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"Resource Allocation and Strategic Planning at the Securities and Exchange Commission"

Good morning, Chairman Platts, Ranking Member Towns, and sub-committee members.

Thank you for inviting me to speak with you today. I hope that my experience in the mutual fund industry will be helpful in considering the issues before you regarding resource allocation and strategic planning at the Securities and Exchange Commission.

I have been involved with the mutual fund industry ever since I began to write my senior thesis at Princeton University in 1949. In 1951, I went to work for industry pioneer Wellington Management Company, heading the company from 1965 to 1974. In 1974, I founded a new mutual fund organization, which I named The Vanguard Group of Investment Companies.

Vanguard represented my attempt to create a firm that would measure up to the goals I set forth for the fund industry in my thesis, all those years ago:

- To place the interests of fund shareholders as the highest priority;
- To reduce management fees and sales charges;
- To make no claim to performance superiority over the stock market indexes;
- And to manage mutual funds, "in the most honest, efficient, and economical way possible."

These goals proved to be closely aligned, not only with what I regarded as the *spirit* of the Investment Company Act of 1940, but with its *letter*: to insure that mutual funds are "organized, operated, and managed" in the interest of shareowners, rather than of managers and distributors. We've done our best to achieve those goals, and today Vanguard is both the world's lowest-cost provider of financial services and, with some $730 billion of assets under management, one of its two largest mutual fund firms.

Since relinquishing my position as Vanguard's senior chairman in 1999, I have been engaged in researching, writing, and speaking about investing and the mutual fund industry. I have also written a half-dozen op-ed pieces for *The New York Times* and *The Wall Street Journal* on these matters, as well as several additional books, all presenting strong views of this industry's need to better serve its shareholders. But I am sorry to tell you that the fund industry has yet to measure up to the idealistic, yet wholly realistic, goals I urged upon it way back in 1951, indeed the goals so clearly articulated in the 1940 Act.

Disgusting as they are to someone like me who has made fund management his life's work, the recent market timing scandals have a good side. They call attention to the profound conflicts of interest that exist between mutual fund *managers* and mutual fund *shareholders*—conflicts that arise from an inherently flawed governance structure in which fund owners, in practice, have little voice.

The trading scandals are but the small tip of a very large iceberg of conflicts. One academic estimate of the cost of international time-zone trading came to $5 billion per year. By contrast, in 2003 alone, the total cost of managing the industry's $7.0 trillion of assets in stock, bond, and money market funds may have come to more than the $100 billion, a cost that is largely—indeed, almost entirely—responsible for the shortfall of mutual fund returns to the returns available in those markets themselves. If the management fees that represent the major portion of those costs were subject to arms-length negotiation between the funds and their managers, tens of billions of dollars could be saved and added to investor returns, year after year.

The kind of *stewardship* that demands that fund directors effectively represent the shareholders who elect them and to whom they are responsible under the law is rarely found in this industry. Rather, managers have focused on *salesmanship*, their agendas dominated by the desire to bring in assets under management. That marketing agenda led us to create hundreds of risky "new economy" funds during the stock market bubble, not because they were prudent investments, but simply because we saw that the public was eager to buy them. In the ensuing market crash, these very funds cost their shareholders hundreds of billions of dollars.

The conflicts of interest that engendered these unhappy and costly outcomes for fund shareholders must be resolved in favor of fund *owners*, not *fund managers*. The recent scandals give us the opportunity to at last build a fund industry that is worthy of its early heritage, one that does what I have long—sometimes, I think, *forever*—suggested: Give this industry's 95 million investors a *fair shake*.

The Role of the SEC

Achieving this goal, finally, must come from the industry itself. But it cannot be accomplished without an active, energetic, dedicated, fully staffed Securities and Exchange Commission. During my long career, both before and after the market bubble and the corporate and mutual fund scandals, I have had frequent occasion to work with members of the Commission and its staff. It is without hesitation that I report to the Subcommittee that, virtually without exception, I have found these individuals to measure up to the highest standards of public service—integrity, expertise, education, intellectual curiosity, and willingness to listen and make reasoned decisions. I salute them.

The Commission's oversight and examinations cover tens of thousands of corporations, exchanges, accounting firms, broker-dealers, investment advisers, and mutual funds. As the activities in each of those fields exploded in a frenzy during the late market bubble, the Commission's workload soared accordingly. So did the SEC fees paid by these entities, from $750 million in 1996 to $1.8 billion in 1998 to $2.3 billion in 2000.[1]

Had those fees flowed directly to the Commission, it might have had a fighting chance to hire, retain, and motivate a staff sufficient in number and talent not only to deal with the cascading flow of paperwork from new offerings of securities, new and complex financial instruments, and new mutual funds, but to increase its investigation, overview and probe more deeply into the emerging issues of the era. However, the SEC fees *collected* each year do not represent the funds actually *appropriated* for SEC operations. In fact, the Commission's

[1] All figures are approximate.

appropriation was just $300 million in 1996 (only 40% of the fees), $315 million in 1998 (20% of the fees), and $370 million in 2000 (16%).

It is hard to imagine that the Commission would not have been far more able to handle the added regulatory responsibilities engendered by the bubble had its funding grown apace with its responsibilities. But even in 2003 (when SEC fees had fallen to $1 billion), it was appropriated only $600 million in funding. I am pleased that a substantial increase in funding lies ahead, for a Commission starved in resources and plagued by huge staff turnover is a Commission unable to fulfill its mission of overseeing our nation's vital system of financial markets.

That said, I do not want to appear to excuse, solely on the basis of limited resources, the Commission's failures in its oversight of issues, markets, and funds. Economics, after all, is about the allocation of limited resources in a world where need is essentially unlimited. Neither private enterprise nor public agency ever succeeds in getting its resource allocation precisely right. (I can assure you that in running two different fund management companies, I certainly didn't!) But we must acknowledge our mistakes, learn from them, and use that wisdom to do a better job in the future.

My sense is that the Commission has done, and is doing, exactly that. I am impressed with the leaders of both the Division of Enforcement and the Division of Investment Management as they respond to the clear evidence of unethical, and in some cases illegal, behavior that have been uncovered among a score of mutual fund managers, including some once considered industry leaders. I am also impressed with Chairman Donaldson's vigorous leadership in reforming how the Commission operates, as outlined in his testimony to the Senate Committee on Banking, Housing, and Urban Affairs on April 8, 2004. His initiation of a new Office of Risk Assessment and Strategic Planning is directly and positively responsive, of course, to the subject of your hearing today.

As I am most familiar with the Commission's Division of Investment Management, I will take the liberty of commenting on a few of the issues that are receiving attention today, and some that seem to have received, for whatever reason, inadequate attention in the past:

1. **Mutual Fund Market Timing**. The so-called "time-zone" trading in international funds has been going on for at least a decade, although it seemed to accelerate in recent years. Most industry participants were aware of it, and its frequency could be easily measured, or at least suggested, by the daily purchases and liquidations in each fund's shares; these data, indeed, are published in each fund's annual and semi-annual reports. In funds where the most frequent timing was going on, shares purchased and redeemed each year were three or four *times*—or more—the fund's total assets. In some cases, the sources of these flows were difficult to detect, but far too few fund managers seemed willing to stem the tide by such obvious means as stiff redemption fees, mandatory holding periods, or "fair-value" pricing.

2. **Hedge Funds**. The activity of hedge funds in this illicit market timing activity also was hardly a secret. Indeed, an article by four New York University professors, published in *The Financial Analysts Journal*[2] in 2002, noted that there were thirty hedge funds that identified "mutual fund market timing" as their investment strategy. The article not only described how to implement timing maneuvers and the returns achieved by timers, but also bluntly pointed out that such schemes worked against the interests of the other shareholders in the funds and urged fund managers to take corrective action. (For this and other reasons, I share Chairman Donaldson's view that hedge funds must be brought under the Commission's purview.)

3. **Portfolio Manager Disclosure**. Having full and fair disclosure has been—and should always be—the hallmark of our system of financial regulation. But we should not forget that the reason disclosure works is only in part that it informs the investing public. Even more important, in my view, is that *disclosure modifies behavior*. In essence, if an action has to be disclosed, we'll think twice before we do something questionable. I would hope the Commission would dedicate some resources to the issue of disclosing the compensation of mutual fund executives, often veiled by the fact that they are employed by a management company that is either privately-held or part of a financial conglomerate. The Commission is now considering a proposed rule that would require, among other things, disclosure of *how* (but *not how much*) portfolio managers are compensated. It must be obvious that such a limited disclosure is essentially *no*

[2] "Stale Prices and Strategies for Trading Mutual Funds," July/August 2002, by Jacob Boudoukh, Matthew Richardson, Marti Subrahmanyam, and Robert F. Whitelaw.

disclosure. The Commission should require disclosure of the *dollar amount of each manager's compensation* (including his or her share of the profits of the management company itself). Comparable disclosure should also be required for the five highest-paid executives of the company. There is no rational reason for exempting fund executives from the spotlight of public disclosure applicable to their counterparts in regular corporations.

4. **Pension Accounts Managed By Fund Managers.** Among the 100 largest fund managers, 13 are state and local pension funds. Of the 87 private managers, fully 77 manage *both* mutual funds *and* pension funds. This issue is worthy of Commission focus for two reasons: First, to understand how fund managers handle potential conflicts between the two classes of clients, such as allocations of portfolio transactions and new issues. Second, and even more important, to assess the reasons for the wide disparity in fees paid by pension fund and mutual fund clients. The California Public Employees' Retirement System, for example, often pays advisory fees of a mere *one-hundredth* of the fees paid by the mutual fund controlled by the adviser, both portfolios presumably owning similar portfolio securities. Calpers typically demands, and receives, low base-fee rates, with incentive fees for superior returns, but the adviser doesn't agree to similar arrangements with its mutual fund. There may be reasons for the differences, but the Commission—to say nothing of the fund's board of directors—ought to understand them.

5. **401-k Plans**. Recent press reports have reported clandestine payments from fund mangers to pension clients, often in the form of rebates. The relationship between administrative costs paid by these plans, the costs assumed by the fund sponsor and their relationship to the advisory fees the assets generate, the amounts borne by the company, the amounts shifted to the plan participants, and the sources of compensation to pension consultants all deserve prompt and careful study. Most 401-k plan arrangements are unregulated, and guidelines for fair practice do not seem to exist. This area should be a high strategic priority.

6. **Conglomerates**. Until 1958, fund management companies were privately-held organizations, owned largely by the fund managers themselves. Then, despite Commission opposition, the Supreme Court held that such companies could go public. As a result, public ownership and ownership by fund conglomerates has gradually

become the industry's *modus operanti.* Of the 50 largest fund managers, only seven privately-held firms remain (including Vanguard, owned by our *fund* shareholders). Seven are publicly-held, and 36 are owned by large U.S. and foreign financial conglomerates, banks, brokerage firms, and insurance companies. These businesses purchase fund companies in order to earn a return on *their* capital; yet the 1940 Act makes earning a return *on the fund shareholder's* capital the over-riding priority. This rarely acknowledged conflict of interest cries out for study.

7. **An Economic Study of the Mutual Fund Industry**. While I have been calling for such a study for at least eight years, my voice has fallen on deaf ears. *Such a study must be an essential focus of the Commission's strategic planning efforts*. It would evaluate the role of mutual funds and their managers in the context of our national economy, and facilitate an understanding of how the fund industry actually works. We need, in short, to "follow the money"—to account for the sources of industry's direct revenues (administrative fees, distribution fees, sales loads, out-of-pocket fees, etc.), operating expenses paid by shareholders, and indirect revenues utilized by fund managers, including brokerage commissions. We also need to account for the uses of these revenues—for administration, for marketing and distribution, for investment management, and for other major cost centers (including soft dollars). Without this information, regulation must, in essence, operate in the dark—in an information vacuum. (Be clear, please, that I am *not* in favor of fee regulation.)

Having laid out this litany of priorities for strategic study by an SEC whose resources are already stretched, I fully recognize that the job before the Commission is large and its resources, while larger now, are limited. But these tasks are not only worthwhile, but essential, for the protection of investors. However, I would like to offer a final recommendation that could, in the long run, actually *reduce* the Commission's regulatory responsibilities. Just think about it: One of the principal reasons for existing regulations, the additional regulations now being considered, and the areas for study that I've noted above is the need to deal with the profound and obvious conflicts of interests that exist between mutual funds and *their* shareholders on the one hand, and management companies and *their* shareholders on the other. The timing and late trading scandals are obvious examples of this conflict. The setting of appropriate fees is an equally obvious conflict, and has an economic impact many times the magnitude of the scandals. And the fund industry's focus on asset-gathering through huge sales and marketing expenses and new and exotic "products" clearly manifests another conflict of interest, also of huge dimension.

Yet, as I noted at the outset, the Investment Company Act of 1940 provides that *funds must be "organized, operated, and managed" in the interests of their shareholders, rather than their advisers and distributors.* Metaphorically speaking, the law of the land—our Constitution, if you will—puts the fund in the driver's seat and the management company in the rumble seat. (Indeed, a narrow reading of the Act would not even allow the management company in the *car*!) But the fact is—I think beyond argument—that it is the management company that is driving the car. If funds were truly organized, operated, and managed solely in the interest of their shareholders, many, indeed most, of today's regulatory issues would vanish. *The funds themselves would protect their shareholders*—with their own rules against market timing and late trading; with advisory fees that were set at arms-length and with failed managers not necessarily being replaced by managers from the same company; and with funds organized not merely because they can be sold, but with service to investors and prudent investment principles as their foundation.

How can we achieve, or at least approach, this goal? Now *there* is a good question for the use of SEC strategic resources! For an industry that operates, as the 1940 Act says, "in the national public interest and the interest of investors," public policy *must* move in the direction of an industry structure focused on the interests of its share owners, just as the existing law both intends and expresses.

How to begin?

1. A federal standard of fiduciary duty for fund directors.
2. An independent chairman of the fund board.
3. No more than a single affiliated director.
4. A staff (or consultants) to provide the fund with objective information with which to evaluate the management and marketing performance of the advisor, as well as the appropriate compensation for its services.

We need these long overdue reforms in fund governance, and *we need them now*. Some steps may require only Commission action; some (notably the fiduciary duty standard) doubtless would require legislation. High on the Commission's list of strategic priorities and its allocation of resources should be the decision as to where regulation will suffice and where legislation is required, and it should be a vigorous proponent of such legislation.

These reforms are hardly a panacea that will bring the fund industry into compliance with the spirit of the 1940 Act. But "a journey of a thousand miles begins with a single step." Thank you for hearing me out.