TALKING POINTS FOR ARTHUR LEVTT, JR.
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Thank you, David *[Ruder]*, for that kind introduction.

And let me thank Ned Reagan for hosting us here at Baruch College. As many of you know, I followed -- after a few years -- David as SEC Chairman, and Ned followed my father as New York State Controller.

At this rate, I'll end up as President of Baruch – and David will end up with my golf handicap.

I want to thank David, Allan Mostoff, and the entire leadership of the Mutual Fund Directors Forum for doing the hard work of getting this organization up and running.

When I proposed the formation of the Mutual Fund Directors Education Council during my time as SEC Chairman, it was done with the belief that independent directors played a critical role in protecting the tens of millions of Americans investing in mutual funds.

Therefore, it was imperative that we had a place that was itself independent from the mutual fund industry where independent directors could stay on top of changes in the field and changes in the demands of their job.

That's why I am so glad to see all you here today for this discussion. I am going to speak briefly, and then I'd be more than happy to take your questions.

I. The Interplay of Rules and Culture Change

- The inherent tension in capitalism is that it takes rules and regulations – apparent restrictions on the free market -- to make the free market work. And market breakdown can occur if there are too few rules, too many rules, or the wrong rules.

- This summer here in New York, we saw this occur as the lights just went out.

    - The blackout, according to the experts, was caused by a de-regulatory process that never built in incentives for anyone to invest in transmission lines.

    - Supply increased. Demand increased. And the same number of wires conducted the electricity. The result was a blackout. The cause, ultimately, was a market meltdown.

- Enron, WorldCom, and Andersen were our own version of a total blackout. We had rules that created incentives for people to do wrong – or not to do right.

    - i.e. accounting rules that favored stock options as compensation created incentives to do whatever necessary to meet stock price targets.

- The Sarbanes-Oxley Act and the other regulatory steps taken over the past year began to set the rules right.

    - These rules were necessary, but not sufficient.

- Now, we need to wait for people's behaviors to change – for the entire corporate culture to change. That is the critical next step. It's the difference between ephemeral and enduring reform.

II. The Problem with the Mutual Fund Industry

- Unfortunately, in the mutual fund industry, we have yet to see the vital first step – the reforming of rules to create the right incentives. And there is much work to be done.

- 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 taxes on investment returns – are hidden.

  - According to the Bogle Financial Center, fund expenses and sales commissions -- for the average taxable investor -- eat up 3 percent of equity funds' assets each year. That's almost half the long-run real return on stocks (7 percent).

- Fund directors more often than not are management lapdogs and not investors' watchdogs.

- And, as a whole, the industry spends very little time educating the new investors it attracts.

  - Consider that one study found that 84 percent of mutual fund investors believe that <u>higher</u> fees buy better performance.

- The effect of all of this is now finally coming to the attention of even casual readers of the business pages. We have recently learned:

    - One in three investors who qualified for load discounts didn't get them and overpaid for mutual fund shares by an average of $364.

    - The largest mutual funds pay money-management advisory fees that are more than twice those paid by pension funds.

    - Mutual funds run up trading charges averaging five cents a share – five times the rate paid by retail investors – in order to generate millions of dollars in soft dollars.

    - Big hedge funds have been able to late trade while the rest of us were stuck playing by the rules.

    - The rights to market-time trades within funds were effectively sold to the highest bidder. One study estimates that these trades are costing investors $5 billion a year.

III. The Importance of Independent Directors

- Sadly, one of the most effective checks to these abuses has been broken – independent directors.

- Warren Buffett in Berkshire Hathaway's annual report last year summed up what many of us have thought about independent directors of mutual funds:

- "For the most part, a monkey will type out a Shakespeare play before an 'independent' mutual-fund director will suggest that his fund look at other managers – even if the incumbent manager has persistently delivered substandard performance."

- Part of the problem is that many independent directors are hardly independent – many have professional or collegial ties with the fund managers or themselves are recently retired managers.

- Another part of the problem is that independent directors are stretched far too thin. It's recommended that corporate directors sit on no more than five boards. The typical fund director sits on dozens.

    - The chairman of Bank of America's Nations Funds, for example, sits on 85 funds. The chairman of Janus is a director for 113.

- It is no surprise, then, that fund managers are hardly fired – and that a Morningstar study found that where mutual fund directors were paid particularly well by the fund-management company, the fees were especially high.

- We stopped tolerating these conflicts of interest and this lack of interest in true stewardship in our public companies. It's time that we stop tolerating it in our mutual fund companies.

    - The time has come for fund companies to limit the number of directorships on which a person can serve.

- It's time for the SEC to tighten the definition of independence, increase the number of independent directors, and demand that boards justify to their bosses – the shareholders – the choice of investment adviser and fees charged.

- But more than that, we need independent directors who are independent in mind, in spirit, and in practice.

    - They need to be responsible men and women who would not hesitate to call in their own auditor or counsel...who would not think twice of meeting privately... and who are truly committed to the responsibility they have to shareholders.

    - They would be the type of people who would come to a forum like this. And I hope in the future to see hundreds of directors sitting in these chairs in conferences to come.

- Independent directors are so critical because you can be the catalyst for change. You can – and should – be a voice for change within the mutual fund industry, pushing for reform – not against it.

- Urging you to action is easy – any speaker can do that. So let me end my talk by offering some suggestions for reform. It's not a complete list, but a start – for our discussion today and for true change in days to come.

IV. The Agenda for Change

- <u>First, the brokerage system of selling mutual fund shares is broke, and we need to fix it.</u>

- Just last week, the NASD settled with Morgan Stanley a charge that it improperly offered brokers more than $1 million in prizes in at least 29 internal sales contests to boost sales of specific products.
    - Among the perks the brokerage offered were all-expense trips to resorts, seats to playoff games, and Britney Spears tickets.
    - To quote Ms. Spears, "oops, I did it again" is an excuse that investors should no longer tolerate.
- The NASD should close the loopholes and ban all broker sales contests and quotas, ban the granting of higher commissions to brokers for selling the firm's own funds, and regulate the compensation of branch managers who are paid more for selling more.
- And funds themselves should do their part and limit the number of classes of shares in order to limit investor confusion.

- <u>Second, the industry must share information about revenue-sharing</u>.
    - Not too long ago, most people bought directly from mutual funds themselves. Now, most buy through brokers, and in more than a few cases, brokers don't disclose revenue-sharing deals that pay them more to put clients in a certain company's funds.

    - For the good of the industry, fund companies and brokers should make it a policy to be up-front about any benefits perks they get for selling a certain fund. If not, it's a matter of time that this disclosure will be forced upon you through regulation.

- Third, stop the clock on market-timing. You can – and should – help us fix the problem of market-timing of trades by pushing your funds to put an end to it and embrace fair-value pricing.

    - About two-dozen fund companies have embraced fair-value updates – including Vanguard, T. Rowe Price, and Fidelity. Urge your companies to join them.

- Fourth, don't just watch the portfolio; watch the portfolio manager. It's your job to pay attention to the turnover rate within funds to see if a manager is flipping securities, and driving up costs for shareholders.

    - Bring to light more useful information on how and how much fund managers are compensated.

    - While there's a big debate on soft dollars, we can all agree that it's in the interest of shareholders to know where their money is going and to whom. Disclose it.

- Fifth, when it comes to fees, we need more disclosure. There are many different proposals on how to disclose more about fees. Just keep it simple.

- The truth is that investors will always look at performance to judge what fund to buy. What they need, is the take-home number – that is, what could they have taken home after all fees and taxes are taken into account.
    - Just as you don't set your family budget based on gross income or shop for a TV based on the cost before shipping and taxes, you should not have to shop for a mutual fund based on these metrics.
    - Under this rubric, top performers may not necessarily be the top performers currently at the top of the charts.
    - But if this action is taken, we could bring about reform without relying entirely on the heavy hand of regulation.

V. Conclusion

- New rules will come – of that I'm certain. They will change incentives. But, enduring change will not happen unless the industry itself steps up to the plate and embraces reform.
    - Only then, will we have the type of culture change that will make reform endure.
- If the mutual fund industry does not send a message that it will take meaningful steps to increase disclosure, improve transparency, and heighten accountability, then investors will conclude that they are not getting what they pay for. And they will leave.

- But if the industry takes the opposite, confidence will be restored and the mutual fund industry will prove that they are indeed investors' best friends.

- Thank you, I'd be happy to take any questions.