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Before the
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U.S. Senate Committee on Governmental Affairs

Mutual Funds: Trading Practices and Abuses that Harm Investors

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I am Bill Galvin, Secretary of State and Chief Securities Regulator of Massachusetts. I want to commend Senators Fitzgerald and Akaka for calling today's hearing to examine mutual fund abuses.

Mutual funds play a major role in the wealth and savings of our nation. Today, half of all American households have invested nearly $7 trillion in mutual funds. But mutual funds are about more than money under management. Mutual funds are about the hopes and dreams of middle-income Americans – the hopes of a financially secure and dignified retirement; the dream of a college education for a child. Mutual funds are where America's dreams are invested.

With the decline of interest rates paid on savings, mutual funds have in many instances become the substitute bank of necessity for middle income Americans seeking a reasonable return on their savings.

Investors have placed their trust in mutual funds with the understanding that they would be treated fairly – and the risk of the market would be offset by the skill and commitment of the fund managers.

We are here today because in too many instances the mutual fund industry has failed to live up to its duty. The common theme running through all of the mutual fund issues that we have exposed in recent months is that the mutual fund industry is putting its own interest ahead of their customers – while they market trust and competence too often they have only delivered deceit and underperformance.

We are also here today because self policing and government laws and law enforcement have also failed to effectively protect the investor. The evidence that self policing has failed is in the willingness of the entire industry to quietly tolerate known market abuses while they parse words trying to describe clearly unethical practices as not illegal, their past silence has convicted them of ineffectiveness.

Government laws and law enforcement have failed because they have failed in the past to aggressively and promptly enforce the law. For too long a culture of compromise and accommodation has overwhelmed enforcement efforts. Too often the guilty neither admit or deny any wrongdoing and routinely promise not to cheat again until they can come up with a more clever method to do what they just said they would not do again.

For too long while the merry-go-round of accusations and non-admission go round and round, investors have been the losers.

It has taken the coincidence of dramatic and tragic recent investor losses and aggressive and state enforcement by people like Attorney General Spitzer and myself to convert investor outrage to a call for action.

All mutual fund investors should have an equal opportunity for profit and an equal opportunity for risk. Mutual funds should be precisely that – mutual. Unfortunatley, that is not the case. My investigation has revealed that special opportunities exist for certain mutual fund investors at the expense of the vast majority.

Several months ago my office launched an investigation into mutual fund trading practices. The Enforcement Section of the Massachusetts Securities Division has filed an administrative complaint against Putnam Investment Management, Inc. and two of its employees for violating the anti-fraud provisions of the Massachusetts Uniform Securities Act.

Our investigation found that, in effect, two classes of investors existed at Putnam. The first class were the connected investors – those privileged insiders who were able to skim the funds through a legal trading activity known as "market-timing." The second class were the average investors who placed their trust in Putnam to follow its own policies, including the policy against market timing.

We have uncovered an unsettling pattern of personal deceit, breach of duty, breach of trust and corporate deceit at Putnam Investments, the nations' fifth-largest mutual fund company. It is troubling when you have an industry like this that has spent so much time building the trust of its investors, and then this company failed to honor that trust and ignored it over a period of years. That makes the actions we uncovered at Putnam all the more grievous.

Mutual funds are traditionally designed to be long-term investments for buy and hold investors and are the favored investments for the retirement plans of working Americans. Certain investors, however, have attempted to use mutual funds to generate quick profits by rapidly trading in and out of certain mutual funds. Typically, these so called "market timers" seek to capitalize on stale fund prices, often focusing on price discrepancies involving international funds.

Market timers take advantage of price inequities, but do so at the expense and to the detriment of long-term shareholders. Mutual fund advisers have a fiduciary duty to treat all shareholders equitably. This obligation would preclude granting one group of shareholders (*i.e.*, market timers) privileges and rights not granted to all shareholders (*i.e.*, long-term investors). In addition, when a fund's prospectus disclosure indicates that the fund management will act to limit market timing, it cannot knowingly permit such activities.

Boston-based Putnam Investments is an investment adviser that offers and sells proprietary mutual funds to institutions and individuals. Putnam also acts as the administrator for defined contribution plans, such as 401(k) plans, and offers plan participants a choice of Putnam mutual funds in which to invest their retirement savings. In return for providing these services, Putnam receives a management fee and its funds benefit from the influx of large amounts of plan assets.

The investigation by Massachusetts securities regulators found that Putnam administered the retirement plan of the Boilermakers Local Lodge No. 5 of

New York. Despite prospectus disclosures that indicated market timing would not be tolerated, from at least January 2000 to September 2003 participants in the Boilermakers' retirement plan were permitted to market time Putnam international and other mutual funds.

By market timing, at least 28 Boilermaker plan participants made anywhere from 150-500 trades over a three-year period. At least one individual made $1 million in a retirement account over a three-year period by market timing the Putnam International Voyager Fund ("Voyager Fund"). During that same time period, the total trading volume in and out of the Voyager Fund amounted to approximately half a billion dollars. Each individual profited from over $100,000 to over $1 million in the three-year period.

One Putnam employee stated that the trading activity of the Boilermakers was so prolific that 3 to 4 p.m. was known as "boilermaker hour" within Putnam's Norwood, Massachusetts, office.

The mutual fund prospectus for the Voyager Fund and other Putnam mutual funds created the misleading impression that Putnam would not tolerate excessive exchange activity or market timing. As recognized in the prospectus, this market timing policy was to protect long-term investors from the negative effects of excessive trading, including but not limited to: dilution of share value, negative tax consequences, increased transaction costs, and loss of fund investment opportunities. Unbeknownst to long-term shareholders, Putnam allowed certain mutual fund shareholders, such as the Boilermakers, to engage in market timing activity in direct contradiction to the prospectus disclosure.

The Voyager Fund prospectus also clearly stated that Putnam fund management has the authority to reject market timing trades. For the sake of retaining plan assets invested in Putnam mutual funds and in order to secure future business, Putnam failed to reject short-term trades and permitted certain shareholders, such as the Boilermakers, to market time their international mutual funds. By permitting market timing activity by

certain plan participants, Putnam effectively allowed these customers to capture a portion of the fund's gains from the long-term shareholders within the fund.

Not only did Putnam permit certain plan participants to market time in their international funds, but also even more outrageous — allowed the fund's own managers to market time Putnam funds. At least six Putnam fund managers engaged in market timing, four of whom were timing in international funds they actually oversaw as part of a team of investment managers.

What makes this case so egregious is that Putnam executives knew the firm's policies were being violated. Not only did they conceal this violation, but they joined in and engaged in what can only be called corporate deceit.

Since 1998, Putnam knew that at least two employees had been market timing Putnam funds for which they acted as fund managers. Despite this knowledge, for two years Putnam turned a blind eye and failed to take any remedial action to stop market-timing trades. In early 2000, for example, Putnam merely cautioned two fund managers about moving fund balances and discouraged future market timing. Remarkably, the fund managers were allowed to retain personal profits already gained and were permitted to continue to manage the funds.

Not surprisingly, Putnam's ineffectual warnings were no more than an internal slap on the wrist and did nothing to deter market-timing activity by its employees. Both employees continued to market time Putnam funds. In fact, for three years Putnam overlooked market-timing activity by its own fund managers and took no action until late 2003, ironically following state and federal regulatory inquiries.

Market timing activity by Putnam fund managers amounts to a blatant violation of the manager's fiduciary duty to protect the interests of all of the fund's shareholders. Moreover, the fund manager's market timing activity is a flagrant violation of the fund's prospectus disclosure, which states that Putnam management will police and prevent

rapid short term trading. Such trading activity and practices is fraud under the Massachusetts Uniform Securities Act.

While today's headlines are filled with mutual fund jargon such as "market timing" and "late trading", the simple point is that people are being cheated.

The Putnam case is not an isolated example of this double standard. In fact, mutual funds now have an established history of putting their concerns over those of their customers. In August, for instance, my office charged Morgan Stanley with violations of Massachusetts anti-fraud laws by offering cash prizes and other incentives to encourage brokers to sell Morgan Stanley mutual funds to investors creating a high-pressure sales culture. My office found that Morgan Stanley brokers competed in contests to sell certain Morgan Stanley owned and affiliated mutual funds, for which they received higher commissions than other funds. The contests and higher commissions were not disclosed to investors – material omissions that constitute fraud under the Massachusetts Securities Act.

These enforcement actions are only two examples of the deep problems in the industry. Mutual funds violate investor trust in a number of ways:

- when mutual funds allow marketing timing for their employees;
- when mutual funds allow market timing for certain outside investors, perhaps as an incentive to generate or retain business;
- when mutual funds allow late-trading in a fund's shares;
- when mutual funds pay higher commissions to brokers or offer other incentives to sell proprietary, or in-house, funds to investors rather than funds that may be more suitable to an investor's needs; and
- when breakpoint discounts are ignored or concealed.

State securities regulators are often first to identify investment-related problems and to bring enforcement actions to halt and remedy these problems. Any suggestion that

state regulators have hindered federal enforcement of securities laws is completely false. Any effort to restrict or preempt state enforcement must be called what it clearly is – anti investor.

HR 2420 is a positive response to some of the many problems investors in mutual funds now face. And I endorse its objectives. This bill can be improved however. The original language of section 1, regarding fund operating expenses should be restored. Each individual investor should be notified of the actual costs they are paying and instead of disclosing soft dollar costs – they should be banned.

Prompt passage of this bill is important to bring the regulation of mutual funds to the level of regulation that their role in our financial system demands. But laws alone are not enough – they must be vigorously enforced.

I again want to commend the Subcommittee for focusing attention on this situation. With strengthened laws and vigorous enforcement we can give our nation's investors the fairness and honesty they seek and the protection they deserve.

Thank you.