TESTIMONY OF WILLIAM FRANCIS GALVIN

Secretary of the Commonwealth of Massachusetts

Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"Mutual Funds: Who's Looking Out for Investors?"

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I am Bill Galvin, Secretary of State and Chief Securities Regulator of Massachusetts. I want to thank Representative Baker for calling today's hearing to examine abuses in the mutual fund industry. I also want to again thank Senators Fitzgerald, Akaka and Collins for the hearing they held on the Senate side earlier this week.

Representative Baker, while we may have not seen eye to eye on all issues in the past, I want to thank you for your leadership in this area. Months ago, long before the recent abuses came to light, you put the spotlight on mutual fund governance, fees and conflicts of interest. You deserve much credit for your foresight and for your commitment to America's investors and our securities markets.

The bill you have crafted, H.R. 2420, adds important disclosures and addresses areas of abuse that we have seen relating to fund sales practices and operations and I support it. In two specific areas I think it could go further, and I'll address those in a moment.

Today, half of all American households have mutual fund investments. Americans have nearly $7 trillion invested in mutual funds. Mutual funds are about more than money under management. Mutual funds are about the hopes and dreams of middle-income Americans – the hopes of a financially secure and dignified retirement; the dream of a college education for a child. Mutual funds are where America's dreams are invested.

Investors have placed their trust in mutual funds with the understanding that they would be treated fairly – that fund managers would do their duty as fiduciaries.

Unfortunately, we are here today because in too many instances the mutual fund industry has failed to live up to its fiduciary duty. The common theme running through all of the mutual fund issues that we have exposed in recent months is that the mutual fund industry is putting its own interest ahead of its customers.

Another reason we are here today is because industry self policing and government oversight have failed to effectively protect the mutual fund investor. In too many instances, a culture of compromise and accommodation has overwhelmed enforcement efforts. Too often the guilty neither admit or deny any wrongdoing and routinely promise not to cheat again until they can come up with another way to do what they just said they would not do again.

It has taken the coincidence of dramatic and tragic recent investor losses and aggressive state enforcement by people like Attorney General Spitzer and myself to convert investor outrage to a call for action. Any suggestion that state regulators have hindered federal enforcement of securities laws is completely false. Any effort to restrict or pre-empt state enforcement must be called what it clearly is – anti-investor.

Let's be clear: Mutual fund investors should have an equal opportunity for profit and an equal opportunity for risk. Mutual funds should be precisely that – mutual. Unfortunately, that is not the case. Our investigation has revealed that special opportunities exist for certain mutual fund investors at the expense of the vast majority.

Several months ago my office launched an investigation into mutual fund trading practices. The Enforcement Section of the Massachusetts Securities Division has filed an administrative complaint against Putnam Investment Management, Inc. and two of its employees for violating the anti-fraud provisions of the Massachusetts Uniform Securities Act.

Our investigation found that, in effect, two classes of investors existed at Putnam. The first class were the well-connected investors – those privileged insiders who were able to skim the funds through a legal trading activity known as "market-timing." The second class were the average investors who placed their trust in Putnam to follow its own policies, including the policy against market timing.

We have uncovered an unsettling pattern of deceit, breach of duty, breach of trust at Putnam, the nations' fifth-largest mutual fund company. Mutual funds are traditionally designed to be long-term investments for buy and hold investors and are the favored investments for the retirement plans of working Americans. Certain investors, however, have attempted to use mutual funds to generate quick profits by rapidly trading in and out of certain mutual funds. Typically, these so called "market timers" seek to capitalize on stale fund prices, often focusing on price discrepancies involving international funds.

Market timers take advantage of price inequities, but do so at the expense and to the detriment of long-term shareholders. Mutual fund advisers have a fiduciary duty to treat all shareholders equitably. This obligation would preclude granting one group of shareholders (*i.e.*, market timers) privileges and rights not granted to all shareholders (*i.e.*, long-term investors). In addition, when a fund's prospectus disclosure indicates that the fund management will act to limit market timing, it cannot knowingly permit such activities.

Boston-based Putnam Investments is an investment adviser that offers and sells proprietary mutual funds to institutions and individuals. Putnam also acts as the administrator for defined contribution plans, such as 401(k) plans, and offers plan participants a choice of Putnam mutual funds in which to invest their retirement savings. In return for providing these services, Putnam receives a management fee and its funds benefit from the influx of large amounts of plan assets.

The investigation by Massachusetts securities regulators found that Putnam administered the retirement plan of the Boilermakers Local Lodge No. 5 of New York. Despite prospectus disclosures that indicated market timing would not be tolerated, from at least January 2000 to September 2003 participants in the Boilermakers' retirement plan were permitted to market time Putnam international and other mutual funds.

By market timing, at least 28 Boilermaker plan participants made anywhere from 150 to 500 trades over a three-year period. At least one individual made $1 million in a retirement account over a three-year period by market timing the Putnam International Voyager Fund ("Voyager Fund"). During that same time period, the total trading volume in and out of the Voyager Fund amounted to approximately half a billion dollars. Each individual profited from over $100,000 to over $1 million in the three-year period.

One Putnam employee stated that the trading activity of the Boilermakers was so prolific that 3 to 4 p.m. was known as "boilermaker hour" within Putnam's Norwood, Massachusetts, office.

The mutual fund prospectus for the Voyager Fund and other Putnam mutual funds created the misleading impression that Putnam would not tolerate excessive exchange activity or market timing. As recognized in the prospectus, this market timing policy was to protect long-term investors from the negative effects of excessive trading, including but not limited to: dilution of share value, negative tax consequences, increased transaction costs, and loss of fund investment opportunities. Unbeknownst to long-term shareholders, Putnam allowed certain mutual fund shareholders, such as the Boilermakers, to engage in market timing activity in direct contradiction to the prospectus disclosure.

The Voyager Fund prospectus also clearly stated that Putnam fund management has the authority to reject market-timing trades. For the sake of retaining plan assets invested in Putnam mutual funds, and in order to secure future business, Putnam failed to reject short-term trades and permitted certain shareholders, such as the Boilermakers, to market time their international mutual funds. By permitting market-timing activity by certain plan participants, Putnam effectively allowed these customers to capture a portion of the fund's gains from the long-term shareholders within the fund.

Not only did Putnam permit certain plan participants to market time in their international funds, but also even more outrageous — allowed the fund's own managers to market time Putnam funds. At least six Putnam fund managers engaged in market timing, four of whom were timing in international funds they actually oversaw as part of a team of investment managers.

What makes this case so egregious is that Putnam executives knew the firm's policies were being violated. Not only did they conceal this violation, but they joined in it.

Since 1998, Putnam knew that at least two employees had been market timing Putnam funds for which they acted as fund managers. Despite this knowledge, for two years Putnam turned a blind eye and failed to take any remedial action to stop market-timing trades. In early 2000, for example, Putnam merely cautioned two fund managers about moving fund balances and discouraged future market timing. It was particularly telling that the fund managers were allowed to retain personal profits already gained and were permitted to continue to manage the funds.

Not surprisingly, Putnam's ineffectual warnings were no more than an internal slap on the wrist and did nothing to deter market-timing activity by its employees. Both employees continued to market time Putnam funds. In fact, for three years Putnam overlooked market-timing activity by its own fund managers and took no action until late 2003, following state and federal regulatory inquiries.

Market timing activity by Putnam fund managers amounts to a blatant violation of the manager's fiduciary duty to protect the interests of all of the fund's shareholders. Moreover, the fund manager's market timing activity is a flagrant violation of the fund's prospectus disclosure, which states that Putnam management will police and prevent rapid short term trading. Such trading activity and practices is fraud under the Massachusetts Uniform Securities Act.

Unfortunately, the Putnam case is not an isolated example of mutual fund investors being deceived or cheated. In August, for instance, my office charged Morgan

Stanley with violations of Massachusetts anti-fraud laws by offering cash prizes and other incentives to encourage brokers to sell Morgan Stanley mutual funds to investors creating a high-pressure sales culture. My office found that Morgan Stanley brokers competed in contests to sell certain Morgan Stanley owned and affiliated mutual funds, for which they received higher commissions than other funds. The contests and higher commissions were not disclosed to investors – material omissions that constitute fraud under the Massachusetts Securities Act.

Even more recently, this week my office charged five former Prudential Securities brokers and branch managers with fraud in a scheme that enabled offshore hedge fund clients to profit at the expense of mutual fund shareholders. The particular complaint alleges in vivid detail how a group of brokers, with the active connivance of managers and a see-no-evil attitude by the company, were able to manipulate the mutual fund trading system for the benefit of certain select clients to the detriment of fund shareholders. Company policies against market timing and short-term trading were clear; disciplinary action was non-existent.

For the sake of enriching themselves and their hedge fund clients, the branch managers and registered representatives allegedly engaged in fraudulent tactics and financially harmful trading activity and no one stopped them.

These enforcement actions are only a few examples of deeper problems in the industry. Mutual fund executives violate investor trust:

- when mutual funds allow marketing timing by their employees;
- when mutual funds allow market timing for certain outside investors, perhaps as an incentive to generate or retain business;
- when mutual funds allow late-trading in a fund’s shares;

- when mutual funds pay higher commissions to brokers or offer other incentives to sell proprietary, or in-house, funds to investors rather than funds that may be more suitable to an investor's needs; and
- when breakpoint discounts are ignored or concealed.

As the cases involving Putnam, Morgan Stanley and Prudential Securities illustrate, state securities regulators are often first to identify investment-related problems and to bring enforcement actions to halt and remedy these problems.

H.R. 2420 is a positive response to the many problems investors in mutual funds now face. And I endorse its objectives. I endorse its provisions to enhance the independence of fund board members and audit committees; to improve disclosure of fund fees, and expenses; to make board members responsible to oversee soft dollar arrangements; to require the Securities and Exchange Commission to study soft dollar arrangements and other disclosure issues; to prevent funds from restricting share redemptions, and to require funds hire compliance officers.

This bill can be improved however. I believe the bill could do more.

First, instead of studying and disclosing soft dollar arrangements, I would ask you to consider an outright ban on them. Funds should simply seek the best price and execution for their portfolio trades.

At best, soft dollar arrangements obscure the true costs of mutual fund overhead, and they artificially inflate funds' trading costs. And in far too many cases, soft dollar arrangements constitute severe conflicts of interest for fund managers, because brokerage firms provide benefits to those managers in exchange for a portion of a fund's trading transactions. Soft dollar arrangements have been criticized for many years as fundamentally abusive practices, so this is not a matter that requires further study. Instead, we must act now to draw a bright, clear line prohibiting soft dollar arrangements by mutual funds.

In addition, it may be appropriate to advocate that Section 2(a)(1) of the bill be amended to restore the requirements that each investor receive disclosure of the fund costs and expenses paid by his or her fund account (rather than costs payable on a hypothetical $1000 investment). This would make disclosure more meaningful to individual investors.

Prompt passage of this bill is important to bring the regulation of mutual funds to the level of regulation that their role in our financial system demands. But laws alone are not enough – they must be vigorously enforced.

Representative Baker, I know that you share my opinion that this sort of behavior, this corporate culture, is deplorable, outrageous and unconscionable -- a serious breach of duty and trust, a betrayal of customers faith that their interests come first. In these cases, I'm afraid, greed trumped good business practices. I want you to know that we won't rest until we get to the bottom of this and punish those responsible. Investment and our markets are built on trust. This behavior is equivalent to picking the customers' pockets.

Market timing, which is essentially day trading, sends a simple message to long-term investors: do as we say, not as we do. Fund customers, long-term investors, didn't know that their money was being managed by day traders out for themselves.

These charges involve Massachusetts companies. These cases have had a profound impact on the image and reputation of local companies. I know people who work at these firms, as does my staff. These companies employ Massachusetts's residents, they pay state taxes, they give to local charities.

The actions of a few at these firms have put the jobs of many at risk and threaten to destroy reputations built over many years. This further underscores that our markets are built on trust and how fragile that trust can be. For a relatively small amount of money, management winked at corrupt behavior and risked the reputation and future of multibillion-dollar enterprises. This case should be a lesson to others.

Our investigation took many weeks. It involved substantially my whole securities division. We deposed many people, took pains to corroborate testimony, talked to legal and other experts before deciding to move forward with formal charges. We were very much aware what impact our actions could have and we acted with a sense of sadness as well as a sense of duty to investors in Massachusetts and across this country.

Representative Baker, I again want to commend you for focusing attention on these issues. With tougher laws and vigorous enforcement we can give our nation's investors the fairness and honesty they seek and the protection they deserve.

Thank you.