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The Investment Company Act requires that mutual funds be organized, operated and managed in the interests of the funds' shareholders and not the funds' directors, officers and investment advisors. Despite that express instruction, too many funds have abandoned the interests of their shareholders and instead permitted and indeed fostered an environment that promotes the interests of their managers at the expense of their shareholders.

It has been only two months since my office announced its settlement with Canary Partners. Our investigation into Canary's investment practices revealed that some of the nation's largest mutual fund companies permitted hedge funds to take advantage of after-market information by buying and selling mutual fund shares at the Net Asset Value that had been set earlier that day when the markets closed. That practice, which is known as "late trading," is illegal.

Hedge funds were also permitted to engage in "market timing" activities. "Market timing" permits a trader to take advantage of market information that develops during the lag between the last quoted price for securities held by the mutual fund and the time the funds' Net Asset Value is set. Permitting market timing is contrary to the interests of a funds' long-term investors. As the Financial Analysts Journal observed last summer: "Because the gains [of market timers] are offset by losses to other investors in the fund, the funds clearly have a fiduciary duty to take some preventive action. All the gains are being offset, dollar-for-dollar, by losses incurred by buy-and-hold investors."

Indeed, mutual funds recognize that market timing works to the detriment of funds' long-term shareholders, which is why their prospectuses convey to shareholders the impression that market timing is not permitted. Despite these assurances and the requirements of the Investment Company Act, the funds ignored their promises to -- and the interests of -- their shareholders, and market timing was widespread.

More recently, we have learned that many fund insiders themselves engaged in market timing and late trading activities, directly profiting at the expense of the long-term investors in their funds. This tension – between the interests of the fund managers and those of its investors – is nothing new.

It was evident more than thirty-five years ago, when the Senate was considering legislation affecting the mutual fund industry. This is how Nobel Prize laureate Professor Paul Samuelson explained how the interests of shareholder and managers had diverged:

> I decided that there was only one place to make money in the mutual fund business -- as there is only one place for a temperate man to be in a saloon, behind the bar and not in front of the bar. So I invested in a [mutual fund] management company.

Today, matters have only gotten worse. The extent to which the mutual fund industry has come to devalue shareholder interests was highlighted last year by its vigorous opposition to a proposal that would have required them to report to their shareholders how they voted their proxies. The industry argued that providing the information would cost too much and return little value to shareholders. The refusal to provide even this minimal level of transparency provides us with an important perspective into the industry's thinking. When managers object to informing shareholders how they voted their shares, something is truly wrong.

As the investigations continue, it is important for us to focus not only on what happened but also on why it happened. As more details emerge, I believe that it will become clear that a large part of the problem – and thus an issue that must necessarily be addressed when formulating solutions – is the conflict of interest facing mutual fund directors.

Mutual funds are owned by their shareholders and are led by a board of directors. But the funds tend not to have any employees, instead contracting out for advisory, management, marketing and investment services. Funds that manage tens of billions of dollars operate without a single, full-time employee. The directors are supposed to be the stewards of their shareholders' investments, but too often act at the behest of the advisory and management companies that run the funds' day-to-day operations.

Mutual fund directors are supposed to negotiate lower fees for their shareholders, but there is little evidence of that. And they are even less likely to replace the advisors managing the fund. After all, the Chairman of the fund's Board of Directors is almost always affiliated with the management company. And fund directors sometimes serve on dozens or more fund boards simultaneously – often joining the fund board after retiring from a job at the management company.

In fact, there are some striking parallels between our investigation into the mutual fund industry and our earlier probe of Wall Street analysts.

Some Wall Street analysts ignored their duty to investors by instead giving priority to the interest of their investment banking colleagues. Some mutual fund directors ignore their duty to shareholders by instead giving priority to the interests of the fund advisors and managers.

Wall Street analysts rarely if ever issued a "sell" recommendation, because that would be contrary to the interests of the bankers. Mutual fund directors rarely if ever negotiated lower fees or changed advisors, because that would be contrary to the interests of the fund advisors and managers.

Why did analysts behave the way they did? Because of conflicts of interest, with their compensation often being tied to investment banking business. Why do mutual fund directors act the way they do? Because of conflicts of interest -- the Board chairman is almost always affiliated with the management company, and board members too often have personal and professional ties to the fund advisors and managers.

Some will say that I am being too tough on the mutual fund directors and demand to see evidence of their dereliction of duty. Exhibit A is obviously last week's revelation about the Strong funds. But even beyond that case of gross malfeasance, there was evidence available to fund directors that something was terribly wrong at their funds. Here's why directors were on notice that their funds were being mismanaged:

Fund directors could and should have suspected that their funds were permitting market timing by simply comparing the fund's average net assets -- the amount, on average, that a fund's shareholders have invested in a fund, with the fund's total redemptions -- the amount that the fund paid out to shareholders cashing out their shares. Since most fund shareholders are relatively long-term investors, total redemptions are on average a <u>percentage</u> of its net average assets. A red flag should therefore have been raised if a fund's total redemptions are <u>several times</u> its average net assets. While not the only possible explanation, it strongly suggests that the fund is permitting rapid-fire, in-and-out market timing and trading.

While they had this information available to them, fund directors apparently didn't act on it. For example, at least several of the funds in the Alger family of funds exhibited total redemptions that were many, many times the funds' average net assets – in one case, redemptions totaled more than <u>17 times</u> the funds' net average assets. And yet the directors didn't ask any questions. The same was true at some of the other funds that permitted Canary to engage in market timing.

A red flag should also be raised when there is a very close correlation between a fund's total sales and total redemptions. Since market timers cycle large amounts of money in and out of the funds they are timing, those funds are likely to report that total sales - which represents money flowing into the fund, and total redemptions - which represents money flowing out of the fund, are close to equal. At a minimum, directors who were doing their jobs would give a fund that has an almost 1:1 ratio of sales to redemptions some added scrutiny. Yet sales and redemptions were almost equal in several Alger funds during 2002, and nobody thought to ask why this was so.

Frankly, it wasn't even necessary to analyze financial data to know that there was a market timing problem. The market timers were so brazen about what they were doing, and so unconcerned that the mutual funds would put a stop to a practice that cost their long-term investors an enormous amount of money, that they openly advertised the fact that they were engaged in market-timing. In fact, a study published by four N.Y.U. professors in the summer of 2002 noted that they "know of at least 16 hedge fund companies covering 30 specific funds whose stated strategy is 'mutual fund timing'."

Why didn't the publication of that study cause directors to closely examine whether their funds were permitting timing? Why didn't fund directors make the inquiries that could have protected their shareholders? Because the directors were beholden to the fund managers and advisors.

Permitting market timing and late trading were not the only examples of the failure of fund directors to protect their shareholders' interests. Perhaps most costly to shareholders is the directors' total abdication of any meaningful effort to negotiate lower advisory and management fees. In 2002, it is estimated that mutual funds paid advisory fees of more than <u>$50 billion</u> and other management fees of nearly <u>$20 billion</u>. That does not even include the tens of billions that the funds spend on trading costs – costs that are no doubt significantly increased by the heavy trading of market timers.

And the fees paid by the mutual funds – or, more precisely, the fees that are paid by mutual fund shareholders -- seem to defy the laws of economics. As my good friend Jack Bogle has pointed out, mutual fund shareholders do not benefit from the economies of scale in the industry: mutual fund assets grew by <u>sixty times</u> between 1980 and 2000, but the funds' fees and expenses grew by <u>ninety times</u> during that same period.

Studies have revealed the extent to which mutual fund investors pay advisory fees that are simply too high -- too high because the fund directors are compromised and do not negotiate hard for their shareholders. A study published in 2001 exposed the fact that mutual funds pay significantly higher advisory fees than pension funds. Mutual funds often pay more than 25 basis points more for advisory services than pension funds pay, even when it is the same advisory company providing the identical advisory service to both the pension and mutual funds.

Why the higher fee? Because fund directors do not -- and can not -- negotiate hard on the fees. Why not? What else would you expect when the chairman of the mutual fund is also the chairman of the advisory company?

And make no mistake about it, 25 basis points matters. A couple that invested their $100,000 retirement nest egg for ten years and received an 8% annual return would receive an increase of almost <u>$6,000</u> if their advisory fees were reduced by 25 basis points.

<u>A 25 basis point reduction in the advisory fees that all mutual fund shareholders pay would result in a staggering savings to investors of more than $10 billion annually!</u>

The fact is that in no other industry would a board of directors be permitted to issue billions of dollars in no-bid contracts annually. Yet that is par for the course in the mutual fund industry, where the fund directors essentially contract out for all of the fund's operations. We must not permit this to continue.

Mutual funds that permitted improper market timing and illegal late trading must be required to provide restitution to their investors and to disgorge all profits that they earned in connection with those activities. The managers also must disgorge the advisory fees received during the time that they were mismanaging the funds by permitting timing and late trading.

In addition, as with our investigation of conflicts in Wall Street research, any resolution of the inquiries into the mutual fund industry must require structural reforms that will realign the interests of the funds with the interests of their shareholders.

We must require mutual funds to maintain truly independent boards of directors -- with an independent chairman -- that take an active role in overseeing the <u>trillions of dollars</u> that shareholders have entrusted with them. The boards can begin to demonstrate that they have earned that trust by negotiating hard for lower fees from the advisory and management companies. The managers must know that if they do not lower their fees and improve their performance, they will be replaced. That is what happens in every other sector of the economy, and that is what must happen in the <u>$7 trillion</u> mutual fund industry.

While this is by no means an exhaustive list, some of the steps necessary to achieve these reforms are:

1. Requiring mutual funds to demonstrate that they have negotiated advisory and management fees that are in the best interest of their shareholders. This can be done by obtaining multiple bids, an independent evaluation or appraisal, or by some other means that ensures that shareholders are getting the best deal possible.

2. Requiring mutual funds to obtain most-favored nations clauses in their contracts. This will prevent advisory and management companies from charging them fees in excess of those paid by pension funds.

3. Requiring mutual funds to have an independent Board chairman with no relationship to the advisory and management company, and providing that chairman with the authority and ability to demand and receive any and all information from the fund advisory and management company.

4. Requiring independent directors to be truly independent of the advisory and management company.

5. Requiring mutual funds to provide their directors with the staff and data necessary to ensure that shareholder interests are being protected. This may require moving the compliance function from the management companies to the mutual funds themselves.

6. Requiring mutual funds to provide a uniform, complete and categorized disclosure of the fees that they pay for advisory services, management and marketing services, and trading costs.

These reforms would begin the process of restoring the rights and interests of shareholders and vindicating the Investment Company Act's promise to shareholders that mutual funds will be organized, operated and managed in the interests of the funds' shareholders and not the funds' directors, officers and investment advisors.

They can be achieved in a variety of ways – through legislation in Congress, regulation by the S.E.C. or other regulatory bodies, or as the terms of a settlement of current and future investigations. Our investigations are continuing, and we may turn up other abuses as well. Questions have already been raised about 12b-1 fees, soft dollar transactions, and undisclosed financial incentives for brokers to sell particular funds and particular classes of shares to investors. Some of these issues are addressed in H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act.

The S.E.C. enforcement staff does a terrific job. They are aggressive, tough, smart prosecutors. I remain committed to working together with them and others as we continue our investigations and think about solutions. But there must be a fundamental change of mindset that invigorates those who formulate policy and regulations at the S.E.C. to more actively and aggressively prevent mutual funds from acting against their shareholders' interests.

All of us here today -- lawmakers, regulators and industry officials -- have a duty to make sure that happens.