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THE FEELING IS MUTUAL

"It appears that we are now in the early innings of what already is the biggest scandal in the history of the 80-year old mutual fund industry." Michael Oxley, Chairman, House Financial Services Committee, November 4, 2003

Chairman Oxley is considered a pivotal industry *ally* in this debate and his bill, HR 2420, the Mutual Funds Integrity and Fee Transparency Act, is expected to pass the House *today*. Oxley's Committee passed HR 2420 on July 23, 2003, a full six weeks before Eliot Spitzer stunned the nation on September 3 with his settlement of charges against the Canary Capital Partners, LLC which triggered the snowballing mutual fund scandal. Unlike the House, the Senate will wait until next year to pass a mutual fund reform bill. The final bill will be at least as tough on the industry as the House bill, and is highly likely to become law in 2004.

If Michael Oxley is the conservative reformer in this debate, New York Attorney General, Eliot Spitzer, is the jihadist. Spitzer and fifteen attorneys in his office are working hard to bring to justice mutual fund executives who condoned illegal late trading or misrepresented their policies on market timing . Judging by surveys taken by the Securities and Exchange Commission – which asked 88 large mutual fund families, managing $5.7 trillion in assets, and 34 broker-dealers to explain in detail their experiences with late trading and market timing – Spitzer will be busy for a long time. The SEC told the House Financial Services Committee that 25 percent of broker-dealers confirmed their customers had placed late trades. Separately, fifty percent of funds families were aware that market timers were active in their funds, yet did little to stop them, to the detriment of "buy and hold" fund owners.

Early Committee Action Allows The House to Acts Quickly in the Face of Scandal

Congressman Richard Baker, Chairman of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises introduced HR 2420 in its original form on June 18. Because Oxley gave it quick Committee consideration, he is ready to bring a bill to the House floor in the midst of daily disclosures of improper fund trading. Here is the staff's description of reforms in HR 2420 that the House thinks are necessary to provide proper oversight for the mutual fund industry: "The bill will direct the SEC to issue rules requiring funds to provide investors with improved disclosure of the following: Estimated operating expenses, in dollar amounts, on a hypothetical $1,000 investment; Portfolio turnover rates in a way that facilitates comparison among funds; Soft dollar arrangements; Directed brokerage arrangements used to obtain fund distribution; and Revenue sharing arrangements used to obtain fund distribution." Sometimes it's best for analysts to let the lawmakers and their staffs say what they intend. The following pages include excerpts from a House Republican staff summary of HR 2420 – and also a "manager's amendment" that will respond to the scandal.

From the staff summary of HR 2420 – The bill as approved by Committee will:

Increase transparency: The bill will give investors access to enhanced information with which to compare the costs of different funds and other financial products to help them make informed investment decisions. Provisions included in the bill will:

- Codify SEC rules requiring the disclosure of votes cast on behalf of shareholders as well as the policies and procedures for proxy voting;
- Require each fund to have a code of ethics and chief compliance officer;
- Require fund managers to disclose any holdings they have in the funds they manage;
- Require that brokers disclose to investors whether they have received extra financial incentives to sell a particular fund or class of shares;
- Require notification in brokerage account statements that fees have been deducted;
- Direct the SEC to issue a concept release on how to better disclose portfolio transactions costs;
- Direct the SEC to clarify the definition of "no-load" funds to ensure that investors are not misled;
- Require new record keeping of soft dollar transactions; and
- Call on the SEC to study the recent increase in arbitration cases involving mutual funds.

Strengthen director oversight of soft-dollar and certain distribution arrangements: The bill will require fund advisers to submit an annual report to directors on revenue sharing, directed brokerage and soft-dollar arrangements. It also imposes a fiduciary obligation on fund directors to review these arrangements and ensure that they are in the best interests of the fund. The bill also requires additional record keeping requirements for soft-dollar arrangements as well as an SEC study to consider the implications of repealing the safe harbor for them. Increasing director scrutiny and responsibility regarding these arrangements will guard against the potential conflicts of interest they can create.

Enhance corporate governance and management integrity: The bill will establish several new requirements to strengthen mutual fund corporate governance and management accountability including:

- Requiring two-thirds of all board directors to be independent;
- Directing the SEC to require funds to disclose how portfolio managers are compensated;
- Strengthening the definition of an independent director by authorizing the SEC to issue rules to exclude from that definition persons with business or close family relationships with the fund;
- Imposing fiduciary duties on board directors to review revenue sharing arrangements;
- Giving the SEC the flexibility to exempt board members from participating in board meetings in person under certain emergency circumstances; and
- Requiring that directors be informed of any significant deficiencies in the operation of a mutual fund discovered in a SEC inspection.

This provision builds on the Sarbanes-Oxley Act by furthering the independence and accountability of mutual fund directors. Portfolio manager compensation disclosure will help fund shareholders evaluate the incentives that are provided to the portfolio manager that is investing their money. Increasing the percentage of independent directors on fund boards will strengthen those directors'' ability to protect the interests of fund shareholders.

Apply audit committee reforms to mutual funds: The bill will require all mutual funds to abide by the same audit committee standards required of exchange-listed companies under Sarbanes-Oxley.

According to the Congressional Budget Office, these reforms carry comparatively little direct cost; while these reforms cost $117 million per year, the mutual fund industry takes in $70 billion a year in fees.

A "manager's amendment" also will be offered by Oxley on the House floor and will pass. It shows how the House wants Congress to respond to "late trading" and "market timing" abuses that Spitzer and the SEC have uncovered.

From the House GOP staff summary on HR 2420 – The Manager's Amendment will:

Strengthen Funds' Compliance with Rules:

- Existing regulations governing trading by insiders in the underlying securities owned by mutual funds will be extended to apply to trading in fund shares.
- Funds' codes of ethics will have to be published, as well as any waivers or violations of such codes.
- All funds will be required to have chief compliance officers who report directly to the independent directors, as well as whistle blower protections and internal compliance procedures.
- Independent directors will be required to certify that they have reviewed and approved portfolio manager compensation, and to certify that procedures are in place for valuation, oversight of fund flows, provision of breakpoint discounts, establishment of appropriate classes of shares, enforcement of codes of ethics, and oversight of internal compliance.

Eliminate Conflicts of Interest in Portfolio Management: Joint management by the same person(s) of mutual funds and hedge funds will be prohibited. The ability of firms to provide advisory services to both kinds of funds, however, will not be limited.

Ban Short-Term Trading by Insiders: Insiders will be prohibited from short-term trading of their own fund shares. This bolsters a provision in the underlying bill requiring fund managers to disclose holdings in the funds they manage.

Allow Higher Fees to Discourage Short-Term Trading: Funds will be allowed, but not mandated, to charge higher than the current limit of two percent for redemption fees in order to discourage short-term trading that harms long-term investors.

Encourage Fair Value Pricing: The Securities and Exchange Commission (SEC) will be required to issue clearer rules to encourage fair value pricing, thereby eliminating the stale pricing that makes market-timing profitable.

Establish Strict Monitoring of the 4 p.m. Close to Eliminate Illegal Trading: To ensure a full trading day, investors could place orders up to but not after 4 p.m. In some cases, this means intermediaries could place trades with funds after the close; however, strict monitoring and an audit trail will be required to ensure that the 4 p.m. closing system is not being gamed. In this manner, those in the western parts of the United States and pension funds or other investors using intermediaries will not be disadvantaged. Investors will also be assured of receiving same-day execution of orders.

Eliot Spitzer to the Mutual Fund Industry: Drop Dead

Spitzer's demands go beyond stopping $5 billion in estimated annual diversions to late traders and market timers. He sees a parallel between sell side equity analysts and mutual fund

directors. On November 4, 2003, he explained to the House Financial Services Committee, "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."

The most significant financial complaint made by Spitzer's office is that many mutual fund directors are, at best, indifferent to cost control. They routinely let fund advisors walk off with fat contracts and let fund shareholders take the fall. Spitzer told the Committee that mutual funds often pay 25 basis points more than pension funds for the same advisory services, an amount equivalent to $10 billion in unnecessary expenses. He asked, "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 committee? . . . 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." Spitzer likes to refer to statements made by Jack Bogle, the founder of the Vanguard Funds, who, he says, has pointed out that mutual fund shareholders do not benefit from economies of scale. Between 1980 and 2000, mutual fund assets grew 60 times while funds' fees and expenses grew by 90 times.

What to Expect

Watch Spitzer. After Congress adjourns for the year, which could happen at the end of this week, he'll dominate coverage of the scandal. Spitzer believes that fund restitution should involve not only making fund holders whole for losses due to late trading and market timing but also the disgorgement of management fees as well. He believes that funds that violated their fiduciary duties should be badly punished. If he makes this stick, billions in fees are at risk. Meanwhile, the SEC will send out fact finding inquiries to remaining funds and broker-dealers and then begin the process of deciding who should face civil and criminal charges.

At least 95 million Americans invest in mutual funds. This fact will not be lost on Congress in an election year. Congress will leave it to Spitzer and the SEC to punish past wrong doers. However, next year Congress will pass a law to prevent late trading and preferential marketing timing as well as other abuses. At a minimum, it also will insist on greater disclosure of advisory fees, 12-b fees, marketing fees paid to brokers, and the cost of portfolio turnover to fund holders. For the first time in its eighty-year old history, motivated mutual fund consumers will be able to tell how much they are being charged and for what services. Many consumers may care; mutual fund fees are now the tenth largest item in the family budget.

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