RECENT DEVELOPMENTS IN THE MUTUAL FUND INDUSTRY
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MATTHEW FINK: Good morning. I'm Matthew Fink, and it's my honor to introduce the last of the four online programs on Developments in the Mutual Fund Industry presented by the Securities and Exchange Commission Historical Society. This morning's program was originally scheduled to be the first broadcast on March 1st, but a snowstorm that day prevented us from gathering. I hope that we've saved the best for last.

The SEC Historical Society is a non-profit organization, separate from and independent of the SEC. The Society preserves and shares the history and historic records of the SEC and of the securities industry through its virtual museum and archive at www.sechistorical.org. Today's program will be preserved in the virtual museum so you can listen to the discussion or read the transcript later.

Today's program looks at recent developments in the mutual fund industry. Our panelists are Kathryn McGrath, a partner with the law firm of Crowell & Moring; Robert Pozen, Chairman of Massachusetts Financial Services; and James Riepe, Vice-Chairman of T. Rowe Price, Inc. This is an extremely experienced panel. The four of us have been involved with mutual funds for over 100 years.

The Developments in the Mutual Fund Industry Series is made possible in part through the support of the Richard and Elda Phillips Fund. The remarks made today are solely those of the speakers and are not representative of the Society. Our speakers cannot give investment or legal advice.

Let me begin with the recent revelations regarding market timing and late trading. The mutual fund industry for many years prided itself on the virtually scandal-free record since the enactment of the Investment Company Act in 1940. In December 2002, the Society coordinated a Roundtable on Investment Company Regulation, archived in the virtual museum in which Kathryn McGrath, who was a moderator, asked "Why has the fund industry stayed relatively clean over all these years compared to the other segments of the financial services industry? Is it that big problems, massive scandals haven't been detected, or is there some combination of culture in the industry that has made this work so that the business can go and grow while at the same time, the money isn't being stolen? It was a great question, and it's the kind of issue we're going to address today. Let me begin asking Kathie to set the stage by explaining what is meant by late trading and by market timing.

KATHRYN MCGRATH: Well, late trading means to violate the standard provision that applies to mutual funds, which is that customer orders to buy a fund's shares or redeem a fund's shares are supposed to go in before a certain time, and you don't know what price you're going to get. Your price is computed after the market closes. This was to prevent investors from playing around with funds by knowing what the price was going to be before they made their buy and sell decision. What's happened is that some unscrupulous broker-dealers and other intermediaries let some customers, who paid them off, put their orders in late, after they would know pretty much what the price would be, what they were going to get, or sometimes they let people put their orders in on time, but then allowed them to withdraw their orders after hours once they could see which way the wind was blowing. This is illegal. Unfortunately, the SEC's rules on the subject aren't a model of clarity, so there have been some problems in enforcing it.

Market timing, in the old days, we all thought it meant that you had some system of investing and your plan was to go in and out and try to capture changes in stock price movements or changes in interest rates. What it came to mean in recent years with the introduction of big funds that invest most of their securities and most of their portfolio in foreign securities was taking a look at changes in the US market that turned out to be predictors of what foreign markets were going to do, and trading frequently to capture pricing and efficiencies in a fund because of the way they priced their shares and by trading frequently, making more money

than perhaps other shareholders in the fund. Market timing means frequent trading to try to capture the financial benefit of changes in the market that are going to affect the fund's price.

JAMES RIEPE: I think Matt, one amplification of what Kathie said is that market timing really is kind of an umbrella that covers some things that are quite okay, and some that are not, and the real problem was excessive short-term trading and people arbitraging international markets versus US markets, whereas I suppose there's market timing where people can move money once a year or once every two years and there's certainly nothing wrong with that.

MATTHEW FINK: What was the kind of market timing that raised the uproar here? It wasn't even just day trading, was it? What's led to all these cases in the press, the Congressional hearings?

KATHRYN MCGRATH: Well, mutual funds put restrictions on frequent trading because they found them to be disruptive to the fund as a whole and the shareholders like me who sit there for the long-term with a lot of money going in and out rapidly, they get portfolio transaction costs, administrative costs. It gets expensive and it gets disruptive, so funds put into place restrictions, but weren't enforcing them, or and some times were selling the right to certain selected investors to market time despite those restrictions.

MATTHEW FINK: And I guess in some cases allegedly market timing themselves, people inside the fund complex.

KATHRYN MCGRATH: Yes, there were a number of instances where people who worked in the fund complexes figured out who to do this and tried it with their own 401(k) accounts, or their own personal accounts.

ROBERT POZEN: I think that we ought to carefully distinguish late trading as Kathie says as people submitting orders after the 4 o'clock close and we can see then in cases of some of these hedge funds, they had computer bypasses for the normal routes, and they were able to submit their orders at 7 PM when clearly they had a knowledge of the prices that no one else. While Kathie is right, the rules may not be absolutely clear, I think that those types of late traders were in a very information-advantaged position, and unfair information-advantaged position because they knew what the price was at a time nobody else did, and I think it's fair to say that there were real damages suffered by fund shareholders because these people did have a step up on everybody else. By contrast, market timing is not itself illegal, and I think that should be clear that what Kathie says is right. The questions that have been risen is what where the disclosures made by fund complexes as to how they handle market timing and whether those were implemented fully. Many of those disclosures in retrospect could have been done better, but many of them had words that denoted that there was some discretion on the part of the complex. Some of them said we don't allow market timing to the extent that it's detrimental to shareholders. Some of them said we usually don't allow market timing, so there were lots of different connotations. I think that the SEC is taking a pretty strong position that if you had any of these sorts of statements, you really had to have policed very carefully people from moving in and out, but I think what's interesting is if you look at the potential damages to shareholders, you really have two very different categories.

One is, as Kathie said, international issue, which has been floating around for a long time. That derives because you have a Japanese fund and the Japanese prices finish, and so a lot of funds were just using the Japanese closing price, which was stale by the time it got to be 4 PM Eastern Standard Time. They'd look at various other things and people had a lot of systems. They had a lot of systems that they thought could predict which way the price is going to go. Actually, I've looked at some of these systems, and not surprisingly, some of them work, and some of them don't work. A lot of funds had started at about 1993 doing fair value pricing, which was a way of saying if we as funds saw that there had been a significant change in the price of say, the Japanese securities if we looked at the Nikkei futures that were changing in Chicago after Japan had closed, then we would adjust those prices and therefore making it harder for people who were trying to play that game to win. What's fascinating to me since I was

involved with the first effort to do that is the SEC at that time gave us a real hard time about fair value pricing and question whether or not it was proper procedure. Now of course you probably get an enforcement if you don't engage in fair value pricing, but I think it just shows the times, but I think that it's probably true that fair value pricing is very complicated, this international thing, so there may have been some people who were able to gain the system a little, but I think most of the big complexes were pretty, pretty, pretty diligent about trying to do fair value pricing, but when you actually do it, it's not so easy to figure out when exactly you ought to adjust the prices, and you don't want to be in a position of sort of playing God, every time a price would change because sometimes prices would change in the Nikkei futures and then by the time Japan opened they hadn't changed, so you really had to look at this carefully. Now if you look at the other issues which are large cap US stock funds, bond funds, these sorts of things, I've looked at a lot of the data and I must say that I think that the market timers have sort of lost as much as they gained. In fact, actually, they tended to lose a little more. The notion that you can if you're not late trading, if you don't have this special information you can have some sort of system by which you look at what happens in the market in the last three hours in the afternoon and then you do something and the next day you look at some other signal and you do this. I mean we had this early on at Fidelity with this guy Fabian who at one time I thought was a rock singer, just shows how old I am, but apparently he's now an investment advisor and he's got some sort of system. I mean, these people purport to have all these very ingenious systems, but actually in the aggregate from the shareholders point of view these people who moved in and out quickly, what's interesting is that I would say in general, they didn't make money, and some of them actually lost money, and so from the shareholders point of view, you really can't say that there was real big damage to the funds. Now, you can say, and this is really the core of where the SEC was that the shareholders weren't properly apprised of what the policies were and how they were being implemented and I guess in retrospect it's probably true that people could have been a lot clearer about the policy.

MATTHEW FINK: Well that takes me back, and I'd like to ask you and I think I'll start with Jim, I think I agree with Bob, late trading is fairly simple, market timing gets in a lot more haziness, but whatever the haziness there, as Kathie said, I quoted her earlier remarks, what do you think all of a sudden produced these problems, or was it all of a sudden? Why did we go 60, 70 years without these kind of at least taken by the media and the Hill and the regulators as massive problems?

JAMES RIEPE: Obviously it's not a single factor, Matt, but I think there's a number of factors one can look at that created the environment in which these things happened and one which I think you could tell just listening to Bob's and Kathie's description is that the markets have become so much more complex and more specialized and consequently keeping track of them, valuing them, transacting in those markets has created both opportunities and challenges and I think that frankly is a factor that's typically overlooked. I think secondly, market bubbles for whatever reason seem to produce complacency, they seem to produce hubris. We're seeing it far outside of the fund industry and I think that is very clear. In our case, what followed the market bubble, the bear market created pressure on people to get an edge, to gain assets, so perhaps they exercised some judgments occasionally that they might not have exercised in a different environment. And lastly, which Bob alluded to very briefly, you had unregulated hedge funds making money in mutual funds, which I would say that most of us were simply unaware of in the business, and I've been in the business over 30 years. I didn't realize there were hedge funds out there who made their living investing in mutual funds, and the only way a hedge fund could make its way in mutual funds is to do things in the area of arbitrage and use these pricing arbitrage issues that Bob described to do late trading, which Kathie described, and I think no one knew that, and the fact that they were unregulated meant that the regulators were unaware of those as well, so I think those are at least some of the factors I've thought about.

KATHRYN MCGRATH: Although there were some hedge funds whose prospectuses listed as their investment style, market timing mutual funds.

ROBERT POZEN: They were registered hedge fund repositories. I think Jim has a lot of the important factors. I'd just add two more. One is, I feel like the mutual fund industry was sort of a victim of its own success in bringing about really high quality service. We made it so easy for people to redeem and so cheap in effect we're the only costless way that you can trade. I mean, if you want to go in and out, we don't charge you a fee, we don't charge you a commission. Before it used to be you had to call up or you had to write; we made it basically through the computer. You could affect transactions really quickly and it was hard for people to know exactly what was happening because it was all done very quickly through the Internet, so in a sense, we provided the best pool of costless, frictionless liquidity, and so for somebody in the arbitrage business like a hedge fund, they think well this is a great deal. We can just move in and out very quietly and quickly. I think the other thing, and we as an industry probably have to come to grips with this, is I think there really has been a change in culture between the early '90's and the early 2000's, and it had a lot to do with the level of acquisitions in the industry. I think it used to be the case in the early '90's that the mutual fund industry were basically a set of companies where investment management was the main thing that they did. They were dominated by investment people and people who had long standing relations with the industry. There was so much acquisition, especially in the late '90's, domestically by various types of banks, insurance companies, and European companies, and these people paid very high premiums that I feel like when you got to the early 2000's and the market bubble burst, you had a new sort of person, you had marketing people coming in and heading these institutions who understandably were under a lot of pressure to produce assets because somebody had just paid these big premiums and had somebody in Europe saying, gee, we thought this thing was going to grow, grow, grow and now the market did this. So I think you really did have a change in culture in the types of people, you know, a much different sort of culture.

KATHRYN MCGRATH: And don't forget, back in the '70's and the early '80's it wasn't that easy for funds to invest in foreign securities and it was funds that invested in foreign securities that were involved in most of these problems because of the screwy prohibition on the funds keeping custody outside the United States. That changed over time, and then with all the electronic stuff and the Internet, foreign markets got linked much more and were reacting much more to developments in the US markets, which led to the potential to have this arbitrage and to be able to execute and arbitrage transaction using foreign funds, foreign portfolio funds. That wasn't there.

MATTHEW FINK: Well that's right, we had a series of environmental changes, the growth of the industry, new people coming in, acquisitions, earnings pressures, greater information about foreign matters and so on. One thing that amazed me and I guess whatever caused it and whatever damage was done, and I agree with Bob that the damage is hard to measure or less than a lot of people would have it, we still had, at least in our lifetime, a record number, I think we had ten Congressional hearings, a pile of SEC rules which aggregated maybe greater than in any ten-year period in the history of the Commission and we were all over the media, a lot of us by name in the media. And given all that the huge scandal, also I guess we didn't mention also on the heels of Enron and WorldCom, so we had kind of an atmosphere of that. Actually I'd be curious, how do you think investors have reacted? Jim?

JAMES RIEPE: Well, I think fortunately investors have reacted either however one wants to characterize it favorably or not all that the reactions have been quite bifurcated as best I can tell, and that is those who were not only in the headlines, but who were found to have abused some measure of trust were penalized and those who were not were still viewed favorably by investors, which is the vast majority. I mean when you add up the number of people who have been prosecuted in one way or another, it's really a small percentage of the industry. I would say however within that group there are some offenses that I think any of us

would consider to be egregious, and there were some that would start to get a bit more marginal as Bob was describing that fall into the gray area, but the one high correlation that I think when I look at the data is it was also somebody who disappointed from a performance point of you, so bad performance in the bear market and being brought into some of these violations had a devastating effect, but if you had reasonable performance coming through the bear market, it seemed to me that investors had stayed with those companies. The very good news I think is that the mutual fund as a structure has not been brought into question at all and the empirical data of the flows of several hundred billion dollars since the first revelations back in September of '03, I think would indicate that investors have not lost any confidence in mutual funds, that some of them may have lost some confidence in certain fund managers, fund groups, but they have not lost confidence in funds generally and I would say the ICI did a survey which you're familiar with, Matt, that they've done for seven or eight years, and that came through loud and clear in that survey.

MATTHEW FINK: So we had a situation, which is not unusual in American life where the media, the regulators, the politicians had it up to about eight decibels, and in fact the shareholders were at two decibels.

JAMES RIEPE: Yes, exactly, and I think, and you just mentioned this, the fact that this came on the heels of Enron, WorldCom, Wall Street research, investment banking, all of those kinds of things, the media was ready to jump on one more "scandal" and I think the interesting thing is that investors, I won't say they ignored it, but they didn't just accept the headlines.

KATHRYN MCGRATH: But isn't some of the harsh reaction from those quarters in part due to the fact that mutual funds serve so many regular old people that don't have a lot of money and really can't afford losses?

JAMES RIEPE: The reaction from the media?

KATHRYN MCGRATH: The media and the Congress and the regulators, it was like my mother's in mutual funds. I'm in mutual funds. These guys are supposed to treat us fairly.

MATTHEW FINK: Well why didn't we hear an up cry from those millions of people like your mother?

KATHRYN MCGRATH: Where else is she supposed to go, with a broker? With a bank? With an S&L? With an insurance company with really outrageous fees? I mean mutual funds are still the best deal around for average people.

JAMES RIEPE: For most investors.

MATTHEW FINK: That was Kathie McGrath, former director. The same Kathie McGrath.

ROBERT POZEN: I think probably another factor in terms of the media reaction is that industry for so long had a reputation as being so clean. If you hold yourself out as really clean, and Kathie's quote from the beginning where, you know, you've been clean so long you sort of put your chin out there and leaning against the chance to get a little come-uppance relative to your reputation.

MATTHEW FINK: I think that's right.

KATHRYN MCGRATH: Knock you off that pedestal.

ROBERT POZEN: That's exactly it, well put.

JAMES RIEPE: Also if you have a very clean face, even the smallest pimple looks.

MATTHEW FINK: I mentioned earlier, just the wave of regulation we had, Bob, and if you just focus on these two problems, market timing, late trading, however defined. What has the SEC done in those areas?

ROBERT POZEN: Well, I think that's really the interesting thing is how little the SEC has done in those two areas and how much they've done in every other area, so you would think that the SEC would have focused on those two areas, but the SEC has put out proposals on those two areas, but in one case, late trading has actually not adopted anything, and market timing put out something which has then become watered down, quite watered down. In late trading, the original proposal was the so-called hard close that you would say no order can be

implemented unless it was received before 4 PM, and that was just a hard wall. But once the SEC started to learn about the operational issues, about how various intermediaries bunched orders and put them together, they realized that, for instance, if you had a broker-dealer with a so-called omnibus account where they bunch the orders and they submit it to a mutual fund, that they probably in order to make 4 o'clock, they would probably have to start gathering their orders at 2 or 3 o'clock, and there were a whole series of operational issues, and I think that the SEC has not gone forward with its hard close proposal. My personal view is that rather than have a hard close or we've also seen some very fancy computer systems proposed, that we should have a low-tech proposal what I call is a certification system by which the intermediaries would certify once a quarter that they had time-stamped the orders. They really had them before 4 o'clock, combined with surprise audits by somebody like the NASD that that would probably go a long way to stamping out almost all late trading and quite frankly it would avoid many of the operational issues and many of the technology issues that I think would be involved with some of the so-called hard close issues. On market timing, the SEC originally came out again with a very tough proposal to require mandatory redemption fees, which would be imposed on any trade within five business days of any fund and the fees would be 2%. Well, as we've discussed, I mean as the SEC learned this is not itself illegal and people have a lot of methods of dealing with it, and it's not clear that redemption fees are appropriate for all funds. In fact, we look at large cap US funds or most bond funds other than high yield funds, it's hard to make a case for redemption fees if you have a reasonable monitoring system and you have reasonable exchange controls, and these sorts of things even in the international area, people will say if you have good fair value pricing, that may be good. In the end, the SEC adopted a rule that says basically it's up to every Board of Directors, every mutual fund to determine what should be, if any, the redemption fee, and if they have a redemption fee, how long it should be, etc. And I think what's happened is actually a relatively sensible thing, people looked at their small cap funds, they looked at their international funds, they looked at their high-yield funds, and so you'll still see redemption fees in those areas, but I think the idea of having across the board redemption fees in many of these large cap funds, very highly liquid, highly efficient markets or just even less basis in things like government bond funds and these sorts of things. I think the SEC was right to back off. And so I think we've reached a middle ground, but I think customers still are not actually very enthused about redemption fees. We may say we're protecting them, but, and the customers may say, well, I don't really trade that often, but it's got sort of like an opportunity cost. People don't like to have choice and the question is what's the benefit?

KATHRYN MCGRATH: Yes.

JAMES RIEPE: It's a big net that catches a lot of people who were not intending to abuse it. I'll tell you, we tried to put a redemption fee on a fund ten years ago, and at the time thought that this would be, we might as well take it to shareholders and they turned it down.

MATTHEW FINK: Is that right?

JAMES RIEPE: And so Bob's point is exactly right, I mean, and then we heard from all the 401(k) participants. They didn't like the redemption fees.

ROBERT POZEN: You have 401(k) issues like every month or every quarter your employer is putting in money and then within five days you move the fund. Well is that a short-term redemption, and you say well, that's not really what we mean by that, and then you get into how exactly are we going to program the computers to eliminate this or that. I think the SEC came out in the right position and I think fund complexes are looking at funds, really small groups of funds where there are real short-term liquidity issues and being careful about that and also trying to develop other mechanisms to deal with this issue.

MATTHEW FINK: So I guess, we'll turn to Kathie next, but when you look at this torrent of SEC rules, I think what Bob indicated I guess by the negative, Bob said, is they've had nothing to do, very little to do, instead we've had a record number and we only have a little time, but I don't want you to talk about everything, but give me three or four of the major things.

KATHRYN MCGRATH: Well they threw the kitchen sink at the fund industry and the advisors. The staff went and threw at it everything they wished they might have done and they started piling it on. So we have new corporate governance requirements, independent chairs, super majorities of independent directors, we have now re-expanded the prospectus and the statement of additional information to make it like the Manhattan telephone directory. We have disclosure on this.

MATTHEW FINK: It's all stuff you wish you could have done.

KATHRYN MCGRATH: Yes, I would have loved it, chief compliance officers, boards have to approve all of the funds and service providers, including the strangers, compliance policies and procedures, employees have to rat out any violations among their fellow employees.

ROBERT POZEN: How much you're paid if you run a portfolio?

KATHRYN MCGRATH: Right, portfolio manager disclosure. They put shares of mutual funds from your own complex under personal trading restrictions so they really run a whole gamut of things and they've done it in a very short time frame and piled it on with little time to think through the rules and make sure they're being implemented properly. And they've hit everybody. They've hit the guilty and the innocent. So it's been very tough and as far as I know, nobody has yet sat back and said hmm, the last time I checked, shareholders paid for all this regulation and compliance. How much is it costing them and is it worth it at the end of the day? I'm not sure it is.

MATTHEW FINK: I told KathieI developed at the Institute what I call the Matt Fink medicine cabinet theory of legislation, and my theory was that in good times when there were no problems, professors, writers, cranks, reformers came up with proposals and nobody paid any attention to them. They're kind of thrown in the medicine cabinet. And then when a crisis hits, the government feels it has to act. Don't just stand there. Do something. And since they don't have time to do a study and really get at it, they reach in the medicine cabinet. So we may have a case of poison ivy, but we're taking anti-cholesterol drugs for it.

KATHRYN MCGRATH: It's like what the guys in the Navy used to say, when in danger or in doubt, run and circles, scream and shout. And the dynamic is very different. We used to get total hard time from the industry and the ICI, and half the stuff on our wish list, it would get batted down. Now it's like the guy in *Animal House*, he's getting spanked. You know, the SEC comes out with another one. The industry says thank you, sir, may I have another? Whack.

ROBERT POZEN: I think one of the most disappointing things to me, if you look at Sarbanes-Oxley when it was passed, there was no discussion of mutual funds. There was the slimmest cross-reference which you can't even find in the legislative history, it was just one section in the '34 Act which has nothing to do with the '40 Act, under which somebody filed a statistical report for mutual funds, and on the basis of that very thin reed, and boy that was a thin reed indeed, the mutual fund industry became subjected the whole internal controls of the Sarbanes-Oxley Act. Now that never would have happened but for this issue, and I mean, I think you can argue, well maybe there should have been some improvement of some internal controls or compliance, but you would have gone back to it a very different way. I mean the cost that's been incurred by the mutual fund industry to have to be subjected to this internal controls regime, which was never designed for mutual funds, has been really big.

MATTHEW FINK: I just want to add, Bob, the cost is not just a dollar and cents, it's a distraction cost, and you're keeping your eye on a lot of irrelevant or not that relevant balls, and it could actually take you off something that was more important.

ROBERT POZEN: What are investors really interested in? Investment performance, that's what they're really interested in.

MATTHEW FINK: I guess we don't agree with all of these rules. Let me talk about the impact of, not with each and every one of them. Let me talk about the likely impact. We all agree, and I guess other people would think a lot of these were a lot better than we think they

are, but what's going to be the effect of these on the industry, and I'm kind of curious, what about people, smaller fund groups, existing fund groups, and what people thinking about entering the industry? Kathie, I was curious. When somebody came to you five years ago and said, gee, I'm a money manager, I'm thinking about going into the mutual fund industry, and if they came to you today, would you give different?

KATHRYN MCGRATH: Yes, you don't have the money. You can't afford it. It's terrible because regulation never did do as good a job of keeping things straight as did competition and it was always possible for groups of people to peel out of the big companies and at least start a private account management business and maybe get into institutional and then go to mutual funds when they got big and successful enough, and that has really I think probably been the biggest factor, the biggest single factor that kept the industry straight over the years and I think a lot of that has been cut off because the compliance and regulatory cost of entering the business is now extremely high.

JAMES RIEPE: I've heard stories of small fund groups who've, in fact know a couple people who required small fund groups, where the manager said you know, they tell me I have to have a chief compliance officer, I don't even have a full-time attorney, and so the costs are really, I think they're going to damage some of the entrepreneurial spirit that Kathie was referring to that really created the competition in the business. You could come into this business as a manager and generate some good numbers over time, and you could raise assets and that would be good for investors and that's the competition, and I guess we worry about that, but I also worry about your earlier point, Matt, and that is this is an enormous distraction. If you put this on top of all the other things that are going on, you've take really the manager's eyes off the investment ball, and every bit of researcher we ever have done says that's the reason people buy, they don't buy funds because they know have an independent director as chair. You know, they don't buy funds because they found out how much of the other funds in the complex the portfolio manager owns, and I'm worried about the insidious part of the distractions here.

ROBERT POZEN: Yes, I think if you look in the 1990's I did a quick and dirty survey. There were over 400 new managers of mutual funds that came into the industry, and some of them did really well, had good records and they went on to thrive, and others didn't, and that's a good thing. And actually, the percentage of assets that were held between 1990 and 2000 by the top ten mutual fund companies and the top 25 companies actually declined right now, I'm going to predict between 2001 and 2010 it's going to go the other way. You're going to have a lot fewer new entrants and they're will be a lot more concentration and I think that's a structural statement about these regulations now serve as a quasi barrier to entry and there's a sort of new economy of scale for compliance. Like if you have a compliance officer, you know that person might as well be doing, you know, 100 billion as they're doing 10 billion, or something like that.

MATTHEW FINK: I think Bob's right. Every year the Institute studies concentration in the industry, and almost every year, there was less concentration. I think we're going to see a tremendous change, just in one year I bet we do.

KATHRYN MCGRATH: Yes, you know, I had a sense in the mid-'80's that creeps were creeping into the mutual fund business because the markets were so hot, and I used to say thank God for the market crash in the fall of '87. It cleaned them out and let them go do something else.

MATTHEW FINK: That's a Darwinian thought.

KATHRYN MCGRATH: But this is not a good way to keep them out because it keeps out both good people and bad people.

MATTHEW FINK: I guess of all the things that hit me is when I read Senator Fitzgerald's bill, and that was like taking this even another layer up and it was kind of nationalizing,

commoditizing the fund industry and I think in effect the bill almost had that intent. I think here nobody intended it, but I think the aggregation of all these rules is pushing it that way.

KATHRYN MCGRATH: Almost move to the bank model, where you have to ask permission to do something.

MATTHEW FINK: In fact the Fitzgerald fee had a provision for any new fee, you had to get prior SEC approval, which to me meant any new service. You're the bank holding company.

JAMES RIEPE: Well I think one of the things that the regulators and the politicians perhaps understandably miss is the challenges for those of us in the business to attract really bright, capable people, and if you impose all of these burdens and rules on them, almost by natural evolution, they're going to go somewhere where all those burdens and controls aren't on them because all they want to do, for example if you're an investor is invest. And if someone's looking over their shoulder and every time they do anything, they have to get permission to do it and they have to disclose personal things that they don't have to disclose somewhere else. This over time will make it harder and harder, and it will, I think push funds generally more towards mediocrity.

MATTHEW FINK: Well Kathie alluded to it before sort of by talking about her mother and all these other middle-income people. It could be that what we've seen is not just these scandals, but the industry has become so wrapped up in America's retirement that the economics of it are driving government not to look at us as just another provider, but as the provider and almost quasi-governmental.

KATHRYN MCGRATH: It's a blessing and a curse for the industry because people are thinking my Social Security's not going to be there. There has been a massive elimination of defined benefit contribution plans across the country and everyone's told by the government and everybody else, well, you know, invest for your own retirement. Okay, what do I invest in? I invest in mutual funds and they're not safe? It's very scary.

MATTHEW FINK: Good for the lawyers, I assume, Kathie?

KATHRYN MCGRATH: The lawyers are pooped.

ROBERT POZEN: What I think happened in the defined contribution business is we had the situation where the participant was going to have choice of different things like that and we increased the amount of choice that these people had to the point where you saw employers with 30, 40, 50 choices.

KATHRYN MCGRATH: Everybody's in the money market.

ROBERT POZEN: I don't think we did the participants any favor, actually, because I think that they were overwhelmed. In fact, I saw a study where somebody said for every five new funds that you added to a plan, you've produced x-percentage more in money market funds because people got too confused and I think that people say they lost money in mutual funds. They didn't lose money because of the scandals. They may have lost money because they put all their money in growth and super-growth funds and the bubble burst.

MATTHEW FINK: No, I think Kathie and I were making the point thought, we've become so successful and so integral to people's planning and their futures, that government doesn't look at us the same, they almost want us to be a bank where it's foolproof. We're everything but a safety net now.

KATHRYN MCGRATH: And Bob's point is correct. I mean, I've tried working with some of the secretaries to encourage them to get into the 401(k) and at least start some savings. The biggest problem I had is to get into it, they have to make a decision among this confusing array of mutual funds, and that freezes them.

JAMES RIEPE: So this is why these so-called target date funds are now so popular, and in effect it's a backlash, if you will, against having too many selections, and so this has been the fastest growing part of new product introduction for many of us in our business and one simply says when are you retiring? I'm retiring in 30 years. This is 2005. Therefore, you take the 2035 fund and somebody will manage the asset allocation process until 2035.

KATHRYN MCGRATH: It'll be a new pickup line in bar. Are you a 20-20?

MATTHEW FINK: Wow. Okay, let me, we've had this not happy discussion about the scandals and the regulatory impact, but we got into retirement and I'll just say that if you look at the industry's growth, certainly during our times, it has been fueled by people saving for retirement. I think mutual funds are over 40% of the IRA market, over 40% of the 401(k) market, and even the studies of people saving outside of qualified plans and IRAs, the number one reason, I think 80% of them identified retirement as the reason. So that's been, I think the driver. It's a lot of different factor. I'd like to just ask a couple of questions about that. We now have the boomers on the edge of retiring, and that's one thing, the demographics of this big cohort coming through while we were prospering certainly drove us. Are you concerned they're going to stop putting money into funds and are going to start redeeming out?

JAMES RIEPE: I'm not, Matt. Somebody, I was doing an employee talk not too long ago and one of my associates asked me that question from the audience and I rather flippantly said well, to tell you the truth, that's your problem, not mine, because of my age. They're still going to be accumulating while I'm here. But I think the real world experience is that people, it's not binary. People don't flip a switch, so the accumulation will abate, but people don't all of a sudden accumulate and then the next day start withdrawing. Also, it relates a lot to how much money people have been able to accumulate. Even at lower wealth levels, people want to leave something. They would prefer not to sort of exhaust their savings by the time they pass away. So I think the accumulation phase will definitely slow down until the Gen-X, the next generation comes through, but all the data tells you that people have not saved properly, so you have this mad rush to save in their last ten years before they hit retirement. So I think you'll see a gradual slowdown of accumulation, but I do not think you'll suddenly see this great reversal.

MATTHEW FINK: Bob, do you have any experience on that?

ROBERT POZEN: Well, I think people are living a lot longer. If you have a married couple, both of whom are 62, they're in good health, and they're not smokers, and you look at the actuarial tables, at least one of them is likely to live to 92, so this is a 30-year retirement. This isn't a two- or three-year retirement. It used to be the case that people would say, well, you cash out, you live off bonds for a few years, but if it's a 30-year horizon that you are looking at, then you're looking at a very different investment scenario, and so I agree with what Jim says, but I think also as the so-called retirement window gets larger and larger, then you can't take money out and just assume that you're going to be able to be okay. The longevity risk is such that you've got to deal with that.

MATTHEW FINK: I was going to ask about new products and services, but Jim actually got us into one new product which is these lifecycle funds. Any other ideas like that?

KATHRYN MCGRATH: Anything that is going to make it easier so that I don't have to make a decision as to a sensible choice or mix or investments. And my financial planning strategy has always been inertia, and I think I'm very typical, and I have a hard time making those choices, and I almost wish we'd go back to the single flavor fund. Put it in that and that will give you enough exposure to different things.

JAMES RIEPE: When we were talking before about the markets becoming more complex, I think that funds are simply a mirror of the underlying markets, and there is no average investor. There's all kinds of investors that use funds and so the fund industry in effect has responded to that, and there are people out there who want to make the single fund choices and there are people who want to make just the 20-35 choice, and I don't think that is a product of marketing or selling, I think that's simply a product of now having 40, 50 million people invested in mutual funds, and all of them having different knowledge bases, different desires, different stages of their life, all those kinds of things.

ROBERT POZEN: Yes, I think it used to be the case that mutual fund industry sponsors and everybody was really geared to putting out a product. We really now are putting out a product and a service, and the service is financial planning for lack of a better word, and so it's

the combination that's being put out and this goes to the whole. Some funds are priced so you do your own advice, any fund that's sold through an intermediary. There's some pricing that's involved with the intermediary giving the financial advice. And for a lot of people, they may actually be more interested in the financial advice then they are about the specific product because they haven't begun to sort out what they want. And I think that's the key, no matter where you are in the industry, even if you're a real direct marketer, you're still going to have to put out more education materials and in the intermediary channel, I think your success is determined by a large degree how well you do in terms of helping people sort out their financial objectives and selecting asset categories. I think we all know that asset category choice over the long run, whether it's stocks or bonds or international stocks, these are more important than actually the specific fund that you choose. Asset allocation drives more of your long-term returns then whether your particular fund has relative outperformed us or not by 50 basis points.

KATHRYN MCGRATH: I think this is the advantage that brokers have and that individual financial planners have because at the end of the day, they tell the customer, okay, here's what we're going to do. Instead of what you get when you go to someone who's going to give you like a direct marketer advice. Well on the one hand you consider this, you consider that, and I can't consider any of it. I'm confused. Tell me what to do.

MATTHEW FINK: But all the big direct marketers at least, I mean T. Rowe, and Fidelity, and Vanguard, all now have financial planning services. They have to.

JAMES RIEPE: It's just a question of degree whether you do it as a small account, or as Kathie says where that's going on. The reality is that for as long as I can remember, roughly four out of five investors for whatever reason want help. Whether they don't have the time, they don't have the interest, they don't have the knowledge, they don't care.

KATHRYN MCGRATH: They care.

JAMES RIEPE: Yes, they care about their money, but they don't care about making the decisions. They don't care about the process, they just want someone to…

KATHRYN MCGRATH: They get frozen.

JAMES RIEPE: do it. And so the one out of five who are prepared to make some of their own decisions.

MATTHEW FINK: Well I think it's not much different than remodeling your house or doing anything else. Most of us would rather get an interior director or a general contractor than sit and put it together ourselves.

KATHRYN MCGRATH: You don't like fabric samples?

MATTHEW FINK: I do, actually I do, Kathy. I was using a hypothetical. I love color. Bob, I have to ask you, since we have you here today and I think you may know, there's been a lot of political stuff on partial privatization of Social Security, private accounts, personal accounts. I know the unions have been saying this is going to be a windfall for the fund industry, and I wonder as one of the world's experts what your view is?

ROBERT POZEN: I think we ought to begin by saying this is a highly political question, whether we're ever going to have personal accounts within Social Security, but I think one of the real myths is that if we have personal accounts, that this is going to be some tremendous windfall for the mutual fund industry, and I think it's because the people who believe that sort of are working either implicitly or explicitly in their heads with an IRA-type model by which they assume you would take some portion of your payroll tax and you choose among 50 different mutual fund companies and you choose this fund or that fund. I think if there's one point of consensus among everybody on all sides of the aisle that is if we do have personal accounts, it's not going to be an IRA model. This was tried in England and it really was quite unsuccessful and very high administrative costs and people wind up in very specialized products, so if we do have any type of personal account, what it will involve is money going into the Treasury through the payroll system. Once a year you'll be allowed to go to some sort of federal thrift plan. It will be quite a limited array, maybe something like, presumptively the money will go into a target

timeline fund or a lifestyle fund or maybe go into 50-50 balance fund, and then you might have a choice to go into a fund that was, say 75% in equities, 25% in bonds, or 75% in bonds, 25% in equities. And these will be run essentially as broad-based, low-cost index funds, just like the federal thrift plan runs the retirement program. So I think for a small, very small group of mutual fund managers who do index funds, they'll have a change to participate in this market, but for the bulk of the mutual fund industry, it really won't be interesting at all. And then the other thing, there are a lot of different variants of these plans, but I would say on average you're talking about $1000 a year going into these accounts. So even after five years, you're talking about well, maybe six or seven thousand and I think the realities of the mutual fund economics are is that these small accounts just aren't windfalls, and in fact many of them aren't even profitable. So I think this is just an area where the mutual fund industry is sort of getting it both ways. I mean on the one hand, people are saying oh, you're going to get a windfall and then, but in fact if it came about, we wouldn't have a windfall, and if we had all these small accounts it would be unprofitable. So I just think this is the real myth. We ought to decide Social Security with mutual funds out of the picture.

MATTHEW FINK: It's funny how pervasive the myth is. There's another thing the Bush administration has proposed that has not gotten a hundredth of the attention, and that is today we have all kinds of IRAs, deductible IRAs, non-deductible IRAs, Roth IRAs, SEP IRAs. The administration, as I understand, has proposed a single universal IRA that would be like a Roth IRA, no front-end deduction, goes tax-free, not taxable when it comes out. Jim, if that went through, how do you think that would affect the industry?

JAMES RIEPE: I think it would, first of all, I think it would positive for investors, and I think it would probably be positive for the industry in that it would make it easier for people to save. I think there's something American about having fragmented and diversified approaches to everything, and I think you need only one payroll deduction deferred savings account and you only need one individual deferred savings account, so to me, the government really should move in that direction because savings is a very serious issue and they ought to make it as simple for people to save as they can, and if they're successful in saving, this will ultimately reduce pressure on Social Security because the third leg of the stool will be larger.

MATTHEW FINK: And Jim alluded to it, Bob, I guess another third Bush proposal is to take 401(k)s, 403(b) plans, 457, I think have a universal.

ROBERT POZEN: Yes, I think having a universal defined contribution plan is also very much a positive idea. I think these grew up for historical reasons. There are various differences. The difference is just really imposed operational costs make it harder for people to move from one type of plan to another.

JAMES RIEPE: It's more expensive for them.

ROBERT POZEN: More expensive. I think there's a compelling case to try to move toward whether it's 401X is one thing, same requirements, same whether you're a private employer, public employer, teachers, this or that, so I'd strongly support that.

MATTHEW FINK: We only have a few minutes left. I'd like to give each of you like a minute to say any particular concerns, predictions, observations.

KATHRYN MCGRATH: I'd like the SEC to slow it down and remember that the phrase ready, fire, aim is supposed to be a joke, and give the fund industry and the people who work in it the chance to catch up and make sure that the new requirements are all working and implemented right.

MATTHEW FINK: Well that's what I heard Paul Stevens say too at the ICI's meeting. No and it doesn't mean, it's breathing space. Jim?

JAMES RIEPE: I just don't, at that point, what I'm hoping for is the SEC has operated for all my decades in the business in a very deliberative, thoughtful way and we have, as Kathie described earlier, we have not had that in the last 18 months. I also think that the investor has been totally lost in this political prosecutorial, media headlined environment that we've had the

last 18, 24 months, and someone's got to go back and start thinking about what actually is helpful to the investor again, what kind of information truly is useful to the investor and what is it the investor. All the people who have imposed a lot of these issues have professed to be representing the investor, but I think the investors been lost in the whole thing.

MATTHEW FINK: Well picking up from what Jim says, I think probably the thing that's really on the table now is this thing called point-of-sale disclosure, POS, and what point-of-sale disclosure really is is the SEC has given up on the prospectus. Nobody reads the prospectus anymore. It's gotten longer and longer.

KATHRYN MCGRATH: Anymore? Did they ever?

ROBERT POZEN: Well for a while we were involved in trying to have a short-form prospectus. This is all out, and the profile, this new POS, I think they call it profile plus, has one page which summarizes fund information on one page, summarizes broker information, and the most important thing is, at least the way the NASD has pushed it and other people including people here pushed it, is this would be deliverable on the web. And that is the key because then you'll go to the web, and you could have links to more and more information, so we've got to find a way to get a very summary document, a two-page document that people actually read, but then to deal with the question is well, how do we know people got all they needed to know. Did they want to know more? That's where we link them to the web and get more information.

MATTHEW FINK: Well, thank you to all three of you. It was a very good discussion. A reminder to today's audience, the program is archived on the Society's virtual museum. You can listen now to the discussion or read the transcript later on. The Society's next online program will be its 2005 Annual Meeting broadcast on Thursday, June 9th at 4 PM. The theme will be Crisis and Resolve: The SEC and the Securities Industry Remember September 11th, 2001. Former SEC Chairman Harvey Pitt will be the keynote speaker, preceded by a panel discussion of SEC and securities industry representatives. I thank our audience for being with us today.