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SENATE BANKING COMMITTEE HOLDS THREE MORE HEARINGS ON MUTUAL FUNDS

[17180] March 5, 2004 TO: BOARD OF GOVERNORS No. 19-04 CLOSED-END INVESTMENT COMPANY MEMBERS No. 14-04 FEDERAL LEGISLATION MEMBERS No. 7-04 INVESTMENT COMPANY DIRECTORS No. 11-04 PRIMARY CONTACTS - MEMBER COMPLEX No. 23-04 PUBLIC COMMUNICATIONS COMMITTEE No. 12-04 SEC RULES MEMBERS No. 36-04 SMALL FUNDS MEMBERS No. 29-04 UNIT INVESTMENT TRUST MEMBERS No. 10-04 RE: SENATE BANKING COMMITTEE HOLDS THREE MORE HEARINGS ON MUTUAL FUNDS The Senate Banking Committee has held three additional hearings in its series of hearings on the current investigations and regulatory actions regarding the mutual fund industry.1 The written testimony of the witnesses appearing at the hearings is summarized below. I. February 25th Hearing: Understanding the Fund Industry from the Investor's Perspective The witnesses testifying at the hearing were: Tim Berry, Indiana State Treasurer and President, National Association of State Treasurers; Gary Gensler, former Undersecretary of the Treasury for Domestic Finance and co-author of The Great Mutual Fund Trap; James K. Glassman, Resident Fellow, American Enterprise Institute; Don Phillips, Managing Director, Morningstar, Inc.; and James S. Riepe, Vice Chairman, T. Rowe Price Group, Inc.2 1 For a summary of the written testimony from the Committee's first hearing, see Institute Memorandum to Board of Governors No. 63-03, Closed-End Investment Company Members No. 94-03, Federal Legislation Members No. 24-03, Investment Company Directors No. 19-03, Primary Contacts – Member Complex No. 102-03, Public Information Committee No. 40-03, SEC Rules Members No. 159-03, Small Funds Members No. 68-03, and Unit Investment Trust Members No. 43-03 [16788], dated Nov. 20, 2003. 2 The written testimony provided by these witnesses is available on the Committee's website at http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=84. 2 Testimony of Mr. Berry Mr. Berry testified that state treasurers, in their oversight of state investments and as fiduciaries of state and local government pension plans, have a direct stake in issues raised by mutual fund trading and sales practices. He offered his view that recent rulemaking initiatives by the Securities and Exchange Commission will go a long way toward rectifying many of the abuses that have been identified in recent investigations and that the mutual fund industry does not need a wholly new set of operational rules or new oversight groups. Mr. Berry also described how state treasurers have pressed for changes in the way that mutual funds operate, stating that the fundamental goal of these efforts has been to ensure that mutual funds provide timely and accurate information about costs and fees, performance, and potential risks. Mr. Berry recommended that Congress act promptly to eliminate the current disclosure gap with respect to revenue sharing arrangements and other incentives provided by mutual funds to brokers selling their shares. While

acknowledging that the SEC is considering possible reforms in this area, he called on Congress to require confirmation statement disclosure of all compensation received by brokers in connection with sales of fund shares. Mr. Berry further recommended that Congress address the scope and adequacy of financial literacy training in the United States, noting that many citizens lack the basic skills needed to manage their financial affairs. Testimony of Mr. Gensler Mr. Gensler began by stating that the recent mutual fund scandals have revealed the need for substantive reform regarding how mutual funds are governed and operated. He offered a wide-ranging critique of mutual funds, including that fund directors serve on a part- time basis, are unlikely to "make waves" because they are recruited by advisers, and rely solely on the adviser for information. He also offered several reasons for the failure of the market to provide better protection for fund investors, including: (1) the effectiveness of mutual fund advertising in encouraging investors to chase recent performance, which he called a losing strategy; and (2) mutual fund costs are "practically invisible" because they are deducted from monthly returns. Mr. Gensler stated that although the SEC is pursuing an active reform agenda, Congress should give serious consideration to: (1) strengthening fund governance (e.g., require 75% independent directors and an independent chair for all fund boards); (2) restricting payments of soft dollars and Rule 12b-1 fees; (3) enhancing fund disclosure of transaction costs and revenue sharing arrangements; and (4) endorsing or enhancing the SEC's actions on certain issues raised by the recent scandals (e.g., "hard 4:00 pm" close to address late trading). He stated that the most important step Congress could take in promoting reform would be to codify "the duties which independent directors hold to investors and tighten the standards to which they will be held" (e.g., amend the Investment Company Act of 1940 to include a fiduciary duty for directors, revise or repeal the Gartenberg standard for review of advisory fees. 3 Testimony of Mr. Glassman Mr. Glassman testified that, while steps need to be taken to ensure that some investors do not exploit stale pricing at the expense of others, the mutual fund industry is basically sound. Of greater worry to him is that policymakers could limit choices and raise costs for small investors by rushing to increase regulations in areas such as fees, board composition, and disclosure. Mr. Glassman suggested that policymakers could perform a more useful service by using the bully pulpit to condemn firms who abuse their clients' trust and laud those that act responsibly. He pointed to recent outflows of assets from firms facing allegations of impropriety as proof that investors can exact a greater degree of discipline from fund firms than can regulators. With respect to fees and expenses, Mr. Glassman testified that despite clear disclosures of fees and the best efforts of regulators, commentators, and others, many (if not most) investors do not know the fees that their funds charge. He stated that investors are simply more interested in returns and that no amount of disclosure will change that fact. He also criticized the SEC's proposed disclosure requirements concerning broker incentives and conflicts in selling mutual fund shares, stating that they are so complicated as to be unusable. Mr. Glassman concluded his testimony by stating that policymakers should instead focus on investor education, calling it the most important step for improving fund governance and helping small investors. Testimony of Mr. Phillips Mr. Phillips testified that mutual funds have a proud history but that the recent scandals have badly damaged the industry's credibility. He stated that investors need assurances that: (1) mutual funds operate on a level playing field; (2) checks and balances exist to safeguard investor interests; (3) adequate information will be available to allow investors or their advisers to make intelligent decisions about their funds; and (4) mutual funds represent good value. Mr. Phillips recommended 10 steps that legislators, regulators, and industry leaders could take to ensure that mutual funds meet their obligations to the investing public. These steps include: (1) defining what constitutes abusive market timing and taking meaningful steps to eliminate it; (2) eliminating soft dollar and directed brokerage arrangements and providing better disclosure of "pay-to-

play” arrangements; (3) eliminating or seriously reconsidering the role of Rule 12b-1 fees, so that payments to selling brokers and fund supermarkets are made directly and not through a fund’s expense ratio; (4) making fund directors more visible and accountable to shareholders; and (5) requiring dollar disclosure of actual fund costs. Testimony of Mr. Riepe Mr. Riepe began his testimony by stating that T. Rowe Price operates its mutual fund business in accordance with the fundamental principle that the interests of its fund shareholders are paramount and, as a result, his firm has been deeply dismayed by the recent revelations of abusive mutual fund trading practices. He expressed support for regulators’ forceful responses to these practices and for the SEC’s efforts otherwise to strengthen mutual fund regulation, including: (1) a “hard 4:00 pm” close (although Mr. Riepe added that an electronic trade monitoring process should soon be developed that would permit trades to be accepted from intermediaries post-closing); (2) various measures to address abusive market timing; and (3) a 4 ban on directed brokerage arrangements. He also stated that the SEC has begun a “prudent and timely reevaluation” of Rule 12b-1. Mr. Riepe stated that the recent disturbing revelations do not evidence a failure of the fund governance system, but they do indicate that fund directors would benefit from additional tools to assist them in serving effectively in their oversight role. He further cautioned that certain proposals to “improve” fund governance, such as mandating that all fund boards have an independent chair and requiring independent directors to make certifications relating to matters outside the scope of what they could reasonably be expected to know, are unwarranted, unrelated to the abuses that have been revealed, and counterproductive. Mr. Riepe also acknowledged that the challenge of restoring and maintaining investor trust falls not on regulators but on the fund industry itself. He outlined the various steps that T. Rowe Price has taken in this regard, including thorough reviews of its policies and practices, active involvement by the funds’ boards, and communications to educate fund shareholders about the alleged improprieties and T. Rowe Price’s efforts to protect them from these types of abuses. In closing, Mr. Riepe observed that the industry must take advantage of the current problems to make improvements that will guard against future breaches of trust and assure fund shareholders that their interests come first. II. February 26th Hearing: Fund Operations and Governance The witnesses testifying at the hearing were: John C. Bogle, Founder and Former Chief Executive, The Vanguard Group; Mellody Hobson, President, Ariel Capital Management, LLC; David S. Pottruck, Chief Executive Officer, The Charles Schwab Corporation; and David S. Ruder, former SEC Chairman and Professor, Northwestern University School of Law.3 Testimony of Mr. Bogle Mr. Bogle testified that it is time to “rebalance the scale on which the respective interests of fund managers and fund shareholders are weighed.” He stated that in order to tilt the scale so that a preponderance of the weight is on the side of shareholders, Congress must mandate that a fund board has: (1) an independent chair; (2) no more than one interested director; (3) a staff or independent consultant that provides objective information to the board; and (4) a fiduciary duty to assure that funds are organized, operated, and managed in the interests of their shareholders. Mr. Bogle also called for better information for fund investors, including: (1) annual statements showing the actual dollar amount of annualized fund expenses and portfolio transaction costs paid by each investor; (2) mandatory reporting of “dollar-weighted” investment returns; (3) complete disclosure of all compensation paid to fund executives; and (4) an express requirement that advisers provide, and fund directors consider, the amount and structure of fees paid to the adviser by institutional clients. Testimony of Ms. Hobson Ms. Hobson began by describing her firm and reminding the Committee that small mutual fund companies like Ariel are the norm in the industry, rather than the exception. She 3 The written testimony provided by these witnesses is available on the Committee’s website at http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=85. 5 stated

that, despite her profound disappointment about the abuses that have occurred, she still takes enormous pride in being part of the mutual fund industry. She also expressed her belief that most mutual fund companies do not ignore their fiduciary obligations, have not lost their connection to their customers, and have not abandoned the basic principles of sound investment management. On the issue of Rule 12b-1, Ms. Hobson stressed the importance of Rule 12b-1 fees in providing small fund companies with access to broad distribution channels. With regard to fund fees, Ms. Hobson rebutted claims that such fees are excessive when compared to management fees paid by institutional investors, and she emphasized that research by the SEC, the General Accounting Office, and the Institute has concluded that total costs to fund shareholders have in fact declined. She noted that the fee table appearing in fund prospectuses was redesigned in 1998 with extensive input from focus groups on how to make it as accessible and useful as possible, and that the SEC has testified before Congress that the fee table provides an extremely useful and accurate way to compare fees among competing funds. On the issue of fund governance, Ms. Hobson said that although the Ariel board has an independent chair, she believes such a designation is “irrelevant” because independent directors already make the major decisions for the funds they oversee. As to addressing problems through more disclosure, she said that approach could impede rather than enhance decision-making by investors. She noted that when the SEC reformed fund prospectuses in 1998, it urged great caution about adding new disclosure requirements because too much information discourages investors from further reading or obscures essential fund information. Finally, Ms. Hobson urged the Committee to: (1) concentrate a considerable part of its efforts on how to clarify and increase understanding of the critical information already disclosed to investors; (2) not permit heightened mutual fund oversight to erode the competitive position of small firms; and (2) be mindful that if regulatory burdens on mutual funds increase too much, companies may find it more attractive to market less regulated investment products and services. Testimony of Mr. Pottruck Mr. Pottruck testified that mutual fund supermarkets have revolutionized investing for millions of Americans, helping the fund industry to remain extraordinarily competitive and supporting the existence of funds managed by small companies. He argued that fund supermarkets are an indispensable tool that must be preserved and strengthened – not weakened by reform proposals, no matter how well intentioned. Mr. Pottruck stated that Schwab fully supports many of the reforms undertaken by the SEC, but he expressed concern about the proposal to require that each fund board have an independent chair. He also stated that individualized fee disclosure would be enormously expensive and would not facilitate the type of comparisons among funds that investors need. Much of Mr. Pottruck’s testimony focused on the SEC’s proposal for a “hard 4:00 p.m.” close. He stated that the proposal would do nothing to increase transparency, minimize conflicts, or maximize convenience for investors, but that it would undermine the goal of competition and deprive investors of choice. Instead, he stated that Schwab’s “Smart 4” solution, which the testimony discusses in detail, would crack down on late trading without disadvantaging different groups of investors. The “Smart 4” solution would allow a fund 6 intermediary to submit fund orders after the market close, provided that the intermediary adopts several specific protections to prevent late trading. Testimony of Mr. Ruder Mr. Ruder testified that the most important way to increase protections for mutual fund investors is to enhance the power of independent directors and to motivate them to perform their duties responsibly. He recommended several governance reforms, including that: (1) at least 75% of a fund’s board and its chair be independent; (2) fund complexes be required or urged to adopt a board committee structure that would include nominating, audit, and compliance committees composed entirely of independent directors; and (3) authorizing independent directors to hire independent consultants and/or staff. He described as unnecessary proposals to require certifications by fund directors or the

establishment of a mutual fund oversight board. Mr. Ruder urged Congress to proceed cautiously with any mutual fund reform legislation, noting the SEC's expertise in dealing with the industry's complexities and the fact that the agency is using its rulemaking and enforcement powers to remedy industry problems. He did call, however, for legislation to repeal the soft dollar safe harbor in Section 28(e) of the Securities Exchange Act of 1934, and he said that the SEC should deal with soft dollar payments by rule. With regard to advisory fees, he recognized that directors could be more active in attempting to reduce such fees but he strongly rejected any government interference in setting fee levels. Rather, Mr. Ruder said, the proper way to achieve better control over advisory fees is through fund governance reforms, director education, and increased disclosure regarding the fee setting process. III. March 2nd Hearing (first panel): Fund Operations and Governance Testifying on the hearing's first panel, which focused on fund operations and governance, were: William Armstrong, former U.S. Senator and Independent Chairman, Oppenheimer Funds; Vanessa C.L. Chang, Independent Director, New Perspective Fund (member of the American Funds family); Marvin L. Mann, Independent Chairman, The Fidelity Funds; and Michael S. Miller, Managing Director, The Vanguard Group.4 Testimony of Mr. Armstrong Mr. Armstrong testified that "we ought to throw the book" at executives in the mutual fund industry who have violated shareholder trust, but he urged Congress to go slow in considering new requirements that could end up costing shareholders more than the abuses they were meant to correct. He likewise cautioned that the SEC is the appropriate agency to 4 A second panel addressed the SEC's proposed "hard 4:00 p.m." close and possible alternatives to prevent late trading. Appearing on that panel were: Anne E. Bergin, Managing Director, National Securities Clearing Corporation; William A. Bridy, President, Financial Data Services, Inc. (a wholly-owed subsidiary of Merrill Lynch & Co.), on behalf of the Securities Industry Association; Raymond K. McCulloch, Executive Vice President, BB&T Trust, on behalf of the American Bankers Association; and David L. Wray, President, Profit Sharing/401(k) Council of America, on its own behalf and that of several other organizations. Their testimony is not summarized in this memo. The written testimony provided by witnesses from both panels is available on the Committee's website at http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=95. 7 oversee the fund industry and that Congress should increase SEC funding rather than establish a new mutual fund oversight board. Mr. Armstrong also suggested that consideration of many worthwhile proposals (e.g., the appointment of an independent board chair) might be better left to the discretion of fund boards and management. Mr. Armstrong offered his support for several reform proposals, including: (1) requiring a supermajority of independent directors on fund boards (although he noted that simultaneously tightening the definition of "interested director" could cause real problems for fund boards); (2) a "soft close" approach to prevent late trading, coupled with strict monitoring of intermediaries; and (3) enhanced disclosure in areas such as market timing and the structure of portfolio manager compensation. In contrast, he expressed his opposition to several other proposals, including: (1) requiring that each fund board include at least one financial expert; (2) imposing a fiduciary duty on directors to review soft dollar, revenue sharing, and directed brokerage arrangements; (3) requiring various certifications by independent directors or the board chair; and (4) mandating disclosure of the dollar amount of portfolio manager compensation. Testimony of Ms. Chang Ms. Chang testified that she is greatly dismayed by abuses in the mutual fund industry and, in particular, that some industry participants apparently chose to benefit themselves at the expense of fund investors. She stated that their behavior is contrary to her own experience with fund directors and advisory personnel, whom she has found to be smart, responsible, and outspoken. Ms. Chang described for the Committee both how funds operate and the role of independent directors, stating that it is important to understand each before evaluating proposals to reform fund governance. Ms.

Chang stated that some of the reforms that have been proposed would improve the fund governance system, while others threaten to add more cost and burdens on boards and fund shareholders without any benefit. She expressed support for, among other things: (1) broadening the definition of “interested person” to draw a clearer line between independent directors and persons with ties to the fund’s adviser or other service providers; (2) requiring 75% of a fund board to be independent; and (3) self-assessing annually the board’s performance. She spoke in opposition to proposals that would require: (1) every fund board to have an independent chair, a decision she said should be left to the board’s discretion; and (2) independent director certifications on a number of matters, which she said would badly confuse the oversight responsibilities of fund directors with the operating responsibilities of management. Ms. Chang concluded her testimony by asking the Committee, when it evaluates proposals relating to fund governance, to be mindful of the fact that the vast majority of independent fund directors take their responsibilities seriously. Testimony of Mr. Mann Mr. Mann testified that an engaged and well-functioning board of trustees is able to undertake the responsibility of overseeing a large number of funds and do the job well. He suggested that there are five general characteristics of such a board: (1) highly qualified and experienced trustees who have the disposition to act independently; (2) the ability to make the significant time commitment necessary to prepare for and fully participate in board meetings; 8 (3) the ability to exercise a strong voice in setting agendas for board and committee meetings; (4) access to information and resources (e.g., independent legal counsel, commitment by the adviser to keep the board fully informed); and (5) effective and flexible structures and processes, such as a well-defined committee structure. He remarked that such a board need not have an independent chair and, moreover, that the key structural component in assuring that independent trustees control the board is making sure that they constitute a substantial majority of the board, as the SEC has proposed. Mr. Mann also observed that funds within a complex share a substantial number of common elements (e.g., fair value pricing procedures, brokerage allocation processes) and that a well-functioning unified board can leverage its knowledge of the common elements and also resolve issues relating to those elements in a uniform way. Mr. Mann objected to imposing certification requirements on independent directors, saying that such requirements would: (1) not serve any practical purpose; (2) blur the line between the board’s oversight function and the day-to-day management and operation of the fund; and (3) have a chilling effect on the board’s ability to recruit and retain independent trustees. He also expressed his personal belief that the following reforms would improve the regulation of mutual funds and of the financial markets generally: (1) dollar disclosure in quarterly account statements of the fees and expenses that an investor actually paid on his or her investment (this requirement would apply to all types of investment vehicles and accounts); (2) repeal of the soft dollar safe harbor in Section 28(e) of the Exchange Act and regulatory action to require that mutual fund brokerage commissions reflect only execution costs; (3) a prohibition on the use of Rule 12b-1 payments as a substitute for sales loads, and the deduction of installment loads directly from shareholder accounts; (4) a prohibition on revenue sharing and other cash payments to intermediaries; and (5) an “unbundling” of fund fees so that a fund’s advisory fee represents only charges for portfolio management services, which would make it more directly comparable to the management fees paid by institutional investors. Testimony of Mr. Miller Mr. Miller’s testimony focused on the issue of joint management of mutual funds and other accounts and, in particular, on a proposal to prohibit an individual from managing both mutual funds and hedge funds. He stated that while Vanguard does not manage or offer hedge funds, it hires external investment advisers to provide portfolio management services to certain of its mutual funds. Mr. Miller observed that managing money for multiple clients is, and has always been, an inherent feature of a successful asset

management firm. He also observed that any firm managing mutual fund assets is required to be a registered investment adviser and – consistent with the Investment Advisers Act of 1940 and its fiduciary duties – should have substantive policies and procedures to help ensure that its investment professionals manage multiple accounts in the interest of all clients. Mr. Miller described a ban on side-by-side management as an extraordinary step that would disadvantage mutual fund shareholders and fail to protect them fully. Specifically, he stated that such a ban would: (1) force portfolio managers to choose between mutual funds and hedge funds, thereby reducing the pool of top investment professionals available to mutual fund investors; (2) negatively impact an investment firm's continuity and stability, which is a key factor in long-term investment success for the firm's clients, including mutual fund clients; and (3) fail to address potential conflicts that may arise with the management of accounts other than hedge funds. Mr. Miller suggested that a better approach would be to require mutual fund 9 directors to review and approve stringent procedures to address conflicts of interest and to review the adviser's performance under those procedures. He stated that enhanced compliance obligations, when combined with additional support for independent directors (e.g., providing independent directors with the authority to hire staff or other experts to help them fulfill their fiduciary duties) would sufficiently protect mutual fund investors from potential conflicts of interest present in the management of multiple accounts. Rachel H. Graham Assistant Counsel

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