Testimony
of

Mellody Hobson

President
Ariel Capital Management, LLC/
Ariel Mutual Funds

“REVIEW OF CURRENT INVESTIGATIONS AND REGULATORY ACTIONS REGARDING THE MUTUAL FUND INDUSTRY: FUND OPERATIONS AND GOVERNANCE”

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

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Thank you Chairman Shelby, Ranking Member Sarbanes, and members of the Committee. I am honored to be here today. The issues facing mutual fund companies demand serious and thoughtful attention from industry leaders, mutual fund regulators, and from the members of this Committee. An appalling breach of trust by some in the fund industry has raised doubts about the industry's commitment to integrity – a commitment that hundreds of mutual fund companies and tens of thousands of fund employees have spent more than sixty years building. As such, I sincerely thank you for allowing me the opportunity to testify.

I particularly welcome the chance to speak on behalf of hundreds of small mutual fund companies, and applaud the Committee for its thoughtful consideration of our special concerns.

I am the President of Ariel Capital Management, LLC, which serves as the investment advisor to the Ariel Mutual Funds, a small mutual fund company based in Chicago. By way of background, our firm's Chairman, John W. Rogers, Jr., founded Ariel twenty-one years ago at the young age of twenty-four. John's exposure to the stock market began when his father started buying him stocks every birthday and every Christmas instead of toys starting when he was just 12 years old. Ultimately, his childhood hobby evolved into his life's work—a passion that led to the creation of our firm.

It is worth noting that at the time of our inception in 1983, Ariel was the first minority-owned money management firm in the United States. In many ways, you can say we are a testament to the American dream. John and I certainly feel that way.

In part because of our pioneering status, we work particularly hard to reach out to those who have not experienced firsthand the wonders of long-term investing, compound growth, and the creation of enduring wealth. To this end, I also serve as the financial contributor for a national network news program. Besides educating all investors, our unique mission is also to make the stock market a regular part of dinner table conversation in the Black community.

Ariel's four no-load mutual funds hold about $5.5 billion in assets and serve approximately 280,000 investors. So clearly, our responsibilities to investors are quite large. But it should be just as clear that as a company, in comparison to the largest mutual fund firms, we are quite small. Ariel has a total of 74 employees.

I think it is important for the Committee to be aware that small mutual fund companies are the norm in our industry, not the exception. In fact, more than 370 mutual fund companies in the U.S. manage $5 billion or less.

Perhaps the point is stronger if you consider it from a different perspective. If you combined all the assets of these 370 smaller mutual fund companies that manage $5 billion or less into a single firm, we would still be a little less than half the size of the nation's largest mutual fund company.

Clearly, there are important ways in which Ariel and other small, entrepreneurial mutual fund firms stand far apart from the giants in our industry. Yet, because of our vision and hard work -- and because of regulatory innovations like the SEC's Rule 12b-1 -- we are able compete fiercely and often quite successfully with larger fund companies every single day. In this way too, you can say Ariel is a testament to the American dream.

The revelations about trading abuses involving mutual funds are extremely painful. I am, of course, profoundly disappointed about the abuses that have occurred at mutual funds. Ariel is 100 percent committed to supporting effective reforms that ensure these abuses will not happen again. I am greatly concerned that mutual fund investors have had their confidence shaken and my life's work has been threatened by individuals motivated by their selfish, shortsighted interests.

Nevertheless, I think it is important to tell you that I still take enormous pride in being part of a great industry. I do not believe that most mutual fund companies ignore their fiduciary obligations, have lost their connection to their customers or abandoned the basic principles of sound investment management. In fact, I believe nothing could be further from the truth. As a mutual fund executive, I know my future, my credibility, and my livelihood are inextricably linked to the success of Ariel shareholders.

The fundamental obligation of a mutual fund company is to provide dependable, cost-effective, long-term investment products. This is no small feat considering the destinies of average Americans and the capitalist system itself is at stake. Each day, my firm, Ariel, strives to do just that. I strongly believe the overwhelming majority of the nation's mutual fund companies work to do the same.

Regarding the three areas I have been asked to address today, I would like to emphasize the potential affects on small mutual fund companies like Ariel.

<u>FEES</u>

First, I would like to address the costs and fees borne by mutual fund shareholders. In order to adequately discuss this issue, it is important for

policymakers to understand not just the sum of mutual fund fees, but also the parts.

A shareholder in a mutual fund is unique. No matter how much is invested, each receives equal access to all of the benefits the mutual fund offers—diversification, professional management, liquidity and simplicity. For example, Ariel investors who invest fifty dollars per month are afforded the same benefits as those who have multi-million accounts.

Industry critics claim mutual fund fees are excessive when compared to management fees of pension funds and other institutional accounts. This argument is incomplete and wrong. Comparing the fee structure of an institutional account to a mutual fund is like comparing an apple to an orange. In fact, despite some surface similarities—mainly the offering of investment management services—the organizational, operational, legal and regulatory frameworks for mutual funds versus institutional accounts could not be more different.

More specifically, total costs for a mutual fund investor include a litany of services that are not commonly offered to institutional investors. These services have been developed to increase shareholder access and knowledge. They include phone centers with licensed service representatives made available to answer any questions; web-sites that often provide 24 hour account access; compliance, accounting and legal oversight; as well as the development of everything from the prospectus to the shareholder letter that keep investors informed about how their funds are performing.

In contrast, the management of an institutional account generally only calls for portfolio management and a letter detailing performance. As opposed to the investment manager, the pension plan sponsor generally is responsible for legal, regulatory and participant communication. The ICI recently completed an excellent study of this question. I have attached a copy of it to my testimony as Appendix 1, and commend its key findings to you. Among the most important is the fact that, when you adjust for the substantial differences between managing mutual funds and pension plan portfolios, the costs of the two are essentially identical.

Fee differences aside, the total amount mutual fund shareholders are being charged, contrary to what some claim, has decreased. The SEC, GAO and ICI have all found that substantial majorities of mutual funds lower their fee levels as they grow, which is the very essence of economies of scale.

In addition, the ICI has found that since 1980, the average cost of owning stock mutual funds has decreased by 45 percent; bond funds, 42 percent;

and money market funds, 38 percent.[1] Not to mention, because of the great deal of competition in our industry, investors can and *do* vote with their feet. This is clear from the fact that 87% of the assets shareholders have invested in stock mutual funds are in funds whose fees are lower than the industry average. Stated differently, the typical investor's equity mutual funds have total annual expenses of just one percent, which is nearly 40% less than the fees charged by the average fund. The SEC reached similar conclusions in the mutual fund fee study they completed in 2000.

When an investor buys a fund, they receive a prospectus with a fee table listed within the first pages which details total cost. A critically important part of the fee table is the mandatory, standardized example it includes that illustrates the costs an investor can expect to pay over a one-, three- and five-year period given a $10,000 investment. This example enables investors to make exact apples-to-apples comparisons of the total costs of any of the 8,000 mutual funds in the country.

It is for some reason neglected in many of the media reports I see on mutual fund fees, but the fact is that the fee table was redesigned by the SEC in 1998 following the most extensive testing with investors ever undertaken by the agency. Multiple focus groups were sponsored to determine how to make the fee table as accessible and useful as possible. And both the SEC and GAO have since testified before Congress that the fee table is an extremely useful and accurate way to compare the costs of competing mutual fund investments. The SEC has made the further point, which again is frequently overlooked, that the fee table provides a form of disclosure to investors that is superior to what is offered by all other financial services.

A significant mutual fund fee issue that has been frequently misunderstood relates to a component of the fund expense ratio called the Rule 12-b-1 fee.

This issue is of great import to small mutual fund companies like Ariel, and impacts our ability to distribute funds to investors. The easiest way to think about mutual fund distribution is to equate it to distribution in the film industry. You may be an inspired director and have made a great movie, but if you do not have a distributor, no movie theaters will get copies of your film and most individuals will never have a chance to see it.

The same is true of mutual funds. You can have a terrific, well-managed mutual fund with an excellent track record. But if the fund company does not have access to wide sources of third party distribution, it will most likely be a fund without investors. Third party firms with the scale to offer

[1] "The Cost of Buying and Owning Mutual Funds," Investment Company Institute, Volume 13, No. 1, February 2004.

small mutual funds access to broad distribution channels obviously must be paid for their services. Rule 12b-1 fees have been absolutely critical to our effort to expose many small mutual fund companies like Ariel to millions of potential investors around the country.

Lastly, on the subject of fees, the mutual fund industry is the only industry I know of where price increases are rare. In order to raise its management fee, a fund company must first get a majority of all fund directors to agree. They must then get a majority of the independent directors to separately vote in favor of the increase. Those steps alone are insufficient: the fund company must ask its shareholders to vote on the increase, and a majority is required for the proposed increase to take effect.

For this reason and others, price regulation of mutual funds would be directly counter to the principles of capitalism. With over 500 mutual funds companies and nearly 8,000 mutual funds, investors have choice. Federal regulation of prices is often necessitated when there are few competitors and so little choice that the opportunity for monopolistic practices is a threat to the consumer. This is not the case in our industry.

GOVERNANCE

Secondly, the issue of board governance is worthy of some discussion given the recent push to mandate independent chairs for mutual fund boards. While we do have an independent board chairman at Ariel Mutual Funds, I would argue the designation is irrelevant based upon the unique way in which mutual funds are governed. More specifically, independent directors already make all of the major decisions affecting the funds they oversee. For example, independent directors have the exclusive ability to renew the investment manager's advisory contract, which is clearly one of every mutual fund's largest annual expenses. A full review and renewal of this contract must take place each and every year. Independent directors also have extensive authority with respect to hiring and retaining firms that provide key services to the fund, such as the fund's outside auditor. Additionally, independent directors are solely represented on Board nominating committees—leaving affiliated or inside directors little say in the board's ultimate composition. Finally, as both the SEC and GAO testified in June of last year, once boards are composed of a majority or super-majority of independent directors – as most funds already are -- the independent directors are fully empowered to dictate who the chairman of the board will be.

Another governance-related point worthy of discussion is the newly enacted requirement pertaining to fund company boards and the hiring of a compliance officer. I certainly understand why the SEC and others –

including the ICI – have looked to such a requirement in response to the abuses revealed in recent months. ICI President Matt Fink has said that he views this particular requirement as one of the changes most likely to have enduring benefits for funds and their shareholders.

We will defer to policy experts with respect to the likelihood that the compliance officer requirement will produce the hoped for benefits. But we urge everyone involved to also recognize the substantial disproportionate cost that requirements like this – and many others currently on the table or being discussed – will pose for smaller mutual fund companies. We obviously have much more limited resources than the small number of very large fund companies. Therefore we hope you and other policymakers are aware of the serious impact such requirements will have on our cost structure and on our competitive position within the industry. While obviously well intended, rules of this nature could create a barrier to entry for future entrepreneurs – like my colleague John Rogers -- interested in starting a fund company.

DISCLOSURE

Federal Reserve Chairman Alan Greenspan recently observed, "[I] n our laudable efforts to improve public disclosure, we too often appear to be mistaking more extensive disclosure for greater transparency."[2]

Chairman Greenspan 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."[3] 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."[4]

In a report to the House Financial Services Committee last June, the SEC reported that it had adopted 40 new investment company rules since 1998, averaging one every seven weeks. The list the SEC developed is attached as Appendix 2. At the time this represented the busiest period of SEC mutual fund rulemaking in its history.

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

[3] Id.

[4] "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.

Since the first revelation of trading abuses on September 3 last year, the SEC has averaged one new regulatory action every two weeks. During this time, the SEC has adopted two additional mutual fund rule requirements, proposed nine new regulatory initiatives, and issued a concept release about whether to require a new form of cost disclosure.

I believe that in responding to new concerns and problems by simply calling for more disclosure, we risk impeding rather than enhancing decision-making by individuals. It is worth remembering that when the SEC overhauled mutual fund prospectuses six years ago, the simplified plain English prospectus was hailed as the most beneficial SEC change to disclosure requirements in the industry's 60 year history. At the time they adopted the new prospectus requirements, 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.[5]

Earlier, I mentioned I serve as an on-air financial contributor to a television network news program. I also author a bi-monthly column to aid investors. In these roles, I have literally received thousands of questions and requests for guidance. The recurring theme in these appeals for help is that 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. Rarely do I hear complaints about too little information. Instead, it is nearly always the opposite—investors drowning in data and paper with no ability to assess what really matters. Interestingly, I've received many fairly sophisticated inquiries, but I have never received a question about some of the more esoteric fund company matters currently under review.

For these reasons, I respectfully suggest that Committee concentrate a considerable part of its efforts in the weeks ahead on how we could clarify and increase understanding of the critical mutual fund information that is already disclosed to individuals. This Committee clearly recognizes from its past work that financial literacy is fundamental to any serious effort to empower investors to make the right choices that will secure their futures as well as those of future generations.

At Ariel, we take financial literacy very seriously. We have partnered with Nuveen Investments to create an investment and financial literacy program at a Chicago Public School bearing our name. Through this effort, we award each first grade class a $20,000 gift that follows them

[5] Id.

through their grade school career. As the students progress through the school's unique investment curriculum, so does their involvement in the portfolio process and the management of their class fund.

The ICI has developed a major initiative with similar goals. Through its Education Foundation -- the ICI created a program called Investing for Success Program. The program is a partnership with the National Urban League, the Coalition of Black Investors Investment Education Fund, and the Hispanic College Fund. Carefully designed programs have been presented in conferences and workshops across the country, on the Internet, and at historically black colleges and universities.

We believe educational programs like these will help diminish the confusion and fear that shrouds the investment decision-making process and replace it with a culture of knowledge and confidence.

CONCLUSION

My colleagues at Ariel and in the fund industry are grateful for the Committee's efforts. When you find effective ways to reinforce investor protections and support the integrity of our markets, you help our business and our shareholders.

Recent events notwithstanding, it would be deeply regrettable if attempts to heighten mutual fund company oversight eroded the competitive position of small firms, one of the most dynamic and entrepreneurial parts of the fund business. For fund companies such as Ariel, it could seriously impair any efforts to enter and even remain actively engaged in this marketplace.

Similarly, I urge you to bear in mind the consequences for mutual funds overall if regulatory burdens increase so much that companies determine it is more attractive to them to market far less regulated investment products and services. I know that groups like Fund Democracy and the Consumer Federation of America share this concern, and I too think it merits your serious study.

Thank you again for the privilege of testifying. I look forward to your questions and appreciate your patience.