Testimony of Mellody Hobson

President
Ariel Mutual Funds

"H.R. 2420, The Mutual Funds Integrity and Fee Transparency Act"

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE &
GOVERNMENT SPONSORED ENTERPRISES

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ARIEL MUTUAL FUNDS 20 YEARS OF PATIENT INVESTING

Thank you Chairman Baker, Chairman Oxley, Ranking Member Kanjorski, and members of the Subcommittee. Testifying about investor confidence when that issue is more important to our economy and more relevant to the destinies of average Americans than ever before is a great honor – and an even greater responsibility.

I am the President of Ariel Mutual Funds. Ariel is a small investment firm and a small business. We offer four mutual funds. More than 100,000 individuals have $3.7 billion currently invested in our funds. Ariel is based in Chicago and has 67 employees. In addition to my work at Ariel, I have for the last three years contributed a weekly segment on personal finance issues for a network television news program.

My colleague John Rogers founded Ariel twenty years ago. It was the first minority-owned money management firm in the United States. He was 24 years old. John discovered the stock market at a very early age, when his father began buying him stocks on his birthday and at Christmas instead of toys. John's childhood interest evolved into his life's work. That passion led to the creation of Ariel Mutual Funds.

This story tells you about the heart and soul of one small mutual fund company. Some have suggested to the Subcommittee that the mutual fund industry is dominated by firms who've forgotten their fiduciary obligations, lost their connection to individual shareholders, abandoned the basic principles of sound investment management, and repudiated the industry's proud history. Nothing could be farther from truth. As a mutual fund executive, my future, my credibility and my integrity are inextricably linked to Ariel shareholders' success.

Ariel takes enormous pride in being part of a great industry. We work hard to reach out to those who've not seen firsthand the wonders of long-term investing, compound growth, and the creation of enduring wealth. One important aspect of our work is a unique mission: to make the stock market a subject of dinner table conversation in the Black community.

It is heartening to come to Washington and see policymakers who care so much about our shareholders. We applaud your efforts. When you find effective ways to reinforce investor protections and support the integrity of our markets, you help our business and our shareholders.

REGULATIONS

I'm aware that four major government reports on mutual funds have been published in the last 36 months, two by the SEC and two by the GAO. Taken as a whole, the reports reaffirm the health of the fund industry and the continued effectiveness of the regulatory regime that governs it.

It would be logical to think that the SEC put most other fund initiatives on hold while these studies were completed, but that has not been the case. Since 1998, the SEC appears to have adopted at least 20 new mutual fund regulatory initiatives –

averaging at least one every twelve weeks. This appears to be the fastest rate in the SEC's history. Of course, each initiative can include multiple forms, rules, requirements and mandatory filings. I'll attach a more extensive list for the record, but recent SEC mutual fund regulations have included new requirements in areas ranging from consumer privacy, to proxy voting, to after-tax performance.

In addition, at least four new major rules are pending.

The sheer number and range of these regulations demonstrates the vitality of the SEC's efforts to help 95 million fund investors. I also think it bears noting that the ICI has worked constructively with the SEC on virtually all of these matters and has endorsed the overwhelming majority of them.

COSTS

We should remember, however, that new regulations invariably lead to significant costs. The SEC deserves credit for several efforts that reduced fund regulatory costs. But those initiatives are dwarfed by regulations that have added far larger costs and burdens. Reviewing the SEC's own cost estimates for these rules is striking. The net impact of SEC mutual fund rulemakings since 1998 appears to have increased the fund industry's regulatory costs by at least several hundred million dollars annually.

I'm worried that the impact of all this on small mutual fund companies could ultimately contribute to making the fund industry less hospitable to innovative start-ups and perhaps less competitive. I'm not certain I could, in good faith, advise a 24 year old today to take on the costs and burdens of starting a mutual fund as John Rogers did.

Let me turn to some general observations about the bill.

Section 2 of H.R. 2420 directs the SEC to initiate expedited rulemakings on six broad new mutual fund disclosure mandates. As the Subcommittee considers whether to support this directive, we are hopeful that the inevitable impact on smaller fund companies will be carefully considered. It would be deeply regrettable if attempts to heighten shareholder disclosure eroded the competitive position of one of the most dynamic and entrepreneurial parts of the fund business. I strongly agree with Paul Haaga's comments a few minutes ago, and urge you to provide sufficient time so that a consensus approach to these issues can be embraced.

INFO OVERLOAD

Fed Chairman Alan Greenspan recently observed that "in our laudable efforts to improve public disclosure, we too often appear to be mistaking more extensive disclosure for greater transparency."[1]

[1] "Corporate Governance," Remarks by The Honorable Alan Greenspan, Chairman, U.S. Federal Reserve Board, May 8, 2003.

He said that improved transparency is more important -- but harder to achieve -- than improved disclosure. “Transparency challenges market participants not only to provide information but also to place that information in a context that makes it meaningful.”[2] Former SEC Chairman Levitt once expressed a similar concern, “[t]he law of unintended results has come into play: Our passion for full disclosure has created fact-bloated reports, and prospectuses that are more redundant than revealing.”[3]

The possibility that disclosures might impede rather than enhance decision-making is a real concern. For example, when the SEC overhauled mutual fund prospectuses five years ago, prospectus reform was hailed as the most beneficial SEC change to disclosure requirements for individual investors in its 60 year history. At the time, the SEC urged great caution about succumbing to the future temptations to add new disclosure requirements, noting that they had learned that too much information “discourages investors” from further reading or “obscures essential information” about the fund.[4]

FEES

After reading the SEC and GAO reports and reviewing the transcript of the Subcommittee’s March hearing, it is obvious that a substantial effort has been undertaken to explore ways to bolster mutual fund investors’ understanding of their funds’ fees and expenses. Fortunately, recent ICI data about investors’ actual behavior strongly suggests that the message about fund fees has broken through. The ICI looked at all equity fund sales over a five-year period ending in 2001 and found that.

- 83 percent of all equity funds bought by investors had expense ratios below the 1.62 percent charged by the average fund.

- The average investor holds equity funds with a total operating expense ratio of 0.99 percent – about 39 percent lower than the fee level charged by the average fund.

Similar findings have been reported by others. I am pleased but not surprised by these findings. They indicate convincingly that very large majorities of fund shareholders own funds with lower than average costs. I hope the Subcommittee will bear this data in mind as it further considers these issues.

As consideration of H.R. 2420’s various provisions advances, I am particularly hopeful that the Subcommittee will review the new account statement alternative described by the GAO. Most of the fee disclosure proposals for account statements that we’ve heard have given us shivers. From our perspective, these proposals, including

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[2] Id.

[3] "Taking the Mystery Out of the Marketplace: The SEC's Consumer Education Campaign," Remarks by The Honorable Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, October 13, 1994.

[4] Id.

regrettably the provision in H.R. 2420, produce two undesirable but certain outcomes: breathtakingly high costs, and substantial shareholder confusion. However, a new "legend" alternative -- described by the GAO in its report yesterday -- avoids both problems. Instead, for what we suspect will be a much more reasonable cost, the proposal fully accomplishes the goal of providing investors with a prominent reminder of the fact that fund fees reduce investment returns. As we understand it, the legend could also encourage investors to review the fee table in the prospectus or to consult with their financial adviser.

By bringing the SEC, the GAO, fund industry representatives and industry critics together today, the Subcommittee is simultaneously providing leadership on these issues and helping to facilitate a consensus approach to their resolution. Because H.R. 2420 was introduced just as the SEC report was submitted, and several days before the GAO report was released, I would respectfully suggest that another review would seem to make sense. In the meantime Paul Haaga set forth a thoughtful and proactive way for the fund industry to embrace and push forward on many of the H.R. 2420's important reforms. Ariel would be pleased to work constructively with the Subcommittee in full support of such an approach.

I mentioned earlier that I conduct personal finance features on a television network news program and author a bi-monthly column. I've literally received thousands of questions and requests for guidance, and hear one refrain more than any other: people feel overwhelmed. Young, old, married, single, black, white, working, or retired. Investors want insight, timesavers, and ways to cut through the noise to get to the most important information that will help them make the best investment decisions. I never hear complaints about receiving too little information; it's always the opposite – from shareholder mailings to the broadcast media to magazines to websites. Interestingly, I've received many fairly sophisticated inquiries, but have never once received a single question about soft dollars, directed brokerage, rule 12b-1, or many of the other mutual fund issues we've discussed today. Perhaps there's a small insight to be gleamed from that.

Thanks again for the privilege of testifying. I look forward to your questions, and would welcome the chance to work with you on these issues in the days and weeks to come.