

***Review of Current Investigations and Regulatory Actions  
Regarding the Mutual Fund Industry:***

***Understanding the Fund Industry from the Investor's  
Perspective***

**Statement of the Honorable Tim Berry**

**Indiana State Treasurer**

**and**

**President, National Association of State Treasurers**

**Before the**

**Committee on Banking, Housing, and Urban Affairs**

**United States Senate**

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## **Introduction**

Mr. Chairman, thank you for the opportunity to appear before this distinguished Committee. My name is Tim Berry and I am the Treasurer of the State of Indiana. I am honored this year to also serve as the President of the National Association of State Treasurers. We are pleased to offer our comments relative to current mutual fund practices and their impact upon investors, including the states as investors. We are also pleased to provide you information on efforts to expand investor education, and the role such efforts play in building investor confidence in the financial markets.

The National Association of State Treasurers, or NAST, is a bi-partisan membership organization composed of all state treasurers, or state finance officials, from the United States, its commonwealths, territories, and the District of Columbia. As the elected chief financial officers of the states, the state treasurers directly oversee more than \$1.5 trillion dollars in state funds. The treasurers are important daily participants in the domestic securities markets, investing state funds in U.S. corporations and small businesses. They have a direct stake in the health of the nation's economy and diligently share their expertise in fiscal and investment matters with other government officials and the general public. Based on this role, the state treasurers are in the forefront of addressing concerns about corporate business practices and governance, leading efforts to ensure investor confidence in the stock markets and to increase shareholder value for the citizens of their states.

A great majority of state funds are invested in the domestic equity markets. Earnings from investments are an important source of revenue for state governments. These

earnings are used to fund vital public services, to cover public employee retirement obligations, to help families save for college, and to fund beneficial economic development programs, among other uses. In contemporary financial markets, maximizing this source of revenue is a complex and time-consuming undertaking. To make the best use of investible public funds, investors like the state treasurers strive to earn the best returns possible without sacrificing the safety of their funds or subjecting their portfolios to undue risks. State treasurers and other public investors must achieve this goal within the constraints of applicable state and federal laws, keeping in the forefront the overriding principles of safety, liquidity and yield.

The nature of state investments has made the state treasurers keenly aware of issues surrounding the mutual fund industry and its impact on investor confidence in the capital markets. We believe that accurate and reliable financial reporting lies at the heart of our financial market system and that investor confidence in such information is fundamental to the health of our markets. We further believe that expanding and strengthening the disclosure requirements of mutual fund companies will address concerns about investor confidence and enhance efforts to raise the level of understanding of the complexities and risks of mutual fund investing.

### **What's at Stake?**

The recent allegations of fraud in the mutual fund industry have fundamentally altered Americans' perceptions of these important investment vehicles. These allegations do not involve isolated instances of individual wrongdoing by low-level employees – the proverbially “few bad apples,” but rather appear to involve a large number of mutual

fund complexes, and wrongdoing by a significant number of employees, including, in some cases, executives at the highest levels of management.

Revelations regarding significant problems in mutual fund compliance have made regulatory reform a critical issue. The alleged frauds in these cases were open and notorious and violated express legal requirements. Fund stewards were on notice and failed to take action. Recently, the U.S. Securities and Exchange Commission surveyed most of the largest mutual fund complexes in the country and 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 the ability to participate in other abusive practices.

Investors have placed their trust in mutual funds with the understanding that they would be treated fairly – that fund managers would do their duty as fiduciaries. Unfortunately, there have been instances where the mutual fund industry has failed to live up to its fiduciary duty. The common theme running through all of the mutual fund issues that have been exposed in recent months is that certain participants in the mutual fund industry are putting their own interest ahead of mutual fund investors.

These violations of the fiduciary duty owed to investors have caused real harm – particularly in confidence and in lost investment value. These frauds reflect a systemic compliance failure in the sense that the current structure of fund oversight is not resulting in fund shareholders receiving the most fundamental and obvious forms of protection from actual and potential abuses. If shareholders are not being protected from the most

obvious frauds, they may not have any confidence that they are being protected from frauds that we have yet to or may never discover.

### **The Vital Role of State Treasurers**

The state treasurers have a direct stake in issues raised by mutual fund trading and sales practices. Twenty-five states utilize money market mutual funds to invest a portion of their general fund investments. Thirty-eight states use mutual fund companies as intermediaries for general fund investments. Many state treasurers also directly oversee or sit on the boards of state and local government pension plans, including supplemental pensions, 401(k) and deferred compensation plans, many of which are based on mutual fund investments. Most significantly, the state treasurers are directly involved in the oversight and management of Section 529 college savings plans, the bulk of which are based on an investment model linked to the mutual fund market.<sup>1</sup> Additionally, numerous mutual fund firms manage institutional portfolios for state and local government pension systems and other investment programs, but these operations are generally separate from the mutual fund's retail business. Mutual fund investments and mutual fund companies are a critical component of the treasurers' investment functions.

As fiduciaries of public investment funds, the state treasurers, their investment oversight boards, and their money managers maintain great responsibilities which bear directly on mutual fund company issues. First, as *fiduciaries*, they have a duty to act prudently and

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<sup>1</sup> The enactment of Economic Growth and Tax Relief Reconciliation Act in 2001 has enhanced the attractiveness of Section 529 plans by allowing greater contributions and flexibility in the plans. The 2001 Act allows tax-free distributions from Section 529 savings plans for qualified higher-education expenses. Previously, withdrawals from these accounts were generally taxed at the rate of the beneficiary—usually a child or grandchild. In another change, contributors now will be able to move their 529 plan investments from one state's plan to another once a year without having to change beneficiaries. As a result, assets in Section 529 savings plans have more than quadrupled since 2001, increasing from \$8.5 billion at year-end 2001 to \$45.7 billion by December 31, 2003. The number of accounts rose to over six million, and the average account size was approximately \$7,600.

in the best interests of their plan participants and beneficiaries. Second, as *investors*, they have an opportunity and duty to speak out on the strategy, direction, and governance of the mutual funds in which they and their constituents invest. This is the essence of responsible investment management. State and local governments are among the nation's most important institutional investors. Both singly and collectively, government fund investments are frequently the most important shareholders a mutual fund has. Consequently, they are in a unique position to influence corporate policies and financial markets.

Federal laws such as ERISA generally do not apply to state and local pension funds, which are governed by state and local regulatory structures that vary from jurisdiction to jurisdiction. In every jurisdiction, however, those who control state and local investment funds – state treasurers, pension boards and trustees, etc. – are considered fiduciaries. As fiduciaries, they are duty-bound to act in good faith and for the exclusive benefit of plan participants and beneficiaries. They must discharge their duties with the care, skill, and diligence that a prudent investor would exercise on his or her own behalf under like circumstances. To meet this high standard, they must demonstrate that the investment practices and policies they adopt on behalf of plan participants and beneficiaries are fundamentally sound.

As fiduciaries, state treasurers must factor allegations of improper mutual fund practices into the fiduciary's determination of the continuing appropriateness of a fund. They must be attentive to activities that materially affect the plan's investment in the mutual fund or

expose the plan to additional risk. They must have more active communication with mutual fund management in order to meet their obligations under state law.

As competent and effective fiduciaries, individual state treasurers are demanding numerous changes to the manner in which corporations and mutual funds operate. These important activities have long been recognized as a fundamental function of our association, which last year established a standing committee on corporate governance. Currently chaired by Connecticut Treasurer Denise Nappier and Nevada Treasurer Brian Krolicki, the corporate governance committee has taken a leading role in responding to issues raised by corporate behavior, including work on the proxy access issue, reforms to corporate board structure, composition and functions, and oversight of the stock exchanges. We have taken a number of strong positions on these matters and would be pleased to share them with the committee.

In a continuation of these efforts, North Carolina Treasurer Richard Moore, working with our corporate governance committee, has implemented a series of “mutual fund investor protection principles” designed to provide greater transparency in mutual fund practices. The principles aim to stop late day trading by requiring the fund to hold all trades for twelve months. They require the fund to report how the managers are compensated and require at least two-thirds of the mutual fund board to be independent directors.

These principles illustrate how the treasurers are acting in good faith on behalf of the citizens of their states. They are discharging their duties with care, skill and due diligence. They are adopting fundamentally sound investment policies and implementing them within their states. They are attentive to fund activities that are affecting the health

of their state's investments. And finally, they are active in their communication with mutual fund management, working to find equitable solutions to recent industry abuses. These actions have been taken with a fundamental goal in mind: to restore investor confidence, mutual fund companies need to provide timely and accurate information about costs and fees, performance and potential risks. Mutual fund companies should be required to provide investors access to timely and understandable information.

### **What should investors do?**

Investors must actively research and monitor their fund investments to ensure that fund managers have their best interests in mind. At a minimum, investors should look to see that the mutual fund charges reasonable annual expenses; and that the fund management provides open and honest communication with investors.

The fees charged for participation in a mutual fund are a key issue for investors. These fees can be substantial and may erode investment returns in mutual funds. Generally, investors do not pay enough attention to mutual fund expenses. Some funds charge investors upfront or back-end "loads," or commissions, and all funds charge investors management fees, under the term "expense ratio." Investors should be aware that even small fees may detract from growth in investments. In fact, fees mount over time because investors' total assets mount as well.

These recommendations, of course, are predicated on investors having adequate access to timely and intelligible information on mutual fund fees and expenses. Equally important, particularly for the long-term health of investors, and by extension to the whole economy, these investors need a strong education on how to approach and manage mutual fund

investments. Thus, in considering regulatory reform, the Committee should also address the scope and adequacy of financial literacy training in the United States.

### **Policy Recommendation**

In recent months, the Securities and Exchange Commission has taken a number of steps to address issues raised by state and federal investigations into mutual fund sales and trading practices. For example, to address late trading issues, the Commission adopted a new rule to require that an order to purchase or redeem mutual fund shares be received by the mutual fund by the time that the fund establishes for calculating its net asset value in order to receive that day's price. We believe this rule would effectively eliminate the potential for late trading through intermediaries that sell fund shares.

The Commission also recently proposed an amendment to rule 12b-1 under the Investment Company Act of 1940 that would prohibit mutual funds from directing commissions from their portfolio brokerage transactions to broker-dealers to compensate them for distributing fund shares. This would eliminate a large potential conflict of interest, aligning fund companies more directly with the interests of their shareholders.

The Commission also recently adopted a compliance rule that will require funds and advisers to have compliance policies and procedures, to annually review them and to designate a chief compliance officer who, for funds, must report to the board of directors. The designated compliance officers and written policies and procedures will have several benefits, including having a designated person charged with fund compliance who must answer to, and be accountable to, the fund's board of directors, thereby enhancing

compliance oversight by directors, as well as allowing the SEC's examination staff to review the reports made to the board.

The Commission also proposed enhanced disclosure requirements. These enhancements would require funds to disclose market timing policies and procedures, practices regarding "fair valuation" of their portfolio securities and policies and procedures with respect to the disclosure of their portfolio holdings. This type of disclosure should shed light on market timing and selective disclosure of portfolio holdings so that investors could better understand the fund's policies and how funds manage the risks in these areas.

Mutual fund boards of directors play an important role in protecting fund investors. They have overall responsibility for the fund, oversee the activities of the fund adviser, and negotiate the terms of the advisory contract, including the amount of the advisory fees and other fund expenses. In order to improve such governance, the Commission recently proposed amendments to its rules to enhance fund boards' independence and effectiveness and to improve their ability to protect the interests of the funds and fund shareholders they serve. First, independent directors would be required to constitute at least 75 percent of the fund's board. Second, the board would be required to appoint a chairman who is an independent director. Third, the board would be required to assess its own effectiveness at least once a year. Its assessment would have to include consideration of the board's committee structure and the number of funds on whose boards the directors serve. Fourth, independent directors would be required to meet in separate sessions at least once a quarter. Finally, the fund would be required to authorize the independent directors to hire their own staff.

We commend the Commission for its efforts in this area. The new rules governing board composition and functions, as well as governing trading practices and expense disclosures, will go a long way toward rectifying many of the abuses identified in the recent investigations of the mutual fund industry.

The implementation of these new rules confirm our opinion that the mutual-fund industry is neither inherently corrupt nor in need of a major structural overhaul. While these rules properly clarified and strengthened, it is not necessary to undertake wholesale reform of the regulation of this industry. The vast majority of people in the fund-management industry are honest and hard working. Collectively, they provide a valuable service to the American public. Moreover, the U.S. fund industry has a good long-term record of serving investors. This record reflects the strengths of the industry's structure and the emphasis placed on disclosure by its overseers and regulators. To the extent that the industry has lost its way in recent years, we believe that it is a function of its participants placing profit over the needs of mutual fund investors. The profitability of the fund company or its employees must never take precedence over the interests of fund shareholders.

However, we remain concerned in particular about a practice that does great damage to investor confidence in the fairness and equity of mutual fund investments. Specifically, what are prospective mutual fund investors being told about revenue sharing arrangements and other incentives provided by mutual fund companies to brokers selling their funds? Do customers understand that their broker is being paid to sell a particular fund? And when these payments are being made from fund assets, do customers

understand that their own investment dollars are being used to foot the bill for the mutual funds' premium "shelf space" at the selling broker's office? Such fees may increase costs to investors as well as create conflicts of interest between investors and the financial professionals with whom they deal.

Congress should act promptly to eliminate this gap in mutual fund fee disclosure. Current SEC rules and positions provide investors with a misleading picture of the incentives of brokers from whom they buy fund shares. If an investor buys shares of a particular company, his broker must send a confirm that shows how much the broker was paid in connection with the transaction. In contrast, if an investor buys shares in a mutual fund, the confirm is not required to provide this information. The Commission is considering possible solutions to this problem. But we believe this issue is so critical to restoring confidence in mutual funds, that Congress should require that all compensation received by brokers in connection with sales of fund shares be disclosed on fund confirmations, as well as any information necessary to direct investors' attention to incentives that a broker may have to prefer the sale of one fund over another. With America's investors experiencing a crisis in confidence in the mutual funds, fee disclosure reform is more important than ever.

### **Financial Literacy Programs**

In order to succeed in our dynamic American economy, our citizens must be equipped with the skills, knowledge, and experience necessary to manage their personal finances and retirement needs. All members of our society should have the financial knowledge necessary to make informed financial decisions. Despite the critical importance of

financial literacy, many citizens lack the basic skills related to the management of personal financial affairs.

The recent allegations of fraud in the mutual fund industry underscore the tremendous need for financial education in the United States. Improved financial education will help mutual fund investors better understand the costs associated with this form of investment, as well as the risks and rewards of mutual fund investing. A better-educated class of investors would understand the industry, which would increase overall confidence in the capital markets.

State treasurers have long recognized the need for improved financial education for all of our citizens. For many years, treasurers have taken a very active role in promoting financial literacy to the residents of their state. State treasurers strive to provide and promote financial education for the benefit of the citizens of the states, to improve their quality of life. State treasurers draw on their substantial expertise in the financial management of both personal and public funds to provide opportunities to educate the citizens of the states on savings, from birth to retirement. Members emphasize there is a critical need for personal savings to the citizens of the states. Through the legislative processes, state treasurers support public policy positions that promote savings, and seek changes of current policies which hinder and penalize savings.

The financial literacy programs range across a variety of target demographic groups, from school-age children, to women, to public officials. For example, state treasurers have developed an innovative personal finance workshop targeting women interested in learning how they can take control of their financial situations. Since that first Women

and Money Conference, more than 15 treasurers have implemented this program in their states. The treasurers in Delaware, Maine, Massachusetts, Ohio and many other states have developed strategic partnerships with local, regional, and national organizations and they continue to provide Women and Money Conferences for residents of their states.

Alabama Treasurer Kay Ivey, who has worked on financial education matters for 30 years, works closely with local Boys & Girls clubs to teach financial basics to the young people in her state. In another example, Delaware Treasurer Jack Markell has developed an innovative program called the Delaware Money School designed to bring community-based financial education to participants in a pressure-free learning environment. Topics covered in the Money School include basic money management, investing, and retirement planning. Specialized classes are also offered at the request of churches, senior citizen centers, or community groups.

In the Delaware Money School, a coalition of financial professionals—from the financial service industry, nonprofit organizations, and government—volunteer to teach the classes. The Money School is a collaborative undertaking with various community and public organizations, it can also be structured to fit the specific needs of a group of people or provide educational opportunities as they arise.

Many of us take the lead in providing education programs for state and municipal employees charged with managing public finances. These workshops present participants with tools to deal with the fiscal and ethical issues they face when investing public resources. In some states, continuing education is mandated for public fund managers, and the treasurers' programs satisfy this requirement. In other states, the treasurers

initiate the workshops on their own. In California and Ohio, where the programs are mandated, more than a dozen workshops on topics, ranging from investment management to innovative financing techniques, are held each year. In Illinois and Indiana, where the programs are not required by law, the treasurers hold annual conferences for local public finance officials.

In addition to the programs administered by the states, the National Association of State Treasurers has taken an active role in providing educational opportunities to members and other public officials responsible for the management of public funds. For eight years, NAST has sponsored the National Institute for Public Finance, a comprehensive curriculum designed to enhance participants' understanding of public financial management and increase their abilities to make independent financial decisions. We also recently established the NAST Foundation, a not-for-profit organization, to promote and improve the educational initiatives of the organization and individual state treasurers.

The common theme among these programs is the vital need to provide all citizens, and the public officials who serve them, the tools and information to understand and negotiate our complex financial markets. The issues raised by the recent developments in the mutual fund industry amplify this need. Financially literate investors, supplied with clear and understandable information, are better able to make informed investment decisions, which is critical to their and the nation's financial health and well-being.

## **Conclusion**

Collectively, legislators, regulators, and the industry can rebuild and preserve the public's trust in mutual funds by implementing stronger disclosure requirements in order to better align fund management company interests with those of fund shareholders. This will give current and prospective investors access to the type of information to enable them to make fully informed decisions about their investments.

By bringing more visibility to the corporate structure of funds and by enhancing the availability and usefulness of financial information disclosed by the firms, this Committee can demonstrate to American investors that mutual funds will continue to operate as the cleanest, brightest investment method for all Americans. The industry does not need a wholly new set of operational rules or new oversight groups, it simply needs to be held accountable to both the letter and the spirit of the rules that have guided it well for decades. We believe the simple improvements suggested here can help keep the industry focused on its ultimate mission—helping investors meet their goals and secure a safer future for their families.