Testimony for Subcommittee on
Government Efficiency and Financial Management
Tuesday, April 20, 2004
Pace University, New York City

Good morning. Thank you Chairman Platts and Ranking Member Towns for the opportunity to address this committee.

I want to talk to you about a series of cases brought jointly by my office and the Securities and Exchange Commission that have resulted in the return of nearly two billion dollars to mutual fund investors and significant industry reform -- all in the span of about six months since my office filed the first case in this area.

Though our philosophies of engagement have not always been identical, I believe that the SEC and I share the same over-arching goals of:

- Restoring funds to damaged investors;
- Restoring investor confidence to the marketplace; and,
- Reforming industry operating practices.

These goals have guided the steps we have taken to date from the cases we have chosen to prosecute to the remedies we have set out to achieve.

The first step in this process was to focus on the practices of late trading and market timing. Each is a discrete violation of the law. Late trading – or trading after the 4:00 P.M. close of the market -- is clearly illegal. And, market timing – the rapid in and out trades of the same fund to reap an arbitrage profit on stale prices – is a long-standing practice that becomes illegal when a manager permits it and when it is carried out in violation of what is disclosed in a fund's prospectus.

The funds we have charged all had prospectuses that clearly stated that the fund either strongly discouraged market timing or flatly prohibited the practice altogether. Nonetheless, the management companies of these very same funds either turned a blind eye to market timers, or worse, created special arrangements with market timers in which the mutual fund's management received what are called "sticky assets," - - a payoff for granting market timers market capacity in which to time - - while long-term buy-and-hold investors got nothing except diluted shares of their investment. Fund management reaped profits, the market timers reaped profits while traditional buy-and-hold investors -- the very people mutual funds were designed for - - lost out. I won't go into the details of how investors lost money, but I would note that there have been a number academic studies quantifying the degree to which gains were reduced and losses exacerbated by these illegal trading practices. The estimates ranges from hundreds of millions to billions of dollars annually.

My office views illegal trading practices as symptomatic of a larger problem. That problem is the inherent conflict of interest that exists when the board of directors of a mutual fund board is essentially the product of the management company that created it. When this happens - - and it happens more often than not - - the board and the management company look out for each other, leaving no one to protect the interests of the fund's investors. Neither the fund boards or management companies were looking out for the millions of everyday investors whose investments were being diluted by late trading and market timing. In addition, neither the management nor the boards were offering or negotiating for the best fees. Indeed, when it came to setting the fees that retail investors would ultimately pay, the board and the management company essentially operated as a single entity negotiating with itself – about as far away from an arm's length relationship as one can get. And the result was that investors were cheated. They paid more than they should have – and that was wrong.

To address this fundamental flaw in the market, I required fee reductions in each of the settlements that my office has finalized. The SEC has opted not to address fees its settlements and we have respectfully "agreed to disagree" on this particular issue, while continuing to jointly investigate and resolve these cases.

Now in this regard, I would like to take a moment to address a criticism that has arisen. The fee reductions have prompted complaints from some that I was somehow interfering with the proper functioning of the market. I would note that at no time did I set a particular fee or make any declaration regarding what an appropriate fee is or should be. Instead, what I suggested was that funds be required to demonstrate the "reasonableness" of their fees. Specifically, the funds should do what the boards should have been doing all along, which is to ask: "Is there a difference between fees charged institutional investors and retail investors for the same advisory services? And if so, why?"

If that question was asked and honestly answered, it would have been revealed that retail investors were being overcharged for management services at many funds. We are now requiring those funds to do what is fair and right – which is to give back those overcharges and to do the job they were always supposed to do -- which is stick up for the rights of small investors. And that, I think, is progress.

Now the most recent chapter in the cases that my office and the SEC have pursued together illustrates what is perhaps the ultimate ill that both offices agree needs to be eradicated: a breakdown in corporate governance. Sadly, it has become clear in a number of our investigations that certain mutual fund board members simply do not understand or do not care about their responsibilities to investors. That is why, in addition to restitution to investors and a fee reduction, the recent settlement with Bank of America provides for the replacement within one year of many of the Nations' Funds board members. This might seem like a drastic measure, but I believe it was clearly warranted, and we will use the remedy whereever the evidence so warrants.

Much work remains to be done in the areas of corporate governance and mutual fund reform. But working together, the SEC and my office have made significant progress and – as I indicated earlier – succeeded in returning a large amount of money to damaged investors. I am confident that we will reach our goals, through a combination of SEC rulemaking, individual civil and criminal enforcement actions, and continuing SEC-state enforcement actions.

Again, I thank you for the opportunity to testify today, and I welcome any questions you might have.