution resulting from stale pricing. See, e.g., Letter from Richard M. DeMartini to Nations Fund Shareholders (Sep. 19, 2003) (promising restitution for harm caused by "discretionary market-timing agreements") at http://www.bankofamerica.com/nationsfunds/pdf/press_release.20030919.pdf.

recommendations regarding which categories are expected to outperform in the short-term, and there are mutual fund families that cater specifically to market timers.[13]

Traders who exploit stale prices and engage in late trading also are market timers, but there is no necessary connection between market timing and the two frauds. Such traders are market timers, that is, frequent traders, because trading in and out of the fund promises them the greatest profit for the least risk. Their goal is to remain invested in a fund only as long as necessary to collect their risk-free profits and to minimize their exposure to fluctuations in the value of a fund's portfolio.

Permitting market timing is, by itself, legal. Permitting market timing in contravention of a fund's stated trading policies, however, violates the federal securities laws. Some fund prospectuses state, for example, that the fund does not permit frequent trading in fund shares.[14] The purpose of these policies is to hold down fund costs; they are not required by law. Market timers can increase fund costs because a fund must spend more on processing transactions in fund shares and investing fund assets. Market timing also can adversely affect a fund's investment performance by disrupting the management of its portfolio. Another benefit of market timing restrictions is that they limit the ability of traders to exploit stale prices or engage in late trading, although the best protection against these frauds is, of course, to accurately price the fund and to reject trades that were placed after the fund was priced.

---

[13] Two examples are the ProFunds and Rydex fund complexes.

[14] See, e.g., Prospectus for the Vanguard U.S. Stock Index Funds at 52 (July 3, 2003) (limiting round trips to two per 12-month period and requiring 30 days between round trips).

Recent allegations have revealed that many fund complexes, perhaps even a majority, have permitted market timing and have even entered into market timing arrangements with selected traders. These arrangements can violate the securities and general antifraud laws to the extent that they are not consistent with the fund's stated policies. They also can be illegal if the special treatment afforded to the traders violates the fund manager's or another participant's fiduciary duty to the fund.[15]

D. Commission Overcharges

Another fraud that was uncovered prior to the current mutual fund scandal is the systematic withholding of discounts on commissions from qualified investors. Mutual funds frequently offer discounts on sales commissions that are based on volume, which are known as "breakpoints." For example, a $10,000 purchase might incur a full 4% sales commission, whereas a $100,000 purchase might be charged only 2%. A $1,000,000 purchase typically would not be charged any commission.

Funds often permit purchases by different accounts, by different family members, and in different funds in the same fund complex to be aggregated for purposes of calculating the breakpoint. Some funds also permit purchases made over time to be aggregated for breakpoint purposes. Other, more complex circumstances in which shareholders are entitled to breakpoints are summarized in a joint SEC/NASD/NYSE report released earlier this year.[16] The calculation of breakpoints can thus require fairly

---

[15] There is not, however, a general duty to treat all shareholders equally. Fund shareholders are routinely treated differently based on, for example, the size of their accounts, the size of their initial investments, and, as indicated by market timing policies, the frequency of their trading.

[16] Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds (March 2003) at http://www.sec.gov/news/studies/breakpointrep.htm.

complex monitoring systems in order to ensure that investors actually receive the breakpoints to which they are entitled.

Between November 2002 and January 2003, the SEC, NYSE and NASD conducted a joint inspection of 43 broker-dealers to determine whether shareholders had received the breakpoints to which they were entitled. The regulators found that shareholders were systematically overcharged by the broker-dealers. They found that shareholders were overcharged with respect to 32% of transactions that were eligible for discounts. Of the 43 firms, only two were found not to have overcharged any shareholders. Three broker-dealers were found to have overcharged shareholders in every single instance in which discounts should have been applied. The average amount by which shareholders were overcharged was $364.

III. A Systemic Compliance Failure

The frauds described in the immediately preceding section represent a systemic compliance failure in the fund industry. Each of these frauds reflects a failure to ensure that there are compliance procedures in place that are reasonably designed to protect shareholders, and that steps are taken to ensure that the procedures are working. None of these frauds is surprising in the sense that the fraud reflects an unknown vulnerability in the operation or regulation of mutual funds. Each of these frauds was predictable and could and should have been prevented simply by enforcing minimal compliance standards.

A. Stale Pricing

The use of stale prices is so widely known that many retail investors routinely exploit international and other funds by buying shares after upswings in U.S. markets. In one case, 28 members of the Boilermakers Local Lodge No. 5 of New York each executed 150 to 500 trades in Putnam funds over a three-year period.[17] They realized profits ranging from $100,000 to $1,000,000 by exploiting stale prices. These profits came directly out of the pockets of the other 916 members of their union who were invested in the funds and other fund shareholders.

The opportunities offered by stale prices have been discussed in Internet bulletin boards and personal finance magazines.[18] A stream of academic studies have demonstrated that U.S. mutual funds lose hundreds of millions, if not billions, of dollars each year as a result of stale prices.[19] In 2000, I published two articles describing the stale pricing problem in which I estimated that stale prices could cost a fund in excess of 2% of its assets in a single day.[20] In 1997, the SEC examined a number of funds that had used stale prices and found that "fairly large numbers of investors attempted . . . to take advantage [of stale prices] which promised potential gains in double digits."[21]

The problem of stale pricing has been successfully addressed by some fund firms. Vanguard, Fidelity and other fund complexes regularly fair value their portfolios when

---

[17] In the Matter of Putnam Investment Management, LLC, Docket No. E-2003-061.

[18] See, e.g., Jill Andresky Fraser, Short Term, Long Enough, Bloomberg Personal Finance at 95 (Sep. 2000) (describing how to exploit stale prices).

[19] See supra note 3.

[20] See supra note 6.

[21] Barbash, supra note 5.

events occurring after the close of foreign markets affect the accuracy of closing prices on foreign exchanges. For some years, independent pricing firms have offered services to funds that enable them to update their prices to reflect such events. The SEC staff has on two occasions described the tools that funds can use to ensure that their portfolios are accurately valued.[22]

Despite the fact that the problem of stale pricing has been widely recognized and, by some fund complexes, successfully addressed, it is clear based on recent revelations that traders have routinely exploited stale prices to the detriment of shareholders of a large number of funds. These funds' managers have been aware that their funds' prices were stale, as further evidenced by aggressive market timing by some fund shareholders. In some cases, fund management allegedly colluded with traders to take advantage of stale prices and even loaned traders the money they used to cheat the fund's shareholders. In at least one case, the portfolio managers themselves alleged exploited stale prices of the very funds that they managed.[23] In another case, the chief executive officer of the fund manager allegedly exploited the stale prices of funds of which he was the chairman.[24]

Further, these funds' directors failed to satisfy minimum standards of compliance oversight. These directors should, at a minimum, have regularly reviewed funds' pricing policies to ensure that they were designed to prevent stale pricing and required periodic spot checks to determine whether the procedures were working. These spot checks

---

[22] Investment Company Institute, SEC No-Action Letters (Dec. 8, 1999 & Apr. 30, 2001).

[23] <u>See</u> <u>supra</u> note 17.

[24] Tom Lauricella, Probe Hits Strong's Chairman: Investigators Say Firm's Founder Engaged in Improper Trading, Wall Street Journal (Oct. 30, 2003).

would include, for example, comparing prices of the complex's international funds to prices of similar funds in other complexes or prices calculated by outside pricing services, and monitoring fund inflows and outflows to determine whether market timers were exploiting stale prices. Although fund directors cannot reasonably be expected to detect individual instances of fraud, their primary responsibility is to detect and prevent the kind of widespread abuses uncovered in recent investigations.

B. Late Trading.

The potential problems of late trading were even more obvious than stale pricing. For years, funds have routinely received orders after 4:00 pm EST. There is no basis for claiming, nor have any fund managers attempted to claim, that they were unaware that orders were received after 4:00 pm EST. Fund managers expressly authorized this practice.

In view of fund managers' and directors uncontradicted knowledge of the receipt of orders after 4:00 pm EST, it was incumbent upon them to ensure that there were procedures in place that were reasonably designed to detect and prevent orders from being placed or cancelled after 4:00 and to take steps to ensure that these procedures were working. It is self-evident that, given the opportunity, some traders will attempt to take advantage of opportunities to profit from late trading (as evidenced by ongoing investigations).

Some fund executives have suggested that protecting fund shareholders against late traders is not the fund manager's or director's responsibility when trades are executed through omnibus accounts. In this situation, an intermediary is responsible for processing fund transactions, and the only trade with the fund is a single order that nets

all of the trades of persons who invest through the omnibus account.[25] Although the presence of an omnibus account may create an additional layer of compliance for a fund manager and fund board, it in no way relieves them of their fundamental responsibility to protect fund shareholders.

Fund managers and fund boards must take steps to ensure post-4:00 pm EST trades are placed before 4:00 and cannot be arbitrarily cancelled. The SEC has permitted funds to receive orders after 4:00 pm EST on the condition that the fund's directors ensure that the orders originate before 4:00. In a letter to Charles Schwab & Co., Inc., in which the SEC authorized Schwab to submit orders after 4:00, the SEC stated that the fund's "board of directors should consider whether Schwab has adopted and implemented internal controls reasonably designed to prevent customer orders received after the Fund's Pricing Time from being aggregated with the orders received before the Fund's Pricing Time."[26] The SEC also stated that the fund directors also should consider whether third parties designated by Schwab to receive orders have internal controls designed to ensure that late trades originated before the fund is priced.

C. Market Timing.

The problem of market timing is so notorious that many funds have adopted trading policies that are designed to combat market timing and have disclosed these policies in their prospectuses. It cannot have been a surprise to fund managers or directors that many investors would seek to trade in and out of their funds.

---

[25] Such omnibus accounts would include employee benefit plans, such as 401k plans, accounts held in street name by a broker-dealer, and accounts held by fund supermarkets, such as Schwab's Mutual Fund OneSource service.

[26] See supra note 11.

Nor can fund managers or directors have been ignorant of the prevalence of frequent trading in their funds. Funds have direct knowledge of daily cash flows in and out of their funds, and it is difficult to imagine, in light of the high profile of the market timing problem, how such cash flows could not have been the subject of constant and careful analysis by fund managers and directors. At a minimum, fund managers and directors must ensure that there are procedures in place that are reasonably designed to protect shareholders against inappropriate market timing and to conduct regular checks to ensure that these procedures are working. Reports that half of the 80 fund complexes subpoenaed in connection with ongoing investigations may have market timing arrangements with some investors and that half of those complexes have anti-market timing policies is evidence that the most fundamental elements of effective compliance -- standardized procedures and periodic verification -- were routinely ignored.

Some have suggested, as similarly suggested with respect to late trading, that fund managers and directors should not be held accountable for frequent trading conducted through omnibus accounts. For the same reasons discussed above, these arguments are incorrect. Further, omnibus accounts are permitted to invest in funds only with the funds' permission, and such investments should not be permitted on the condition that the beneficiaries be allowed to trade in and out of the fund to the detriment of other shareholders.

Further, patterns of frequent trading in omnibus accounts are, in fact, detectable. For example, Putnam was able to detect frequent trading by a deferred compensation plan for which a third party acted as the administrator. As indicated in exhibits to the Mass. Secretary of State's complaint, the deferred compensation plan resisted Putnam's request

to eliminate frequent trading, thereby illustrating that ultimate responsibility for protecting fund shareholders does and must lie with fund managers and directors.

D. Commission Overcharges.

It is fundamental to a fund manager's or director's duty to protect fund shareholders that he take steps to ensure that shareholders are not overcharged. Nowhere is the potential for fraud or embezzlement greater than when persons are able to collect their fees or commissions directly from the amount of a purchase or a shareholder's account. This is especially true in the context of mutual fund purchases, where, unlike virtually every other type of securities transaction, the SEC has exempted brokers from disclosing to shareholders they amount that the broker was paid in connection with the transaction.[27]

It is incumbent upon fund managers and directors to establish procedures that are reasonably designed to ensure that investors are not overcharged, and to require periodic checks to ensure that the procedures are working. The procedures might include regular, independent audits of fees charged to shareholders and occasional sampling to determine whether the audits were effective. It is precisely this kind of sampling that was conducted by regulators and revealed an extraordinary record of overcharges.[28] Regulators cannot police every fund and every broker; effective compliance must begin at individual firms.

E. A Systemic Compliance Failure

The frauds discussed above demonstrate a systemic breakdown in compliance systems in the mutual fund industry. This is not intended to suggest that fund managers

---

[27] SEC Report at 80.

[28] See supra discussion at pp. 9 -- 10.

and directors should be expected to catch every fraud, to detect every frequent trader, to price every foreign security perfectly, day in and day out. This is not the standard to which fund managers and directors are or should be held. Indeed, when brokers process millions of fund transactions, it is to be expected that shareholders will occasionally be overcharged, and in some cases they may be overcharged intentionally. But the extraordinary incidence of overcharges found by regulators exceeds the inevitable glitches that any complex system will produce. For example, investors entitled to breakpoints would almost have had a better chance of not being overcharged if they had flipped a coin. In some cases, such investors had a 100% chance of being overcharged. The overcharges, along with the failure to detect and protect the other alleged frauds, demonstrate a systemic failure of compliance.

The frauds described above have been shown not to be isolated incidents. They reflect widespread abuses occurring at a large number of fund complexes that in a number of cases involve upper level management. Fund managers and directors knew or should have known that their funds were using stale prices, and some even assisted investors in exploiting these prices. They knew or should have known that late trading was occurring, and some even helped late traders process their transactions. They knew or should have known that traders were market timing their funds, and some even negotiated deals to facilitate this practice. They created a system of awarding breakpoints that was complex and plainly susceptible to abuse, yet in some cases investors had a 0% chance of receiving the breakpoints to which they were entitled.

IV. Mutual Fund Reform

These frauds necessitate prompt and forceful action by Congress. In this section, I propose certain measures that are needed to strengthen the independence and authority of fund directors. Strengthening measures, however, are not sufficient. These frauds reflect a systemic compliance failure in the sense that the current structure of fund oversight is not resulting in fund shareholders receiving the most fundamental and obvious forms of protection from actual and potential abuses that have been known to regulators and the fund industry for years. If shareholders are not being protected from the most obvious frauds, they cannot have any confidence that they are being protected from frauds that we have yet to or may never discover. I therefore strongly recommend that Congress create a Mutual Fund Oversight Board, as also described in Section IV below.

Finally, Congress should adopt long overdue reforms to ensure that fund fees and expenses are fully disclosed. These reforms, which already have been passed by the House Financial Services Committee, are critical to restoring investors' confidence and promoting competition in the mutual fund industry. Mutual funds have historically maintained a higher standard of ethics and professionalism than any other financial services provider. This high standard is attributable, in part, to the relative transparency of their fees and the strict regulatory regime under which they operate. The current scandal, however, has severely damaged their reputation, perhaps irreparably. Congress should take immediate steps to restore Americans' trust in this once proud industry.

A. Independent Fund Directors

As discussed above, recent frauds demonstrate systemic weaknesses in mutual fund compliance. These systemic weaknesses require immediate steps to strengthen the independence and authority of independent mutual fund directors, and the creation of a regulatory structure designed to ensure that fund boards of directors fulfill their responsibility to protect shareholders.

As this subcommittee is aware, virtually all mutual funds are essentially a board of directors that oversees a nexus of contracts with different service providers. Recent frauds have implicated a variety of different legal requirements applicable to these service providers, but all of the frauds share a common element: the failure of mutual fund boards to satisfy fundamental standards of compliance oversight. I strongly recommend that Congress adopt the following requirements to restore Americans' confidence in mutual funds and ensure that the industry never again engages in frauds of the kind and scope that have recently been brought to light.

1. Independent Chairman

Congress should require that the chairman of a fund's board of directors be independent. As often noted by the Commission, a mutual fund is effectively dominated by its adviser,[29] and this fact necessarily compromises the control normally exercised under state law by a board of directors. To compensate for this imbalance, it follows that additional requirements, beyond those provided under state law, are necessary for the board to effectively police the adviser's conflicts of interest and protect shareholders.

---

[29] See, e.g., Role of Independent Directors of Investment Companies, Investment Company Act Rel. No. 24082, at Part I (Oct. 15, 1999) ("investment advisers typically dominate the funds they advise").

These additional requirements have become especially important in light of recently alleged frauds perpetrated, in part, by fund managers and, in one case, the chairman of the fund's board. It is self-evident that, where such frauds may be perpetrated by a service providers to a fund, an executive of that service provider cannot provide objective leadership to the fund's board. There is an inherent conflict between the board's duty to evaluate the adviser's conflicts of interest on the one hand, and the appointment of an employee of the adviser as the board's chairman on the other. Requiring that the chairman be independent will remove this conflict and ensure that the fund's independent directors have complete control over the board.

The Commission staff has suggested that an independent chairman is unnecessary because the independent directors already can "influence the agenda and the flow of information to the board."[30] It is not enough, however, that the independent directors "influence" the information they receive; nor is the staff's position consistent with the principle underlying directors' affirmative statutory duty to "request and evaluate" the information necessary to evaluate the advisory contracts.[31] Indeed, the staff's suggestion that fund boards designate a "lead independent director" acknowledges the need for independent directors to exercise authority beyond that afforded by their numerical superiority. Formally appointing an independent director as chairman would better fill that need.[32] There can be no better demonstration of this fact than recent allegations that

[30] Memorandum from Paul Roye, Director, Division of Investment Management, to William Donaldson, Chairman, Securities and Exchange Commission, at 50 (June 9, 2003) ("SEC Report").

[31] See Investment Company Act Section 15(c).

[32] For further discussion of the reasons that an independent board chairman is necessary, see Letter from Mercer Bullard, Fund Democracy, Inc., to the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Enterprises, U.S. House of Representatives, at pp. 8 -- 11 (July 9, 2003).

the chairman of the board of the Strong fund complex, who is also the chief executive officer of the fund manager, personally engaged in market timing the funds whose boards he commanded for the purposes of exploiting stale prices.

The Commission's position also contradicts current trends in corporate governance. Recent corporate scandals have caused leaders in corporate law and practices to reconsider common assumptions about corporate governance. In June 2002, for example, The Conference Board convened the Commission on Public Trust and Private Enterprise to "address the causes of declining public and investor trust in companies, their leaders and America's capital markets."[33] In its report, the Commission on Public Trust specifically recommended that the position of board chairman not be held by a member of management.[34]

If we are to learn anything from alleged frauds in the fund industry, it is that accepted standards of conduct for funds' boards of directors need to be reexamined. I recognize that requiring that a chairman be independent in law will not guarantee that he or she will be independent in fact, but it is beyond dispute that -- all things being equal -- a legally independent chairman is more likely to be truly independent than a person with ties to management.

---

[33] Findings and Recommendations, The Conference Board Commission on Public Trust and Private Enterprise (Jan. 9, 2003).

[34] Id. at 21.

2. Authority and Representation of Independent Directors

Congress also should take steps to ensure that independent directors have the authority and representation necessary to counter the domination of the fund's manager. As discussed immediately above, mutual funds have a uniquely conflicted structure that necessitates an especially strong and independent board. Congress should take five steps to improve the effectiveness and independence of independent fund directors

The first two steps are related. First, Congress should increase the minimum percentage of independent directors on a fund board from 40% to 75%.[35] Second, Congress should prohibit any fund from requiring that board action necessitate the approval of a non-independent board member. This second step is necessary to prevent the circumvention of the independent directors' 75% control, for example, by adopting a provision that requires the approval of 80% of the board for any board action. These measures, in tandem, will ensure that independent fund boards have the authority to act when necessary to address conflicts of interest and detect and prevent fraud.

Third, Congress should ensure that fund directors actually "represent" fund shareholders in a meaningful way. Many current fund directors have never been approved by shareholders. Mutual funds normally do not have annual shareholders meetings, and fund directors typically are appointed for an indefinite term. Congress should prohibit any person from counting as an independent director unless that person has been approved by shareholders at least once every five years.

---

[35] As a practical matter, SEC rules virtually require that all funds have a majority of independent directors. See Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001). This is not, however, a statutory minimum.

Fourth, Congress should require that independent directors be found annually by a majority of the other independent directors, after reasonable inquiry, not to have any material business or familial relationship with the fund or any significant service provider to the fund that is likely to impair the independence of the director.[36]

Finally, Congress should require that independent directors form a committee of their peers that shall have responsibility for selecting and nominating independent directors.[37] This committee should be required, at a minimum, to adopt qualification standards for the selection of nominees that are disclosed in the fund's registration statement.[38]

3. Definition of Independent Director

Without an adequate definition of independence, no law can ensure that independent directors will be effective advocates for fund shareholders. In many respects, the current definition of independence permits persons with significant conflicts of interest to serve as independent directors.[39]

Congress should amend the standard for independent directors to disqualify the following persons:

- any natural person who has served as an officer or director, or as an employee within the preceding ten years, of an investment adviser or principal underwriter to the fund, or of any entity in a control group with

---

[36] See Amendment No. 2 to the NYSE's Corporate Governance Proposals (Oct. 8, 2003) at http://www.nyse.com/pdfs/amend2-10-08-03.pdf (recommending that corporate boards be required to find that independent directors have no material relationship with the company and to disclose these determinations).

[37] Id. (recommending that corporate boards be required to nominating committee that identifies director qualification criteria).

[38] Id.

[39] SEC Report at 47 – 48 (describing independent fund director relationships "that suggest a lack of independence from fund management").

the adviser or underwriter; and

- any natural person who has served as an officer or director, or as an employee within the preceding 10 years, of any entity that has within the five preceding years acted as a significant service provider to the fund, or of any entity in a control group with the service provider.[40]

Furthermore, Congress should authorize the SEC to prohibit any class of persons from serving as independent directors who the SEC determines are unlikely to exercise an appropriate degree of independence.

4. Mutual Fund Oversight Board

Although the proposals discussed above will strengthen fund boards, they will not be adequate to ensure that the kinds of frauds discussed above do not reoccur. These frauds reflect a failure by independent fund directors that cannot be explained solely by a lack of independence or authority. These frauds reflect systemic compliance failures that require structural changes in the way that fund boards are regulated.

Recent frauds demonstrate that the Commission staff has too many responsibilities and not enough resources to provide adequate oversight of fund boards. I strongly recommend that Congress create a Mutual Fund Oversight Board that would have examination and enforcement authority over mutual fund boards. The Board would be charged with identifying potential problems in the fund industry and ensuring that fund boards are actively addressing these problems before they spread.

The Board would be financed from assessments on mutual fund assets to provide an adequate and reliable source of funding. Board members would be persons with

[40] See SEC Report at 47 (noting that a former fund management executive can serve as an independent director two years after retiring from his position); Report of the Advisory Group on Best Practices for Fund Directors, Investment Company Institute, at 12 – 14 (June 24, 1999) (recommending that former officers and directors of a fund's investment adviser or principal underwriter not serve as independent directors).

specific expertise in the fund industry and would be appointed for five year terms by the Commission to ensure their independence. This model, which ideally combines the strengths of independent, expert oversight with the advantages of a reliable and adequate funding source, would do more to restore confidence in the fund industry and protect fund shareholders than any changes in the makeup, qualifications or authority of fund boards.

B. Fees and Expenses

Congress also should act promptly to eliminate two major gaps in mutual fund fee disclosure: portfolio transaction costs and compensation paid to brokers for selling fund shares. As discussed below, current SEC rules and positions provide investors with a misleading picture of the costs of fund ownership and the incentives of brokers from whom they buy fund shares. With America's investors experiencing a crisis in confidence in the mutual funds, fee disclosure reform is more important than ever.

1. Portfolio Transaction Costs

As stated by the Commission, "fund trading costs incurred in a typical year can be substantial."[41] The Commission cites studies that estimate that brokerage commissions alone cost about 0.30% of equity funds' net assets.[42] Other studies estimate that market spread, or the amount by which the price of a security is marked up or marked down, costs about 0.50% of equity funds' net assets, and that "opportunity costs may amount to 0.20% of value."[43]

---

[41] SEC Report at 19.

[42] Id. at 22.

[43] Id.

Another study found that the mean brokerage and market spread costs for a sample of equity funds was 0.75% of assets, or almost three-quarters of the mean expense ratio of 1.09%.[44] The brokerage and spread costs constituted an even larger percentage of the total costs of funds with the highest trading costs, with mean brokerage and spread costs equaling 1.54% of assets and the mean expense ratio equaling only 1.24%.[45] Thus, portfolio transaction costs can be the single largest fund expense, exceeding all other fund expenses combined. These costs are not, however, included in fee information provided in the prospectus. Transaction costs vary greatly among funds, and full disclosure of these expenses will help hold fund advisers accountable for their trading practices.

Fuller disclosure of portfolio transaction costs also will provide a collateral benefit in connection with funds' soft dollar practices. In short, transaction cost disclosure will subject fund expenditures on soft dollar services to market forces, and thereby provide a practical solution to the problem of regulating soft dollar practices.[46] For some transaction costs, fashioning disclosure rules will be a relatively easy task. Fund brokerage commissions already are disclosed in the Statement of Additional Information as a dollar amount. Converting this dollar amount to a percentage of assets and including it with other expenses in the expense ratio in the fee table would be simple and inexpensive.[47]

---

[44] Chalmers, Edelen & Kadlee, Fund Returns and Trading Expenses: Evidence on the Value of Active Fund Management (Dec. 29, 2001).

[45] Id.

[46] For further discussion of this benefit, see Bullard Testimony, supra note 1, at pp. 10 – 13.

[47] Accord, SEC Report at 28.

Providing disclosure regarding other types of transaction costs will be more difficult, but no less necessary. There are no standardized methods for calculating spread costs, market impact or opportunity costs. Nor are these concepts, unlike fund brokerage, generally understood by the investing public. Nonetheless, the Commission has been able to develop effective, standardized, quantitative disclosure tools in other contexts, such as funds' investment performance and expense ratios. There are a number of private companies that already provide fund advisers with quantitative assessments of their funds' transaction costs for self-evaluative and board review purposes.[48] The SEC's inspection staff routinely considers these quantitative assessments when evaluating a fund adviser's obligation to obtain best execution of fund transactions. It should not be difficult, over time, to develop quantitative tools to measure fund transaction costs and disclosure formats that will provide this information in a way that helps investors understand these costs.

The Commission has objected to the disclosure of fund portfolio transaction costs on the grounds that the disclosure of brokerage commissions, while easily comparable and verifiable, would be incomplete, and the disclosure of other components of transaction costs, while completing the transaction cost picture, would not lack comparability.[49]

This objection misunderstands the purpose of fee disclosure rules. The purpose of fee disclosure rules is to ensure that investors have the information they need to make informed investment decisions. Thus, the issue is not whether the disclosure is

---

[48] Id. at 21-22

[49] Id. at 20-22 & 28-35.

theoretically perfect or complete, but rather whether it provides information that facilitates better investment decisions.

For example, Commission-mandated standardized investment performance is imperfect and incomplete in a number of ways. It is calculated net of fees, notwithstanding that this does not accurately portray a fund adviser's pure stock picking ability before expenses. It arbitrarily measures performance at 1-, 5-, and 10-year intervals, and not periods in between. It is based on only one of a number of different methods of calculating an internal rate of return. In advertisements, it is permitted to show the returns of a single class, even though the performance of other classes may have been different.

Similar observations could be made about imperfections in the fee table. Indeed, one drawback of the expense ratio is that it is incomplete, and including commissions would make it a more complete measure of the cost of fund investing. Both standardized performance and the fee table have provided an undisputed net benefit to shareholders, notwithstanding their theoretical inadequacies.[50]

The fact that there is more than one way to calculate the different components of fund transaction costs is not a reason to deprive shareholders of useful information about these costs. The Commission has suggested enhanced disclosure of funds' turnover ratios as an alternative to disclosure of actual transaction costs. Using the turnover ratio

---

[50] Indeed, the same observations could be made about the SEC's preference for turnover rates as a proxy for portfolio transactions costs. Chalmers, supra note 44 (demonstrating that fund turnover is not a reliable proxy for fund trading expenses). If an imperfect, indirect measure of transaction costs such as portfolio turnover is to be used, it is unclear why a direct measure, such as commissions, spread costs, market impact or opportunity costs would not be preferable.

as a proxy for transaction costs, itself an imperfect measure, would be an inferior and inadequate substitute for disclosure of actual transaction costs.[51]

2. Brokers' Compensation

The purpose of prospectus disclosure is to inform investors about the cost of investing in a fund. In contrast, the purpose of disclosure made at the point-of-sale is to inform investors about the economic motives of the person (referred to herein as the "broker") recommending the fund. Rule 10b-10 under the Securities Exchange Act accordingly requires that brokers disclose, to purchasers of securities, "the source and amount of . . . remuneration received or to be received by the broker in connection with the transaction." This disclosure is known as the "trade confirmation" or "confirm." The Commission has, ill-advisedly, taken the position that Rule 10b-10 does not apply to sales of mutual fund shares.[52]

The prospectus does not disclose all of the compensation that may be paid to brokers for selling fund shares.[53] Even the compensation that is disclosed has no necessary relationship to the amount paid to a broker in a particular transaction. For example, the prospectus for two different mutual funds may show that an investor will pay the same front-end load of $500 on a $10,000 investment, but the broker selling the funds may be paid more for selling one fund over another.[54] The broker payout for both of these funds may be lower than for a fund with a 1.00% 12b-1 fee, for which brokers

[51] Id.

[52] SEC Report at 80.

[53] For further discussion of the disclosure of disclosure of compensation paid to brokers in the registration statement, see Bullard Testimony, supra note 1 at pp. 13 – 15.

[54] See Lauricella, Investment Firm's Portfolios Get Priority Despite Rules: 'The Home Field Advantage,' Wall Street Journal (May 22, 2003).

often receive a flat, upfront payment substantially in excess of the amount of 12b-1 fees that the shareholder will pay in the course of a single year. The broker also may receive payments directly from the fund adviser or compensation in the form of fund portfolio brokerage commissions.

If an investor buys shares of IBM or Dell, his broker must send a confirm that shows how much the broker was paid in connection with the transaction. In contrast, if an investor buys shares in a mutual fund, the confirm is not required to provide this information. For a number of years, the Commission has stated that it recognizes this problem and is studying possible solutions.[55] It is time for Congress to overrule the SEC's position that Rule 10b-10 does not apply to sales of fund shares and require that all compensation received by brokers in connection with sales of fund shares be disclosed on fund confirmations, as well as any information necessary to direct investors' attention to incentives that a broker may have to prefer the sale of one fund over another. Further, in light of regulators' discovery that brokers routinely fail to credit investors with commission breakpoints, see supra p. 16, Congress it should consider whether fund confirms should include a separate box that shows the breakpoint schedule and how it was applied to the purchase.

[55] In February 2000, the Commission conceded that current rules fail to require disclosure of payments received by brokers for recommending fund shares and stated that it had directed its staff to make recommendations on how to fix this problem. See Brief of the Securities and Exchange Commission, Amicus Curiae, in Donald Press v. Quick & Reilly, Inc. (2d Cir.)(Feb. 2000). Almost four years later, the Commission has taken no action to remedy this gap in fund disclosure. In a report issued by the Commission on June 9, 2003, the staff restated that it had been "directed . . . to make recommendations" but provided no indication that it was any closer to making recommendations than it was in early 2000. SEC Report at 80.

C. Portfolio Manager Compensation

Congress should require that the amount and structure of portfolio managers' compensation be disclosed ("portfolio manager" hereinafter includes the portfolio management team). In many cases, the frauds described above have involved the portfolio managers of the affected funds. No one stands in a stronger fiduciary relationship with a fund than the person responsible for the actual management of the fund's portfolio. Portfolio managers often have conflicts of interest, however, and these conflicts of interest may be specifically related to their compensation.

The SEC staff has noted that whether a portfolio manager's compensation turns on short-term or long-term, or pre-tax or after-tax performance may indicate whether the manager's and the shareholder's interests are aligned.[56] Whether a portfolio manager is compensated for services provided to other mutual funds or other fund or non-fund clients, or for providing other outside services generally, also is highly relevant to shareholders who wish to evaluate the manager's commitment to a fund and the presence of conflicts of interest that the manager may have as a result of outside duties.[57] Disclosure of portfolio managers' compensation will cause fund managers to minimize such conflicts and enable shareholders to judge for themselves whether portfolio managers' are aligned with their interests.

---

[56] SEC Report at 43.

[57] See Remarks by Paul Roye, Director, Division of Investment Management, before the ALI/ABA Investment Company Regulation and Compliance Conference (June 14, 2001)("As many mutual fund managers look to generate revenues by expanding into other areas of the investment management business such as offering private accounts or sponsoring and advising hedge funds and other alternative investment vehicles, they should be mindful that certain of these new opportunities raise conflict of interest issues and the potential for abuse.").

Requiring disclosure of portfolio manager compensation is not a novel concept. Indeed, for years publicly held companies have been required to disclose the compensation of their highest paid executives. Many mutual fund managers have been exempt from this requirement because the managers' executives work for a separate entity from the fund that is not publicly held. Nonetheless, the policies favoring disclosure of executive compensation by operating companies apply equally to mutual funds.

Executive compensation rules need to be adapted, however, to reflect the particular structure of mutual funds. Mutual funds typically do not pay their executives, as these executives are employed and compensated by funds' managers. In addition, the manager's highest paid executives usually are not the personnel who have the greatest impact on the fund's performance. Thus, the executive compensation most relevant to mutual fund shareholders is that compensation received by the fund's portfolio manager or portfolio management team.