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SUBCOMMITTEE ON GOVERNMENT EFFICIENCY
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Thank you Chairman Platts and Members of the subcommittee for holding this important hearing on mutual fund regulation. I also wanted to thank the committee for holding this hearing at Pace University. It is rare that we get to host such an important event on campus and I hope the committee will consider holding other meetings here in the future.

With this testimony I will give my thoughts on two particular issues concerning the regulation of the mutual fund industry. First, I believe that the Securities and Exchange Commission (SEC) is making impressive strides to improve the institution's ability to regulate the fund industry; however I think more should be done given the increased importance of mutual funds in the U.S. Second, I believe that disclosure is the most important issue to focus on with regards to regulating the mutual fund industry. In general, it is my belief that investors are intelligent. If they are informed of the basic operations of mutual funds in a clear, concise and accurate way, investors can understand the differences between funds and hence make better investment decisions. I say this because I believe that many of the problems in the fund industry are associated with the lack of disclosure.

In terms of the SEC's role in regulating mutual funds, I believe that Chairman Donaldson is moving the regulatory institution in the right direction. The much needed, recent increases in the SEC's budget have allowed it to hire many more people and pay them more competitive salaries. This, combined with the SEC's fresh interest in investigating many of the most important mutual fund abuses such as disclosure, fees and market timing, are all major improvements. However, I would encourage the committee to push for even more funding and support of the SEC with regards to the mutual fund industry. Consider for a moment that the size of the SEC's budget has gone from 166 million in 1990 to a proposed 913 million for 2005.[1] This constitutes an increase of 5.5 times. From 1990 to 2002, mutual fund assets have increased about six times according to the latest numbers from the Investment Company Institute.[2] Hence, on the surface, it appears that funding of the SEC is keeping pace with growth of the industry. But if you look more deeply, these figures do not illustrate the entire picture. For example, in 1990 only 6.7 percent of total financial assets held by U.S. households were in mutual funds. At the end of 2002, the percentage was 17.8 percent, an almost threefold increase. Hence, while the SEC funding may be close to matching the growth of mutual fund assets, it does not take into consideration that the importance of funds has dramatically increased since 1990. For this reason, I believe the funding of the SEC with regards to mutual funds should be increased even beyond the levels it has currently attained.

Furthermore, I would encourage the committee to push for more support of the SEC during the times that it needs it most: bull markets. Paradoxically, the very moments when the SEC needs the largest increases in funding are, I believe, when markets seem to be behaving well. It is during

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[1] Data taken from the SEC's webpage at http://www.sec.gov/foia/docs/budgetact.htm
[2] Data taken from the ICI's Mutual Fund Factbook (2003), page 23.

such times that many scandals arise as support for regulation declines considerably. Congress, like the SEC, must be far-sighted enough to know that bull markets do not necessarily mean the fund industry is functioning well.

The second issue I would like to discuss with the committee is that of disclosure. As I said before, I believe that many of the problems in the fund industry are associated with the lack of disclosure and that forcing the industry to be more up-front about fund practices would greatly help the industry in the future.

First, consider expenses. As is well known, mutual funds do not clearly describe their expenses to investors. While the expense ratio does give information on the cost of running many of the aspects of the fund, brokerage fees are often not included in this calculation. What this means is that it is difficult, if not impossible, for investors to discern the true expenses of a fund. This is vital information for the following reason. In almost all the academic research on mutual fund performance, the one factor that is shown to be of help in predicting future fund performance is expenses. That is, low expense funds, on average, out-perform funds with higher expenses. However, because not all expenses are disclosed to investors, they are left without the key information to help them invest wisely. If the SEC were to require full and complete disclosure of all fees and expenses, it would greatly help investors in selecting funds and, I believe, it would help restore public trust in mutual funds.

Second, another problem with mutual funds that is related to disclosure is window dressing. All mutual funds in the U.S. are required to disclose their actual portfolio holdings only twice a year. Recent academic research (some of it my own) however, indicates that since disclosure is so infrequent, some funds practice a behavior known as window dressing, whereby they cosmetically alter their portfolios right before disclosure in an effort to make the portfolio look better than it actually is. For example, a bond manager may attempt to hold slightly higher quality bonds right at the time of disclosure in an effort to show a safer portfolio. However, immediately after disclosure, the manager dismantles these cosmetic positions. For investors, the detrimental effects of window dressing are two-fold. First, investors are misled about the sources of fund performance. Taken to the extreme, this deception could conceal investing behavior inconsistent with the fund prospectus. Second, additional explicit transactions costs are borne by investors to build and dismantle cosmetic positions. It is my belief that window dressing could be mitigated with more regular disclosure. If funds have to disclose their holding more frequently, say on a quarterly basis, it would be more difficult for a fund to hide what it is actually holding and more expensive to practice window dressing, as funds would have to build and unwind these cosmetic positions more often. Although more frequent disclosure does increase administrative costs, I believe that the gains of more frequent disclosure, i.e., less window dressing and more information for the investor, outweigh the additional costs.

The last issue I wanted to discuss is that of the SEC making mutual fund information easier to understand for the average investor. Indeed, I feel that some recent developments in the mutual fund industry to sell funds via brokers have actually made it more difficult for average investors to understand mutual funds and thus have hurt the industry. For example, consider the issue of multiple share classes. About 12 years ago, almost all funds in the U.S. were either load or no-load mutual funds. However around the mid-1990's, just as investors were beginning to understand the difference between a load and a no-load fund, many funds moved to multiple share classes as a result of the adoption of rule 18f-3 by the SEC in 1995. Just like other mutual funds, multiple-share-class funds represent a portfolio of underlying assets. However, unlike other funds, they have different share classes differentiated only by how investors pay fees. For example, a single-class fund only has one fee structure where as a multiple-share-class fund can have two, three or even four different fee structures on the same underlying portfolio.

To understand the impact of multiple-share-class funds consider that at the end of December 1991, the Morningstar mutual funds database indicated that there were 2,373 funds. By the end of December 2000, the same database indicated that there were 12,029 funds; a more than five-fold increase in nine years. However, since each share of a multiple-share-class fund is counted as a separate fund by Morningstar[3], these numbers are completely overstated. Indeed, when multiple share classes are adjusted for, the numbers drop to 2,322 funds at the end of December 1991 and only 5,349 funds by December 2000. Hence, the rise of multiple-share-class funds is responsible for about 69 percent of the increase in the reported number of funds over this period.

Although the stated intentions of rule 18f-3 seem quite positive for investors, i.e., investors would now be able to choose the fee structure that best suits them without the funds having to pay the costs of creating several funds, many of the effects of the rule change have actually been quite negative for investors. For example, one of the most obvious problems with multiple-share-class funds is that mutual fund fees have become more complicated for investors. Indeed, just as investors were getting used to the distinction between load and no-load funds, the industry adopted an alphabet soup of fund share classes that investors have to sift through.

Moreover, in maybe the most negative consequence of multiple share classes, a colleague of mine, Edward O'Neal, has found that the introduction of multiple share classes has given rise to broker compensation arrangements that can be quite different across share classes. For example, brokers may receive more compensation for selling a deferred-load class share rather than a front-load class share. O'Neal documents that such incentives have lead to clear conflicts of interest as brokers try to sell a share class that is the best for them and not the best for the investor.

To conclude, I would encourage the committee to more fully support the SEC with regards to mutual fund regulation. The industry has seen its importance increase dramatically and this fact alone merits more funding for the industry's chief watchdog. In terms of the focus of the SEC regulation efforts, I believe that fuller disclosure with an emphasis on relatively easy-to-understand statements of fees, expenses and portfolio holdings is the way to go. At some point, mutual funds have to be self-regulating, but it is my belief that the SEC should allow investors to make more informed decisions by requiring funds to disclose much more information to the public.

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[3] It is interesting to note that the methodology of the well-known Morningstar ratings system did not even reflect that multiple share class funds were the same funds until June 2002.