STATEMENT

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT-SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ON

"THE MUTUAL FUND INDUSTRY"

NOVEMBER 6, 2003
2128 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, D.C.

WITNESS: CHARLES LEVEN
VICE PRESIDENT,
SECRETARY/TREASURER
AARP BOARD OF DIRECTORS

For further information, contact:

Roy Green
Federal Affairs Department
(202) 434-3800

Good morning Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises. My name is Charles Leven. I am the Vice President of AARP's Board of Directors.

I appreciate this opportunity to testify on behalf of AARP's over 35 million members on a matter of great importance to the financial security of all Americans -- savings that they have invested in, and entrusted to, the mutual fund industry. Mutual funds control 21 percent of U.S. corporate equity (representing an estimated $19 trillion in assets). More than 95 million Americans are invested in mutual funds, representing more than half of all American households. A 1998 survey of mutual fund shareholders directed by the Investment Company Institute (ICI) produced estimates that:

- Twenty-two percent mutual fund shareholders were born in 1965 or later
- Fifty-one percent are shareholders were born between the years of 1946 and 1964, and
- Twenty-seven percent of the shareholders were born prior to 1946.[1]

AARP supports the efforts of this Subcommittee, under your leadership Chairman Baker, to improve investor awareness of mutual fund costs, and to improve the independent oversight and governance functions of fund boards of directors. The legislation you introduced, and that is now pending before the House, "The Mutual Fund Integrity and Transparency Act of 2003" (H.R. 2420), would put into effect an overdue upgrade in investor protection for the ordinary saver-investor. Similar – although not identical – legislation ("The Mutual Fund Transparency Act of 2003') was recently introduced in the Senate by Senators Akaka, Fitzgerald and Lieberman

These reforms were already warranted by the continuing evolution in market practices and the growth in market choices. They are now more urgently required. Real damage has been done to the economic security and financial well-being of many Americans in or near retirement. This has been in part due to the market's natural cycles – tracking the general economy downward over the last couple of years. But some of the damage was caused by corporate financial reporting, accounting transgressions and market manipulations.

AARP sponsored a national survey (N=1,013 telephone interviews), conducted from November 15 to December 5, 2002, regarding the extent to which stock market declines over the previous two years affected individuals age 50 to 70, who owned stock either as individual stocks, mutual funds, or other types of investment accounts including 401(k)s and IRAs. Key findings include:

- More than three in four (77 percent) of these individuals indicated that they had lost money;
- More than three in four (77 percent) of those investors who lost money in stocks reported that their losses had altered their retirement lifestyles, work plans, or expectations about retirement in at least one of the ways measured;
- Of those who lost money in stocks and had not yet retired, one in five (21 percent) have postponed retirement as a result of their losses; and
- Of investors who lost money in stocks and had already retired, one in ten (10 percent) either have returned to work after retirement due to their losses or are still working due to their losses.[2]

Apart from corporate reporting and accounting scandals, mounting allegations of illegal – or at best unethical -- practices by mutual fund management companies, executives and brokers highlight the need for prompt remedial action. Startling results were reported just this week from a U.S. Securities and Exchange Commission (SEC) survey of 88 of the largest mutual fund complexes in the country and 34 brokerage firms, including all of the nation's registered prime brokers. Preliminary findings reveal the apparent prevalence with which mutual fund companies and brokerage firms had arrangements that allowed favored customers, including themselves, to exercise after-hours trading privileges and market timing options – as well as to participate in other abusive practices.

Among the most troubling of the SEC's preliminary findings is that:

- More than twenty-five percent of the responding brokerage firms reported that customers have received 4 p.m. prices for orders placed or confirmed after 4 p.m.;
- Fifty percent of responding fund groups appear to have had at lest one arrangement allowing for market timing by an investor;
- Almost seventy percent of responding brokerage firms reported being aware of timing activities by their customers; and finally
- More than thirty percent of responding fund companies appears to have disclosed portfolio information in circumstances that may have provided certain fund shareholders the ability to make advantageous decisions to place orders for fund shares.

These apparent violations of the fiduciary duty owed to investors have caused real harm – both in confidence and in lost dollars. These allegations come on top of other more recent examples of conflicts of interest in the industry. We must do more to protect the individual investor. In addition, we are increasingly concerned that lay investor confidence in the mutual fund industry not be allowed to deteriorate further – specifically in its ability to reliably provide fairly priced benefits of investment diversification and expert management.

With regard to initiatives designed to increase fund transparency, we strongly support H.R. 2420's provisions to require, among other new obligations, that:

- fees be disclosed in dollar amounts;
- fee disclosures incorporate <u>all fees</u>, including portfolio transaction costs;
- fee disclosures identify <u>all distribution expenses;</u>
- compensation paid to portfolio managers and retail brokers be fully disclosed;
- disclosure of breakpoint discounts to investors be improved; and
- directed revenue sharing, brokerage and soft dollar arrangements be made to conform to the fiduciary duties to the funds and their investors.

While greater transparency is essential to fair competition among funds for investors, we believe it does not provide a sufficient check on the cost of fund governance. Mutual funds allow investors to share the costs of professional money managers — who under the 1940 Investment Company Act are called "advisers." However, most funds are not established by investors but rather are incorporated by advisory firms, who then contractually provide research, trading, money management and customer support services, and who also have some representation on the fund's board. The advisory firms have their own corporate charters and are accountable to their own boards of directors, posing – as we are seeing -- a range of potential conflicts of interest in the costs of services provided to the fund.

We see these failures of mutual fund governance, not simply as a lack of statutory or regulatory authority, but as a failure of compliance and enforcement. We support the provisions in HR 2420 designed to strengthen the role and independence of boards of directors and further target directors' energies where potential conflicts of interest between the fund adviser and fund shareholders are greatest. HR 2420 seeks to strengthen the role and independence of fund directors by making the board responsible for more than auditing the performance of the advisory firm and making sure there is no malfeasance or any accounting problems. In addition, the board is explicitly charged with advocating shareholder interests in its fee-for-service negotiations with the advisory firm.

Specifically, we strongly recommend the final measure include provisions requiring that:

- A super-majority (i.e., two-thirds to three-fourths) of fund board members be independent;
- The board chairman be selected from among the independent members; and
- The independent directors be responsible for establishing and disclosing the qualification standards of independence, and for nominating and selecting all subsequent independent board members.

In summary, the importance of the mutual fund market as a critical component of the economic security of all Americans – especially older persons – should not be underestimated. We urge prompt bipartisan passage of H.R. 2420 by the House. Full disclosure of expenses and requirements for stronger fund governance will help hold fund advisers accountable for their trading practices, which should reduce costs to investors. We believe these changes will introduce more vigorous price competition into the mutual fund marketplace. We look forward to working with you, Chairman Baker and Ranking Member Kanjorski, and with the other Members of this Subcommittee, in further perfecting and working to enact this important piece of investor protection legislation.

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[1] See: 1998 Profile of Mutual Fund Shareholders, Research Series, Investment Company Institute, published Summer 1999.

[2] See: Impact of Stock Market Decline On 50-70 Year Old Investors, AARP, published December 2002.