Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises

"Mutual Fund Industry Practices and Their Effect on Individual Investors"
March 12, 2003

Thank you, Chairman Baker, for holding this important and timely hearing. This morning, we will discuss the state of the mutual fund business. Our inquiry is simple: are investors getting a fair shake?

At last count, there were 95 million mutual fund investors in the United States. For most Americans, mutual funds are the primary vehicle for accessing the capital markets and building wealth.

The rapid growth in fund ownership over the past 20 years is unquestionably a positive development. Mutual funds provide the opportunity to invest small sums of money in return for a diversified investment in stocks, bonds, and other securities.

Selecting a suitable fund can be a challenge for many investors. Some funds buy large-capitalization stocks, others buy small or mid-caps. Some buy foreign companies, or corporate or municipal bonds. Still other funds invest entirely in one sector of the economy. There are multiple classes of shares, different investment styles, and so on. Add to this the fact that there are now almost 5,000 stock mutual funds.

All of these funds are competing for investor dollars. While there is clearly competition in the fund industry, some question whether it is working the way it does in other industries. That is to say, are costs going down for investors?

Recent data indicate that the answer is "no." Fees and expenses, in fact, are going up, and this despite the efficiencies created by these enormous economies of scale. And while investors have become sensitive to certain fees like sales loads, other fees are either hidden or opaque, escaping the attention of even savvy fund investors. This precludes them from "comparison shopping," a strong market influence that would encourage fee-based competition and would likely bring down costs.

What are investors getting in return for these increasing costs? The evidence is troubling. Noted financial commentator Jim Glassman has said "what is truly remarkable is that hundreds of funds do worse than the rules of chance would seem to allow." He adds that the low-cost Vanguard 500 Index fund has "beaten 76 percent of its managed-fund peers over the past 10 years," according to Morningstar.

Even worse, the NASD and SEC have recently discovered widespread evidence that fund investors are not even receiving the discounts on sales loads that funds promised in their prospectuses. While preliminary reports indicate this failure to provide "breakpoint" discounts does not appear to be the result of fraudulent behavior, one commentator is reported as attributing the problem to "laziness or sloppiness." That is simply unacceptable. I am pleased that the regulators are acting quickly, I urge them and fund directors to take steps immediately to repair this breakdown and to make investors whole.

Along with rising fees that are often hidden or not easily understood, and chronic underperformance, this Committee intends to examine the role of mutual funds in corporate governance. Last year, Congress passed the Sarbanes-Oxley Act, in an effort to help rebuild investor confidence in public companies. New, and mostly sensible, regulations have been enacted for accountants, corporate executives and directors, investment bankers, research analysts, and attorneys.

Until very recently, though, mutual funds have not been the focus of regulators and lawmakers, despite the fact that funds own about 20 percent of U.S. equities. The voting power represented by these securities carries great potential to influence U.S. corporate governance. Whether mutual funds have used their powerful position to do so is an important question that merits attention.

Another important issue to this Committee concerns the role of independent fund directors. Are they looking out for the best interests of shareholders in the fund, as is their fiduciary duty? At least one prominent investor emphatically says no. In his recent letter to Berkshire Hathaway shareholders, Warren Buffett said that fund directors had an "absolutely pathetic" record, particularly with regard to removing underperforming portfolio managers and lowering fees charged to investors.

Some have asked, where were directors during the frenzied creation of a multitude of tech funds during the bubble of the 90s that left so many investors holding the bag? An article in yesterday's Wall Street Journal observed that during the tech bubble, stewardship often gave way to salesmanship – borrowing a phrase from one of our distinguished witnesses here today, Vanguard founder Jack Bogle.

In recent months, the SEC has acted on a number of important mutual fund initiatives – often in the face of fierce industry opposition, I might add. Last December, the Commission issued a proposed rule that would enhance portfolio disclosure and help clarify fund fees. The Commission also recently required funds to disclose both their proxy voting policies and procedures and their actual proxy votes. These are good steps, but more needs to be done. I have the utmost confidence that we can count on Chairman Donaldson to continue Harvey Pitt's fine work on behalf of fund investors.

I look forward to hearing the testimony of this distinguished panel, and yield back the balance of my time.

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