TESTIMONY OF ARTHUR LEVITT

BEFORE THE

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

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Chairman Baker, Ranking Member Kanjorski, Members of the Subcommittee:

Thank you for inviting me to share my thoughts on allegations, and unfortunately, burgeoning evidence of self-dealing in the mutual fund industry.

As regulators and lawmakers examine the sale and operation of mutual funds, it is important, at the outset, to remember that mutual funds represent the best vehicle from which the individual investor can access our markets. Regrettably, the industry has taken advantage of this fact. Investors simply do not get what they pay for when they buy into a mutual fund. And most investors don't even know what they are paying for.

The industry often misleads investors into buying funds on the basis of past performance. Fees - along with the effect of annual expenses, sales loads and trading costs -are hidden. Fund directors, as a whole, exercise scant oversight over management. The cumulative effect of this has manifested itself in the form of late trading, market timing and other instances of preferential treatment that cut at the very heart of investor trust.

It would be hard not to conclude that the way funds are sold and managed reveals a culture that thrives on hype, promotes short-term trading, and withholds important information. The SEC and other law enforcement such as the New York Attorney General, no doubt, will aggressively investigate and prosecute criminal activity.

For the longer term, it's well past time to consider meaningful change in the administration and governance of mutual funds. I hope that the industry will recognize the grave threat these questions represent to its health and will embark on substantive reform itself, along with the necessary hand of the SEC. I also want to thank Chairman Baker for his reform efforts and his often lonely voice on behalf of investors.

I think reform may include the following areas:

One of the most effective checks against egregious abuses of the public trust is broken-the strict oversight of independent directors. Many so-called independent directors have professional or collegial ties with fund managers or themselves are recently retired managers. Fund boards should have only one inside director. Everyone else on the board should meet a strict definition of independence from the fund complex.

Equally important, the chairman of the fund company must be independent. That is one of the best ways to improve accountability for management practices. He or she should sit on a reasonable number of boards. For board members or chairman to be compensated for service on as many as one hundred boards is not reasonable.

During recent weeks state and federal authorities working together have uncovered egregious and sometimes criminal violations of the public trust. Such miscreant entities should be required to appoint to their boards an investor ombudsman for a defined period of time.

The largest mutual funds pay money-management advisory fees that are more than twice those paid by pension funds. It is essential that investment company boards be required to solicit competitive bids from those who wish to undertake the management function. Furthermore, boards should justify to their bosses fund shareholders- why they chose a particular investment adviser and each year demonstrate that they have aggressively and competitively negotiated management fees.

Sadly, funds have moved away from a culture of diversification and probity in favor of an almost frenetic competition to market investment products as if they were soap or beer. The fund industry should themselves proactively ban performance advertising. Such misleading hype encourages bad practices such as portfolio pumping to boost quarterly performance. Companies that do not accept the importance of change to protect their franchise and continue to promote and hype performance should be required to advertise returns only after the effect of fees and taxes has been applied. What millions of American investors currently see in magazines and newspapers is just plain deceptive.

Despite the SEC[1]s efforts to persuade the use of Plain English, the language of the industry is still hopelessly arcane. What average investor understands the meaning of 12b-1 fees, closed-end funds, or A,B,C classes of shares? Mutual funds have a long way to go before they start talking in the language of investors.

The executives, fund managers and directors of a fund complex should be required to disclose their compensation. A fund's shareholders should know how much they are paying someone to invest their money and if the incentives of that manager's compensation is in investors[1] long-term interest. In addition, the trading by managers of fund shares or securities that are part of a fund[1]s portfolio should be prohibited in favor of long-term ownership. Having run several large sales organizations I totally reject the specious argument that such practices are essential to retain competent managers of that such practices hone skills or prove commitment.

I suspect market timing issues are far greater than the industry acknowledges. For instance, the closing down of an unsuccessful fund exchanged for a new fund within the same complex could well be considered an example of a market timing strategy with funds moving back and forth between a stock and a money market fund.

The 1940 Investment Company Act states that mutual funds are to be organized and operated in the interests of shareholders. We should consider a legislative amendment that precedes those words with a statement that it is the fiduciary responsibility of directors to ensure that funds are organized and operated in such a way.

Not long ago, most investors bought directly from mutual funds themselves. Today, more than 80 percent of funds are purchased through brokers and not nearly enough of them disclose revenue-sharing deals that pay them more to put clients in a certain company's funds. The brokerage system of selling mutual funds is riddled with conflicts. Revenue-sharing, sales contests and higher commissions for home grown funds should all be banned.

I have long wrestled with the issue of soft dollars. It's clear that the practice of allowing higher commissions in return for broker-directed research has created great potential for abuse. At the very least, investors should know what commissions they are paying and what the money is going towards.

Disclose it and do it simply. More broadly,in light of the many abuses of this practice Congress should consider revisiting the safe harbor it granted to soft-dollar arrangements shortly after the abolition of fixed commissions in 1975.

“Seek simplicity and distrust it,” someone once remarked. I can't help but wonder if they worked in the mutual fund industry. Mutual funds have a lot to answer for. But I've come to know many in the business and most realize that without investor trust, our markets simply can't function. I hope that they will speak out and be the voice of meaningful, yet pragmatic change. In the last year, the voices in Corporate America and Wall Street were largely silent in face of scandal. Mutual funds, given their very form and function, cannot afford to be.

Thank you.