Statement of
Representative Richard H. Baker
Hearing Before the Senate Governmental Affairs Committee:
Subcommittee on Financial Management, the Budget and International Security
"Mutual Funds: Trading Practices and Abuses That Harm Investors"
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Chairman Fitzgerald, Ranking Member Akaka, and members of the Subcommittee, I am very appreciative and honored to appear before you today. I want to applaud you, Chairman Fitzgerald, for holding this important hearing and for your exemplary leadership in the Senate on mutual fund regulation. As you know, ninety-five million Americans invest in mutual funds. Pooled investment products like mutual funds provide access to millions of Americans to our nation's stock markets. It is therefore imperative that all of us in Congress – both the House and Senate – seek to ensure that there is fairness and integrity in the mutual fund industry. Again, I commend the Chairman and Ranking Member for stepping up to this challenge on behalf of mutual fund investors. It is also my understanding that Senator Shelby, a member of this Subcommittee and the esteemed chairman of the Banking Committee, will be turning that Committee's focus toward these important issues later this month.

As chairman of the Capital Markets Subcommittee of the House Financial Services Committee, I held a hearing in March on the state of the mutual fund industry. This was many months before the major fund scandals were uncovered by the good work of New York Attorney General Eliot Spitzer and Massachusetts Secretary of State William Galvin. Regrettably, at the hearing we heard boastful testimony from the fund industry. Let me quote a representative statement – again this is a quote from an industry witness –

> "In these challenging times that we all face – where public confidence has been shaken and weak market performance continues – it is clear that investors have benefited from the stringent regulation of mutual funds. The disclosure and substantive regulatory requirements imposed upon mutual funds have enhanced competition and helped the industry avoid major scandal."[1]

I would expect that you will be receiving slightly different testimony from the industry today.

Perhaps the most critical component for healthy capital markets is investor confidence. Quite simply, if investors feel the game is rigged, they will avoid the playing field and park their money on the sidelines. Chairman Oxley and I have made investor protection the cornerstone of the House Financial Services

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[1] Testimony of Mr. Paul G. Haaga, Jr., Executive Vice President, Capital Research and Management Company, and Chairman, Investment Company Institute, *Hearing on Mutual Fund Industry Practices and Their Effect on Individual Investors Before the House Committee on Financial Services*, 108th Cong. 21 (Mar. 12, 2003).

Committee's agenda, and more specifically, the agenda of the Capital Markets Subcommittee. Our hearings on the conflicts that plagued the Wall Street analyst community were the first major examination – by any committee in any legislature – of that issue, and planted the seeds that would ultimately become the historic Sarbanes-Oxley legislation. Our investigation of accounting fraud and Wall Street practices, including IPO allocation abuses, predated the WorldCom scandal and the events that led to the global settlement between investment banks, the states, and the Securities and Exchange Commission ("SEC").

But while passage of Sarbanes-Oxley was an important event, it was only a first step. Earlier this year I introduced H.R. 2575, a bill to provide a new regulator for Fannie Mae and Freddie Mac. The introduction of this bill occurred before the full revelation of the problems at Freddie Mac and the recent accounting problems at Fannie Mae. Members of the Senate, specifically Senators Hagel, Sununu, and Dole, have shown exceptional leadership on this issue as well. I mention these legislative efforts not to convince the Members of this Subcommittee that I possess precognitive skills but to make an important point: history teaches us that it is not ideal and often unwise for Members of Congress to ignore early warning signs and wait for a major scandal to erupt before considering legislation. On June 11, 2003, I introduced H.R. 2420, the *Mutual Fund Integrity and Fee Transparency Act of 2003*. At that time, there were no major scandals in the fund industry and several Members questioned the need for legislation, one going so far as to suggest that "all of us are rushing around as part of a bucket brigade to put out sometimes phantom fires." Well, the recent disclosures involving egregious acts by fund executives and portfolio managers entrusted with investors' money have proven these fires to be quite real and, like any dangerous blaze, prone to spreading. It is now obvious that the problems within the industry are not isolated. Sadly, they appear to be widespread.

State and Federal Investigations of the Mutual Fund Industry

As you know, at the beginning of September, Attorney General Spitzer filed formal charges against a hedge fund, Canary Capital Partners ("Canary"), for engaging in improper trading arrangements with four mutual fund companies: Bank of America, Bank One, Janus Capital, and Strong Capital Management. The State of New York's complaint alleged that Canary established special relationships with the mutual fund companies to engage in improper late trading and market timing trading practices that allowed Canary to reap benefits at the expense of mutual fund investors. The complaint outlines Bank of America's effort to go as far as installing an electronic trading platform at Canary's office so the firm could conduct trades with a range of mutual funds after trading had closed for the day. Canary benefited from this arrangement by reaping up to $40 million in profits and Bank of America, in turn, earned substantial commissions from Canary's trades. Canary agreed to pay $40 million to settle the charges.

The allegations of mutual fund trading abuses were a shock to millions of Americans who invested in what was previously considered a reputable industry and had been assured by industry claims that, "[t]he extensive regulatory scheme that applies to mutual funds has been effective in protecting investors and helping the

industry avoid major scandal."[2] The investigation of Canary was the tip of the iceberg and the New York state investigation has since expanded to include other hedge funds, mutual funds, and financial management companies. Just last week investigators revealed that Richard Strong, the Chairman and Founder of Strong Funds – a man with a net worth of approximately $800 million – was engaged in market timing of mutual funds managed by his firm and profited $600,000 over several years. In addition, there is evidence that some fund managers have been aware of irregular trading practices at mutual funds. These revelations are particularly appalling because it shows company executives and fund managers are turning their back on their fiduciary duty to investors to protect their interests in mutual funds.

Along with Mr. Spitzer, Mr. Galvin and the SEC have initiated their own investigations of mutual fund trading practices. Last week, Mr. Galvin filed the first formal complaint against a mutual fund company, Putnam Investments, for trades resulting from Putnam's failure to stop members of a New York union retirement plan from market timing funds. According to Mr. Galvin, the ten most active union members made almost 3,000 trades over the past three years garnering profits of $4.1 million. Two executives are also alleged to have been involved in self-dealing by taking advantage of inside knowledge about the international funds they managed to generate quick profits for themselves. One executive made at least thirty-eight market-timing trades in at least four of the seven funds he managed from 1998 until this year, and at least twenty trades were made after he was warned by superiors to stop. Mr. Galvin credited a whistleblower, a Putnam call center employee, who came to his office in September with allegations that Putnam was knowingly allowing market timing trades. The whistleblower claims he repeated warnings to his superiors that rapid trading was harmful to other fund investors from 2001 until earlier this year. It has been reported that the whistleblower had gone to the SEC in March but inexplicably the Commission's Boston office never acted upon the tip.

For its part, the SEC has launched its own investigation of the mutual fund industry on the heels of Mr. Spitzer's revelations of trading abuses. In September, the SEC sent a letter to one hundred financial institutions to inquire whether they are involved in the abusive trading practices outlined by Mr. Spitzer. So far, the SEC has filed charges against Fred Alger Management for improper trading of mutual funds and imposed a fine on Prudential Securities for improperly overseeing mutual fund trading practices. In addition, the SEC has sent two notices about potential charges to Morgan Stanley for failure to adequately disclose compensation that the firm received from fund companies for selling their products and sales practices related to certain share classes of funds. The SEC is also expected to propose regulations next month intended to halt late trading and market timing practices.

Explanation of Late Trading and Market Timing

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[2] Testimony of Mr. Paul G. Haaga, Jr., Executive Vice President, Capital Research and Management Company, and Chairman, Investment Company Institute, *Hearing on Mutual Fund Industry Practices and Their Effect on Individual Investors Before the House Committee on Financial Services*, 108th Cong. 20 (Mar. 12, 2003).

Late trading and market timing are detrimental to the interests of long-term mutual fund investors. Late trading is a practice prohibited under SEC regulations whereby traders are allowed to purchase mutual fund shares at that day's closing price after the market closes at 4 p.m. in New York. SEC regulations require an investor placing an order after four o'clock to pay the next day's closing price. A late trader is able to profit by making trades based on news disclosed after the market closes when ordinary investors are not allowed to trade. When a trader is allowed to purchase shares at a price lower than the closing price, the trader receives a profit that would have otherwise gone completely to the fund's other investors. One study estimates the harm to long-term shareholders at $400 million per year.

Market timing, on the other hand, is a form of arbitrage that exploits the market inefficiencies when the "net asset value"[3] price of a mutual fund share does not reflect the current value of the stocks held by the mutual fund. The practice of trading "in and out" of funds, using delays between time zones, dilutes the value of shares held by long-term investors. For example, market timers could buy shares of international funds late in the day and lock-in the fund price. The prices of individual international stocks are set on their home exchanges which follow sharp movements on the U.S. exchanges. Therefore, if U.S. markets have a strong day, a U.S. mutual fund with international stocks might be underpriced because the Asian markets have not yet opened by the close of trading in New York, but the fund's value is likely to rise the next day. A trader could invest in that fund before the markets close in New York and quickly sell the next day when the fund's value increases. While not illegal, most fund prospectuses discourage or prohibit market timing because it harms long-term mutual fund investors by (1) diluting the value of the shares; and (2) raising trading costs. An independent academic study published last year estimated that market timing costs long-term investors $5 billion each year. Many funds claim to discourage market timing in their prospectuses by charging extra fees to investors who try to take advantage of pricing anomalies.[4]

Mutual Fund Scrutiny by the House Financial Services Committee

As I mentioned earlier, my Subcommittee held hearings in the spring and summer examining the need for reforms to strengthen corporate governance and management accountability at mutual fund companies. As a follow up to these hearings, I sent the chairman of the SEC a letter expressing concern about mutual fund fees, transparency, governance, and performance. At the end of July, under the leadership of Chairman Oxley, H.R. 2420 was marked-up and favorably reported by the full Financial Services Committee on a unanimous vote. To date, I have been urging my colleagues to support H.R. 2420 and I await Floor action on the legislation.

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[3] Mutual fund companies sell and redeem its shares at net asset value – a price that is computed once a day by calculating the value of their holdings at 4 pm – the close of trading in New York.

[4] Prospectuses from Janus, Strong, and Bank One make statements similar to Bank of America's prospectus which states, "market timing . . . may interfere with portfolio management and have an adverse effect on all shareholders."

The purpose of H.R. 2420 is to (1) improve transparency of mutual fund fees and costs and (2) improve corporate governance and management integrity of mutual funds under the premise that better fee disclosure will promote robust industry competition and will help investors make better informed decisions about which mutual fund is most appropriate for them. While mutual funds have brought the benefits of professional management, portfolio diversification, and securities ownership to millions of individuals, numerous studies and commentators noted in our hearings that equity mutual fund fees have continued to increase while fund returns have lagged those of relevant indexes and investors are often unaware of these fees. I believe mutual fund investors should be the direct beneficiaries of greater fee-based competition among mutual funds, more accessible and understandable information about mutual fund fees, stronger oversight by independent fund directors, and enhanced firewalls against a variety of conflicts of interest raised by the way mutual funds are operated and sold. H.R. 2420 provides all of these critically important reforms for mutual fund investors.

The Legislative Reforms of H.R. 2420

H.R. 2420 strengthens the influence of independent directors, who have a greater inclination to protect the interests of fund shareholders than those directors who are tied to the success of the mutual fund's management company. The bill further promotes investor protection by directing the SEC to promulgate rules requiring enhanced disclosure and director scrutiny of directed brokerage, soft dollar and revenue sharing arrangements. H.R. 2420 also codifies the SEC rule requiring mutual funds to disclose both policies and procedures with respect to proxy voting and the actual votes cast, thus enabling shareholders to monitor their funds' involvement in the governance of portfolio companies. Finally, the bill codifies a pending SEC rule requiring mutual funds to implement internal audit procedures, including appointing a chief compliance officer to administer these procedures.

Specifically, H.R. 2420 contains the following provisions:

Fee Disclosure. H.R. 2420 generally codifies a pending SEC proposal that would require disclosure in a fund's semi-annual and annual report to include a dollar example of the fees an investor would have paid on a hypothetical investment. The dollar example must be based on a hypothetical $1,000 investment and account statements are required to include a legend prominently stating that the investor has paid fees on the mutual fund investment, the fees have been deducted from the amount shown on the statement, and the investor can find more information by referring to documents disclosing the amounts of such fees.

Portfolio Transaction Expenses. Portfolio transaction expenses are the costs funds incur when they buy and sell securities. In some cases, these costs exceed the fund's operating expenses. The bill directs the SEC to promulgate a "concept release" seeking input on portfolio transaction costs that will provide more useful information to investors about these significant mutual fund costs. H.R. 2420 requires mutual fund companies to improve portfolio turnover disclosure (a proxy for fund transaction costs) that funds currently provide by including this disclosure in a

document that is more widely read than the prospectus or Statement of Additional Information, and by requiring a textual explanation of the impact of high portfolio turnover rates on fund expenses and performance.

Portfolio Manager Compensation and Holdings. Mutual funds are not required to disclose the structure of compensation of portfolio managers or their fund ownership. H.R. 2420 directs the SEC to (1) issue rules requiring disclosure of the structure of fund manager compensation and (2) require that fund managers disclose their holdings in the funds they manage.

Breakpoint Discounts. Many mutual funds sell funds with front-end loads that may be reduced based on the amount of an investor's holdings. Many investors, however, are unaware that they may be eligible for these breakpoint discounts and have overpaid front-end sales loads when they were actually entitled to a reduced rate pursuant to the fund's breakpoint policy. H.R. 2420 requires the SEC to mandate improved disclosure of breakpoint discounts to help investors determine whether they are eligible for a discount.

Revenue Sharing Arrangements. Revenue sharing is generally not disclosed to investors, thus leaving investors unaware of the incentives a broker may have for recommending one fund over another. Under a revenue sharing arrangement, the adviser of a fund uses its own profits to pay a broker or other party to sell shares of the fund. Accordingly, the legislation requires fund directors to review revenue sharing arrangements consistent with their fiduciary duty to the fund.

Directed Brokerage Arrangements. Funds increasingly use a portion of brokerage commissions to compensate broker-dealers for distribution of fund shares or certain classes of fund shares. Directed brokerage arrangements are not clearly disclosed to investors. Accordingly, the bill directs the SEC to require enhanced disclosure of these arrangements, as well as enhanced oversight by the board of directors of these arrangements, consistent with their fiduciary obligations to the fund. The bill also requires the SEC to issue a rule requiring disclosure of any conflicts of interest that the broker may face due to such financial incentives, such as a "point of sale" disclosure, or an after-the-fact disclosure such as in an order confirmation that is provided to investors after execution of the transaction.

Soft Dollar Arrangements. A soft dollar arrangement is one in which an investment adviser directs client brokerage transactions to a broker and, in exchange, receives research or other services from the broker or a third party. Soft dollar arrangements have been subject to criticism because of the potential for conflicts of interest between a fund and the investment adviser. There is also an inadequate incentive for the adviser to keep trading costs low.

H.R. 2420 addresses the inherent conflicts of interest with respect to soft dollar arrangements by (1) requiring the SEC to issue rules mandating disclosure of information about soft dollar arrangements; (2) requiring fund advisers to submit to the fund's board of directors an annual report on these arrangements, and requiring the fund to provide shareholders with a summary of that report in its annual report

to shareholders; (3) imposing a fiduciary duty on the fund's board of directors to review soft dollar arrangements; (4) directing the SEC to issue rules to require enhanced recordkeeping of soft dollar arrangements; and (5) ordering the SEC to conduct a study of soft-dollar arrangements, including the trends in the average amounts of soft dollar commissions, the types of services provided through these arrangements, the benefits and disadvantages of the use of soft dollar arrangements, the impact of soft dollar arrangements on investors' ability to compare the expenses of mutual funds, the conflicts of interest created by these arrangements and the effectiveness of the board of directors in managing such conflicts, and the transparency of soft dollar arrangements.

Independent Fund Directors. Mutual funds are distinct from the fund management and are, in fact, owned by their investors, not mutual fund advisers. In practice, many mutual fund investors have very little power over the company they own. Thus, H.R. 2420 strengthens the influence of independent directors on fund boards by requiring that independent directors comprise at least two-thirds of the board, thereby ensuring that directors represent the interests of the millions of investors who put their trust in mutual funds and not the interests of fund management.

Audit Committee Requirements. H.R. 2420 extends provisions to enhance the independence and authority of mutual funds' audit committees. The bill strengthens the audit committees by requiring that all of its members be independent. To further the objectivity of financial reporting, the bill charges the audit committee with direct responsibility for the appointment, compensation and oversight of the mutual fund's accountant. The bill also requires the audit committee to establish procedures for handling complaints regarding accounting matters.

Use of the term "no-load." Under current NASD rules, only funds that charge a 12b-1 fee of twenty-five basis points or less can call themselves no load funds. This misleads investors who are led to believe that "no-load" means the fund is not charging any 12b-1 fee at all. The bill directs the SEC to clarify rules relating to the use of the term "no-load" by mutual funds, so that investors may better understand what they are actually paying when they choose such a fund.

Proxy Voting Disclosures. Recent business scandals have created renewed investor interest in issues of corporate governance, underscoring the need for mutual funds to focus on this issue. Despite the fact that millions of American investors own the underlying securities of mutual funds, funds have been extremely reluctant to disclose how they exercise their proxy voting power with respect to portfolio securities. H.R. 2420 codifies an SEC rule that requires investment companies to disclose their policies and procedures with respect to proxy voting as well as the actual votes cast.

Informing Directors of Significant Deficiencies. The SEC staff regularly inspects mutual funds. In practice, the staff generally informs the fund's adviser of any significant deficiencies that are discovered. H.R. 2420 includes a new requirement that the fund's board of directors be provided with a report of any such deficiencies, to ensure that they will be able to take any necessary corrective action.

Ethics Compliance. H.R. 2420 codifies aspects of a SEC proposal to strengthen the corporate governance practices of mutual funds that would require investment companies to implement internal audit procedures to promote compliance and detect violations of federal securities laws. Specifically, H.R. 2420 requires investment companies to designate a chief compliance officer to administer the internal audit program.

Study of Arbitration Claims Involving Mutual Funds. This provision directs the SEC to study the dramatic increase in arbitration claims involving mutual funds since 1995. Arbitration cases involving mutual funds have increased ten-fold in just the past few years, skyrocketing from 121 in 1999 to 1,249 in 2002. The study will identify the reasons for this troubling trend and will therefore help the SEC to enact measures to reverse it.

Independent Chairman. Regrettably, I was not able to garner enough support from my colleagues to block an amendment at the full committee mark-up to strike a requirement that would require a mutual fund's board of directors to have an independent chairman. This provision was significant because independent directors do not oversee all board matters involving conflicts of interest between advisors and funds. Instead, review of these transactions typically occurs in a meeting with all of the directors that is overseen by the board's non-independent chairman. Fund boards need to have an independent chairman because fund directors and management are not accountable to the same interests: fund directors are accountable to fund shareholders – i.e. the ninety-five million Americans who invest in mutual funds and have an interest in keeping fund fees low – whereas fund management has a fiduciary obligation to maximize profits and increase the amount of fees collected.

H.R. 2420 and the Future of Mutual Fund Governance

As I have discussed, H.R. 2420 is an important first step toward improving accountability and integrity of mutual fund companies. In light of the events that have occurred since the Committee on Financial Services reported the bill on July 23rd, it is clear to me that my legislation needs to be strengthened. The Subcommittee on Capital Markets will be holding two hearings this week on this subject, at which I look forward to hearing the ideas of a variety of distinguished witnesses regarding how best to strengthen the bill. At a minimum, though, I believe there are several areas that call for legislative attention, which I plan to add to the bill.

First, while the Financial Services Committee voted to remove the bill's original provision mandating that the chairman of the board of all mutual funds be independent, I believe, as I stated earlier in this testimony, that provision absolutely must be reinstated. Investors need to be assured that the fund's board chairman is looking out for *them*, and not themselves or the management company. If we are to avert a more severe crisis of confidence by mutual fund investors, we must start by making this fundamental change at the very top and send a message that the

"business as usual" that has been exposed as, in too many cases, corrupt, simply will be tolerated.

In addition, we must act to fight the conflicts of interest that arise when management and portfolio managers are able to steal money from investors by timing their own funds. While existing insider trading laws might already ban this activity, I believe the prohibitions should be made stronger and clearer. Management and portfolio managers simply should not be permitted to market time their own funds. Certainly, their holdings in funds they manage should be disclosed.

Another conflict of interest that is simply unacceptable is that of a portfolio manager managing both a mutual fund and a hedge fund. This arrangement creates opportunities for unfair allocation of securities transactions. It has been widely observed that such an arrangement might create incentives for a manager to allocate the best investment ideas to the hedge fund, because hedge fund managers collect lucrative fees – typically twenty percent of total profits – based on performance. Even worse, it apparently provided at least one manager with the opportunity to market time the very mutual fund he was managing, on behalf of the hedge fund! Such joint portfolio management should be banned.

Market timing is a practice that raises questions about whether any mutual fund – which by nature is a vehicle generally designed for long-term investors – should permit it. However, there are funds that do permit this practice and are even marketed as such. The problem arises where fund investors are told the fund does not permit market timing, or the policy is not clear, and they are disadvantaged by the fund permitting certain select investors to do so. This problem can be solved by forcing funds to make a choice – they either permit market timing or not, and the rules must be the same for everybody. Making this policy "fundamental" under the Investment Company Act of 1940 will improve the disclosure that shareholders receive about a fund's market timing policy and also ensure that funds cannot change this policy without a shareholder vote. It would also help discourage market timing if funds are able to charge more than the current limit of two percent of assets as a short-term redemption fee. I believe that limit should be raised to at least four percent. Finally, the SEC needs to act to clarify the rules that apply to fair value pricing. Market timing would be difficult to engage in if funds were required to value their shares according to their real market value, rather than according to a "stale" market close price.

With regard to late trading, insider trading, and other flagrant violations of the securities laws that appear to be pervasive in the fund industry, it is clear to me that internal compliance at many fund companies is woefully inadequate. Not only do funds need to appoint a chief compliance officer, as H.R. 2420 would require, but I believe that that person should report directly to the independent directors in the chain of command so there are no concerns about repercussions from fund management for whistleblowing.

I also believe that more disclosure of executive and portfolio manager compensation is critical. Mutual funds are simply not as transparent in this regard

as other public operating companies. Just as investors have the right to know how much the executives at Ford and GE are paid for their services, they should be better informed about the compensation of fund managers and executives.

Finally, I believe that investors should have confidence in the primary regulator charged with protecting them from those who would abuse their trust. It seems to me that steps to improve the SEC's use of external tips, and to strengthen communication between the divisions that oversee enforcement and mutual fund regulation, could help in this regard.

These are just a few of the changes that would strengthen the *Mutual Funds Integrity and Fee Transparency Act* and help to restore the confidence of fund investors, which has been so shaken by the shocking allegations of recent weeks.

Thank you again for this opportunity to share my views on this critical issue. I look forward to responding to any questions or comments you may have.