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Mutual Funds in the Coming Century . . .

While We're At It, Let's Build A Better World

Remarks by

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I'm truly excited by the opportunity to address this group of industry participants, attorneys, fund directors, accountants, and regulators on the profound issues that affect mutual fund shareholders. All of us here today—entrusted, one way or another, with the stewardship of our owners' assets—should never forget that the shareholder is the *raison d'etre* for this industry's existence.

So I begin with a sober reminder of the words of our Constitution, if you will, the Investment Company Act of 1940: "the national public interest and the interest of investors" require that mutual funds be "organized, operated, and managed . . . in the best interests of their shareholders, *rather than* in the interests of advisers, underwriters or others."[1]

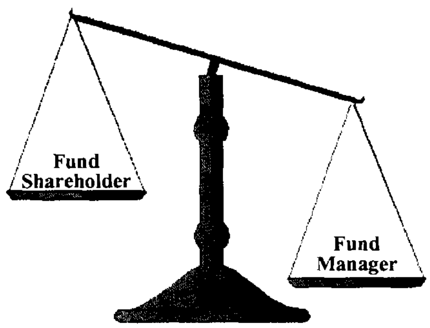
Please be clear: The law of the land says *nothing* about balancing the interests of managers and fund owners. If you visualize a scale, the law would have *all* of the weight placed on the shareholder side, and *none* of the weight on the side of the fund management company. Yet, the fact is that today substantially *all* of the weight lies on the management company side,

Note: The opinions expressed in this speech do not necessarily represent the views of Vanguard's present management.

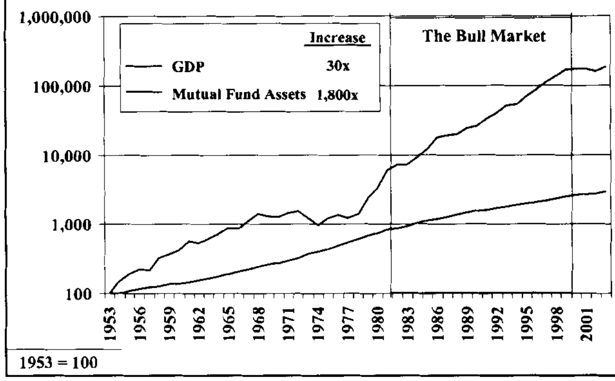
[1] The latter part of the phrase is a direct quotation from the Commission's unanimous opinion in its Vanguard decision (February 28, 1981), which turned the "double negative" in the 1940 Act into a "single positive" that bluntly asserted the Act's underlying principle.

and almost *none* on the shareholder side. Doubtless most of you here today—indeed, probably nearly all of you—think that the imbalance that exists today has been a prerequisite to the fund industry's unarguably enormous asset growth. If an industry grows 1800-fold in an economy that has grown 30-fold (in nominal dollars) over the past 50 years, so the argument goes, "we must be doing something right."

How the Mutual Fund Scale Looks Today



Growth of GDP and Mutual Fund Assets, 1953 - 2003



Such a facile assertion of causality, however, ignores two facts: 1) During the early part of the era, the scale balanced those directly competing interests fairly evenly, and the industry's focus was on prudent funds with long-term strategies and objectives; 2) Fully 1700 of those 1800 extra "folds" came in 1982-1999, with the longest and strongest bull market in all human history. A great tradition and a great bull market, it seems, cover a multitude of sins.

You don't even need to finish the second page of the 1940 Act to understand its unequivocal message. *The shareholder is king.* I believe that the Act got it right. After all, the British common law of fiduciary duty—the obligation of the trustee to place his clients' interest first—goes back at least eight *centuries*. Alas, however, the drafters of the Act did not define just what they meant by "the national public interest and the interest of investors." So let me take a stab at what might be considered a reasonable expectation of those interests:

- A sound repository for long-term investing.
- An efficient medium for accumulating funds for retirement.
- A contribution to the proper functioning of our capital markets.
- Constructive participation in corporate governance.
- Full and fair disclosure of risks, returns, and costs.

- Stewardship of shareholder assets that is independent, conflict-free, and empowered.

Honestly, I think those attributes are the self-evident implications of the Act's statement of purpose. Would that they had been written into the law!

For if this industry had served those six public interests without fear or favor, a conference like this one would probably not even have needed to be held. *Think about it.* If the implicit fiduciary duty standard of the 1940 Act had been explicitly observed, *why* would we have to discuss the need for even more regulation—protecting our investors against late trading and market timing with new compliance guidelines; eliminating "breakpoint" violations; reforming management fee structures; assuring "best execution" of portfolio transactions; eliminating "soft-dollar" abuses; and defining the role and functions of fund directors and trustees. We are discussing these issues because we have not measured up to the central principle of the 1940 Act—the overriding duty to serve our shareholders rather than our managers and marketers.

The fact is that this long litany of issues should be an embarrassment to all those industry spokesmen who have had the temerity to trumpet, time and time again over the years, that, "the interest of mutual fund managers are directly aligned with the interests of fund shareholders." Each of the issues I've listed is a reflection of how misaligned these interests have become.

How could this scandalous conduct have happened? I've been in this industry for more than a half-century and most of the industry executives I've met have been well-meaning, honest, intelligent, and pillars of integrity—persons whom I'd have been proud, using Warren Buffett's formulation, to have my children (and now grandchildren) marry. But fund executives seem to share an inability to face the obvious and quintessential reality about what so much of our industry has become—call it the "Emperor's Clothes" syndrome—a sobering reminder of Demosthenes' observation that, "Nothing is easier than self-deceit. For what each man wishes, that he also believes to be true." Or perhaps Upton Sinclair's remark that, "It is difficult to get a man to understand something when his salary depends on his not understanding it."

Today, I'm going to use this opportunity to talk with you, not about how to regulate-away the calamitous kinds of shenanigans that have come to light in the mutual fund field, but on some vital emerging issues that are on my radar screen, even if not yet on the screens of others. These issues are: 1) The level of mutual fund management fees. 2) The relationship between fund fees and fees paid by pension accounts. 3) Disclosure of manager compensation and shareholdings. 4) Incubator funds. 5) 401(k) plans. 6) Investment in IPOs. 7) The ceding of control of the industry by privately-held professional managers to giant publicly-held financial conglomerates. 8) The need for an economic study of the fund industry. 9) The appropriate structure of mutual fund governance. In the time available today, I can only scratch the surface of these nine issues, but I hope that, once out in the open, they will command the increasing attention they deserve.

1. Management Company Compensation

Way back in 1966(!), in *Public Policy Implications of Investment Company Growth, A Report to the House Committee on Interstate and Foreign Commerce*, the SEC vigorously recommended legislative changes presciently designed to restore a better balance of interest between shareholders and managers. After considering the burgeoning level of fund fees (then a mere $134 million a year), the effective control advisers held over their funds, and, "the absence of competitive pressures, the limitations of disclosure, the ineffectiveness of shareholder voting rights, and the obstacles to more effective action by the independent directors," the SEC recommended the adoption of a "statutory standard of reasonableness . . . *a basic fiduciary standard that would make clear that those who derive benefits from their fiduciary relationships with investment companies cannot charge more for services than if they were dealing with them at arm's length."*

The SEC described reasonableness as "a clearly expressed and readily enforceable standard (that) would *not* be measured merely by the cost of comparable services to individual investors or by the fees charged by other externally managed investment companies . . . (but by) the costs of management services to internally-managed funds and to pension funds and other non-fund clients . . ." If the standard of reasonableness does not "resolve the problems in management compensation that exist . . . *then more sweeping steps might deserve to be considered."*

The fund industry fought—and of course won—its battle against the "reasonableness" standard, and fund expenses have soared to astonishing levels. The *unweighted* expense ratio of 0.87% for the average equity fund that concerned the Commission in 1966 has risen by 86%, to 1.62%. (For those who think that *asset-weighted* expense ratios are a better test, the increase was from 0.51% to 0.95%—the same 86% increase!) Yet even now, 38 years later, "more sweeping steps" have yet to be considered.

But we deceive ourselves when we look at fee *rates* instead of fee *dollars*. When applied to the burgeoning assets of equity funds ($26.3 *billion* in 1965 and $3.7 *trillion* in 2003), equity fund expenses have leaped from that $134 million that troubled the Commission in 1965 to a staggering 2003 total estimated at $35 billion. Fund expenses have risen 261-fold(!) since 1965, nearly *double* the 140-fold increase in equity fund assets.

Where are the Economies of Scale?

	1965	2003	Change
Total Equity Assets	**$26.3 B**	**$3,684 B**	**+140 x**
Average Exp. Ratio	**0.87%**	**1.62%**	**+86%**
Wtd.* Exp. Ratio	**0.51%**	**0.95%**	**+86%**
Fees Generated	**$134 M**	**$34,998 M**	**+261 x**

*Weighted by fund assets.
Fees generated uses weighted average.

The 86 percent increase in fee *rates* (expense ratios), to say nothing of the fact that the fee *dollars* have exploded by 26,000 percent, suggests that the defeat of the "reasonableness" standard has come at a cumulative cost of scores of billions of dollars to mutual fund investors. As these data make clear, "basis points" no longer represent a proper standard for considering fund fees. *Basis points are only basis points, but dollars are dollars*. By looking at rates rather than dollars, the courts have given fund managers a license to charge fees that could easily be regarded as a waste of corporate assets under state law. Consider, for example, that the owners of one giant fund paid fees of $3.5 billion (!) dollars to its adviser during the past decade, only to be rewarded by a cumulative return of +140% in a period when the Standard & Poor's 500 Index rose by 186%. If a huge portion of that $3.5 billion was not a waste of corporate assets, one can only wonder what would be.

2. Fees Paid By Pension Clients

We also ought to be investigating why the advisory fees paid by funds dwarf the fees charged to pension plans by those very same advisers. While the fees paid by pension funds are rarely made public, the $166 billion California Public Employees' Retirement System provides full disclosure of what it pays its managers. Here are the fee data for three cases in which mutual fund managers were *also* managing portfolios for Calpers during 2002:

Mutual Fund Fees vs. Pension Fund Fees

	Assets ($M)		Fee Rate		Fee Dollars		
Manager	M. Fund	Calpers	M. Fund	Calpers	M. Fund	Calpers	Ratio
A	$2,700	$902	0.97%	0.08%	$27M	$710,000	38x
C	22,000	590	0.40	0.10	88M	570,000	154x
P	11,000	675	0.47	0.06	52M	420,000	124x

It's reasonable to assume that substantially the same portfolios are held by both pension account and mutual fund. So how is it that those giant mutual funds managed by the very same advisers are paying fees that average seven times the *rate* and one-hundred (!) times the *dollars* paid by relatively small Calpers? One reason is that the mutual funds, unlike Calpers, are *controlled* by their advisers. A second reason is that the independent fund directors, unlike the Calpers trustees, have failed to negotiate with the adviser on an arms-length basis. A third reason is that, given the high fees generated by the funds, managers are happy to use marginal pricing when they seek to attract new pension clients. A fourth reason may be that the fund directors are not given the information about the fees paid by the adviser's pension clients, a shortcoming that a recently proposed SEC rule would rectify.

And there may be yet a fifth reason: While Calpers negotiates seemingly rock-bottom rates, it offers its managers *incentive fees* under which the adviser may make much larger fees *only if it produces superior investment returns*. Manager A, for example, received an extra $3.6 million in incentives in 2002, and Manager C received an extra $930 thousand. (It is not clear whether Manager P failed to offer an incentive fee, or simply failed to earn one.) But if any of the mutual funds served by these managers demanded similar incentive schemes, they failed to achieve their goal, for such arrangements are anathema to fund managers. Arms-length competition comes into play, apparently, only when those who control both the choice of managers and the level of fees are dedicated to giving the beneficiaries of the pension plan—or the shareholders of the funds—a fair shake.

3. Disclosure of Compensation to Fund Managers

Full and fair disclosure has been—and should always be—the hallmark of our system of financial regulation. But we should not forget that the reason disclosure works is only in part that it informs the investing public. Even more important, in my view, is that *disclosure modifies behavior*. That is, if an action has to be disclosed, we'll think twice before we take advantage of our shareholders. Yet the mutual fund industry *alone* has somehow been able to operate in an isolated enclave in which management company officers and directors are virtually exempt from the same kinds of full disclosure of compensation that are required of *all* other publicly-held companies in the nation.

As a result, since most mutual fund executives are employed by a management company that is either privately-held or part of a financial conglomerate, their compensation is hidden behind a corporate veil, with no thought given to piercing that veil. Even the proposed rule that the Commission is now considering would require, among other things, only the disclosure of *how,* but not *how much*, portfolio managers are compensated. *It must be obvious that such a limited disclosure is essentially no disclosure at all.* The Commission should require not only the disclosure of the *dollar amount of each manager's compensation* (including his or her share of the profits of the management company itself), but also the compensation of the five highest-paid executives of the company. There is no rational reason for exempting fund executives from the spotlight of public disclosure applicable to their counterparts in regular corporations.

While we're about it, we should also require disclosure of the extent to which fund directors, executives, and portfolio managers "eat their own cooking" by investing in the shares of the funds they manage. Unfortunately, there's little solid information on this vital issue, with no requirement that management company officials and portfolio managers disclose either their holdings of fund shares or their fund share transactions.

What is more, a similar information gap also exists with respect to the holdings of fund directors. Somehow our powerful industry lobbyists persuaded the SEC to exempt directors from disclosure of the precise number of shares they own, the standard for *all* other public corporations. Rather, fund directors need now only disclose the *range* of their holdings: none; $10,000 or less; $10,000 to $50,000; $50,000 to $100,000; over $100,000, both for the fund and for all funds in the group. What earthly good does it do when an investor learns only that a given director has spread a modest $100,000 (or more?) among 100 or more funds in the group? If such information is better than no disclosure at all, it is only barely so! The sooner we revise the regulations to provide full and accurate disclosure of management compensation and ownership of fund shares, the better.

4. Incubator Funds: A License to Steal?

Even as the statistical evidence mounts that the simple rate of return earned by a fund is the principal factor on which investors rely in making their choices ("Oh, what fools we mortals be!"), there has been little attempt to determine whether those records are credible. While we assume that fund returns presented in advertising, in shareholder reports, and in prospectuses is accurate, that record is often sheer illusion. Returns reported by giant funds, for example, often include the superior records achieved when they were tiny, returns that melt away as investors, salivating over the past record, pour their money in and the funds reach a size that virtually precludes future superiority.

Promoting a "real" record after the facts have changed is apparently deemed neither inappropriate nor improper by the Commission. But it ought to have a zero tolerance policy toward illusory records that are manufactured out of thin air. Such is the case in the pervasive pattern in which a whole host of incubator funds have been formed by managers. Such funds are typically owned only by insiders, held to minuscule size, and aggressively managed. If they hit the jackpot, they're born, as it were, and offered to the public. If they don't they're given a decent—but quiet!—burial.

A recent Wharton School paper[2] described such fund incubation as a "strategy for enhancing return histories . . . the process of running lightly-capitalized, self-funded investment

[2] "Does Alpha Really Matter? Evidence from Mutual Fund Incubation, Termination and Manager Change," November 2003. Paper by Richard B. Evans, Finance Department, Wharton School of Business.

accounts in a semi-private environment." The paper reported that the return earned by funds emerging from incubation was fully 18% per year above the average return of funds that were discarded. In one example, the paper cited an incubated fund that produced a three-year annualized return of 28.79%, winning Morningstar's highest "5-Star" rating. For some firms the creation of incubator funds is endemic, doubtless part of a carefully-conceived marketing strategy. Fully 128 such funds have come and gone in the past decade alone; funds that never made it out of the incubator, as it were. The paper also found that the funds that survived suffered from "severe return reversal" (i.e., plummeting returns post-incubation, *after* the funds were offered to the public).

Two of the largest fund firms implicated in the recent scandals (Boston managers P and M) were among the major participants in this strategy, starting large numbers of incubation funds in order to, in the paper's words, "upwardly bias investors' estimates of their ability, and thereby attract additional inflows," and killing them off when the tough real world of investing brought their returns back down to reality. Such behavior is "organizing, operating, and managing" funds in the interest of their promoters, and to the detriment of their public shareholders, in direct contradiction to the Act's purposes. It has *everything* to do with the business of marketing and *nothing* to do with the profession of management. It's high time for the Commission to put the kibosh on the promotion of the returns earned on these funds during their incubation period.

5. 401(k) Plans

Recent press reports have described clandestine payments from fund managers to pension clients, often in the form of rebates. The complex relationships between the administrative costs borne by the company and the amounts shifted to the plan participants, the costs assumed by the fund sponsor and their relationship to the advisory fees the assets generate, and the sources of compensation to pension consultants all deserve prompt and careful study. Most 401(k) plan arrangements are unregulated, and guidelines for fair practice do not seem to exist. This area should be a high strategic priority.

An editorial in *Barron's* last autumn only scratched the surface: "There is one more unrecognized mutual-fund scandal disguised as the regular order of business. Ever since Congress invented the 401(k), employers who sponsor retirement plans have been making deals with mutual-fund management companies. We can find little disclosure in this area; employees are not told how much money, if any, changes hands between employers and fund managers to give one management company exclusive access to thousands of employees. But it is clear that most employers, even the biggest and most generous, offer one and only one family of funds in their defined-contribution plans. And it is clear that some employers have chosen fund families with high fees and expenses, making their employees captive customers and unwitting sharers of their savings with fund families implicated in the mutual-fund abuses."

6. IPOs

We also need to understand the extent to which mutual fund managers had access to the "hot" initial public offerings of the recent bubble, their acquisition of these shares, and the length of the holding period before these shares were liquidated. Importantly we should investigate whether the mutual funds that *generated the buying power* and/or good will that facilitated the acquisition of these IPOs were the funds that *received the IPO allocations*.

It must be obvious that the generator of the buying power must be the beneficiary, rather than, say, private pension accounts or small funds served by the advisers, where the trafficking in IPOs would have a larger impact. And of course in those small incubator funds, such allocations would play a dominant role in generating high performance designed to attract the capital of investors. The Commission has already taken action against at least two fund managers who placed IPO allocations in embryonic funds with a view toward pumping up returns and then promoting them through misleading advertisements. This subject too cries out for a comprehensive analysis.

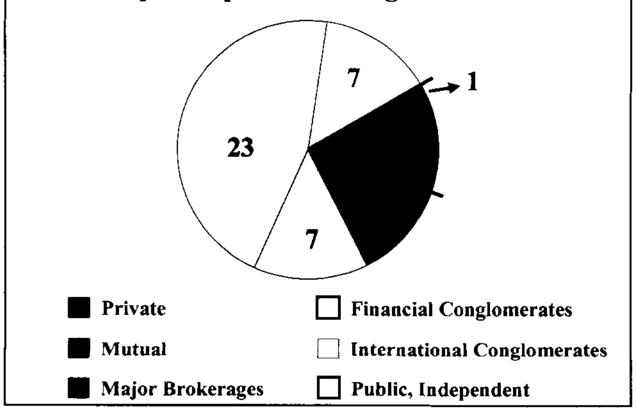
7. Conglomerates Now Control the Fund Business

When I came into this industry all those years ago, virtually all fund management companies were small partnerships or corporations, closely held by their principals. They were but a step removed from the funds they managed, and looked at themselves as trustees, stewards of the assets entrusted to their care, members of the profession of investment management. By 1958, this sound structure was on the way out. When public offering of management company shares then became possible, numerous management company IPOs quickly followed. At that point, managers began to focus on the price of their stock and the interest of their *public* owners—the financial heirs of the well-rewarded founding entrepreneurs. Managers' earlier focus on the interest of *their fund shareholders* had to compete with their focus on the interest of *their own owners*, fostered by building the fund group's asset base, increasing revenues, marketing aggressively, and making as much profit for themselves as they could—hardly what the 1940 Act had in mind.

But that was only the beginning. Gradually, both public and private management companies were purchased by giant financial conglomerates—U.S. and international banks and brokers and insurance companies—whose principal interest was not the return on the capital of their *fund investors,* but on the return on *their* capital. If a bank bought a fund manager for $1 billion, by golly, it would earn its cost of capital, say, 12%—$120 million per year—come hell or high water. As a result, *business* interests—salesmanship, marketing, revenue—superceded *professional* interests—the stewardship of shareholder assets. Gathering assets became the name of the game, manager profits the method of keeping score. The industry's values changed accordingly.

It is no stretch to say that when the chairman of a giant bank holding company told the world that his goal was to increase the financial service share of his firm's revenues from 7% to 15% in the next five years, he set into motion a chain of events that was almost certain to result in something like the fraud found in the Canary hedge fund case. At first, doubtless, the bank's financial services executives strived to reach that goal by fair means, only later by foul. Yet despite these and similar pressures, public ownership is now our industry's dominant organizational structure. Of the fund industry's 50 largest managers, 43 are publicly-owned—

Ownership of Top 50 Fund Organizations in 2004

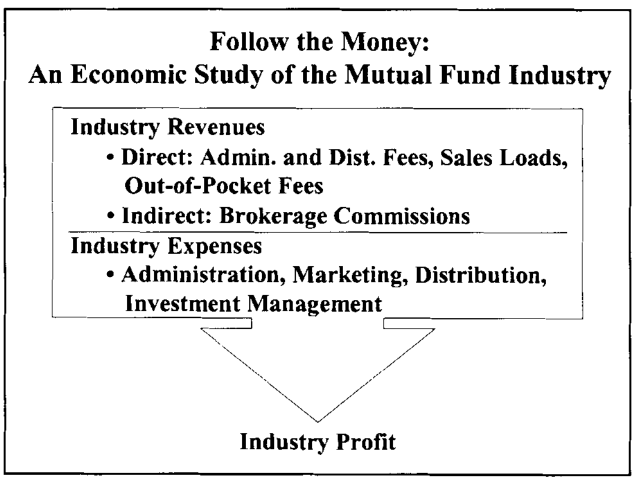


seven independent firms, 36 by giant financial conglomerates. Only seven private firms remain.[3]

8. An Economic Study of the Mutual Fund Industry

Entitled "The Economic Role of the Investment Company," my 1951 Princeton senior thesis was my youthful attempt to undertake an economic study of the industry. Curiously, as far as I can tell, few economic studies of the industry followed. But in 1995, I wrote to the SEC's chief economist calling for just such a study. He wrote back, essentially saying: "*Great idea! But the industry will never give us the data.*" Today, there's far too much at stake to accept that refusal. We need a comprehensive study that would evaluate the role of mutual funds and their managers in the context of our national economy and the public interest, in order to facilitate our understanding of how the fund industry actually works.

It's time to "follow the money"—to account for the *sources* of industry's direct revenues (administrative fees, distribution fees, sales loads, out-of-pocket fees, etc.), operating expenses paid by shareholders, and indirect revenues utilized by fund managers, including brokerage commissions. It's also time to account for the *uses* of these revenues—for administration, marketing and distribution, investment management, and other major cost centers (including soft dollars). Without this information, legislative and regulatory policy in operating in the dark—an information vacuum.



[3] Including Vanguard, which is mutually owned by the shareholders of the funds it manages.

We also need to understand much more about why fund investment policies have changed so radically, including soaring portfolio turnover and the relationship between fund size and fund performance. When, using Warren Buffett's words, "a fat wallet is the enemy of superior returns," why is it that so few fund managers limit the amount of assets they manage in a single fund or in a fund complex? What's more, we should be able to quantify the extent to which fund managers enjoy economies of scale, as well as the extent, if any, to which these economies have been shared with fund owners.[4]

9. The Appropriate Governance Structure

A recent study commissioned by Fidelity Investments evaluated two types of mutual fund structures in terms of whether the chairman of a fund's board of directors was affiliated with the management company or was independent, as defined under the 1940 Act. Fidelity's conclusion: "We found that independent chair funds have not performed as well as management chair funds, and that independent chair funds' expenses are competitive."

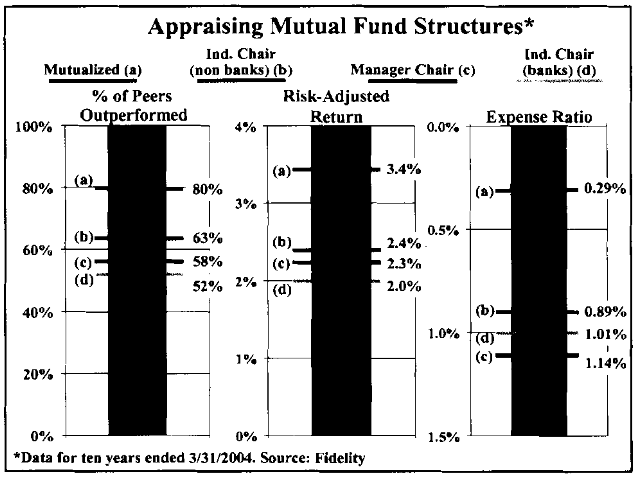
If you accept uncritically that conclusion, I have, as the saying goes, "a bridge I'd like to sell you . . . " In fact, the study should not be given serious credence. First, there are several significant categorization errors. For example, Fidelity placed Fund Complex P, one of the poorest performing of all groups, in the "independent chair" group. Really? The two fund chairmen who served during the decade could hardly be seriously considered as "independent." During the first seven years, the fund chairman was the former head of the management company, and apparently remained a major stockholder in Marsh & McLennan, the giant insurance conglomerate that purchased the management company. During the final three years, the chairman was a former senior executive of that conglomerate. Second, the categories themselves were proscribed in a narrow way that seems almost fated to result in a pre-ordained conclusion.

Using the *identical* statistical information for the funds that Fidelity presented (i.e., no "torturing the data until it confesses"), let's see what happens when we simply correct the mis-categorizations and expand Fidelity's two categories into four. The new categories are: 1) non-

[4] One major fund manager has failed to share *any* of these economies with shareholders. Although the assets of its original fund have grown 430 times over—from $12 million in 1973 to $5.2 billion in 2004—its 1% fee has remained fixed over the entire 31-year period.

bank funds with an independent chairman; 2) bank-managed funds with an independent chairman; 3) funds with a management chairman; 4) funds operating under mutualized structures with the fund chairman affiliated with the fund's *administrator* but not with the fund's *investment adviser*.[5]

The new conclusion: "Management-chaired funds and bank-managed funds ranked at the bottom, statistically indistinguishable except that the former group had slightly higher returns and expenses. Independently-chaired funds did only slightly better in terms of returns, but at lower cost. Mutualized, internally-operated funds not only provided distinctly superior performance, but were the *only* category to do so in a statistically significant way, whether we rely on ten-year performance rankings or risk-adjusted returns. Such mutualized funds also operated at costs fully two-thirds below those of the other three groups. Here are the data:



Even accepted at face value, Fidelity's data constitute muddy and unpersuasive evidence for continuing to allow senior management company officials to sit in the fund chairman's chair. The data presented above, on the other hand, constitute reasonable compelling evidence that independently-chaired, non-bank funds have provided investors with solid advantages. But the clearest and most convincing evidence in the study is that the optimal fund structure is one that is mutualized and shareowner-controlled.

Of course, data are only data. Even if we agree that there is no "smoking gun" in the data that would justify a requirement that chairmanship of a fund not be held by a management

[5] There are 95 such mutualized funds included in the analysis. All of them, as you might suspect, are members of the Vanguard Group.

director, please remember that a similar argument was made in 1999, when the Commission struggled, and ultimately lost, its fight to bar public accounting firms from providing consulting services to their clients. I repeat now what I said then: "*Common sense often makes clear what statistics cannot prove.*" Put another way, it doesn't take a genius to figure out that when there are two clearly distinct corporate ships—the management company and the fund, each with its own set of owners—there ought to be two captains.

Conclusion: "Temporary Problem or Permanent Morass?"

Each of the nine issues I've presented today are closely linked by being manifestations, to a greater or lesser extent, of the reality that mutual funds are run primarily for their managers, to the direct disadvantage of their owners. They deserve careful study both by this audience and by the Commission. A new paper by a Federal Reserve economist—"Mutual Funds: Temporary Problem or Permanent Morass"—accepts that point, yet even argues that, despite the obvious conflict of interest, there is "one and only one reasonable objective (for the advisor), *to maximize its own profit.*"[6]

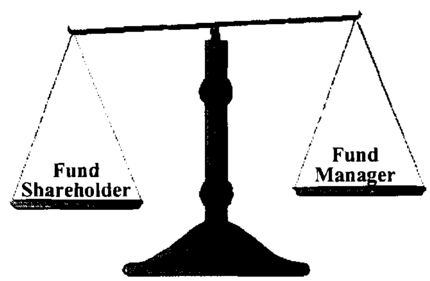
The first step required in resolving this so-called "agency problem" is to strengthen the governance of the *fund* organization so it can deal, independently and at arms-length, with the *management* organization, just as the 1940 Act mandated when it was enacted into law 64 years ago. To at long last balance the scale that I described at the outset, we need a heft, a heavy weight, on the *fund* side that both requires and enables fund directors to serve solely the interests of fund shareholders, beginning with these four steps:

1) A federal statute of fiduciary duty for fund directors.
2) An *independent* chairman of the fund board.
3) No more than one management company director on the fund board. (If *loyalty* is one of the cardinal requirements of a corporate director, how can even *one* such director be allowed?)
4) A dedicated staff, reporting to the board chairman, with responsibility to evaluate the investment performance and marketing strategy of the manager, the reasonableness of fees paid, and any other relevant information that the board may require.

[6] Presented by Paula A. Tkac, economist, Federal Reserve Bank of Atlanta, at the Bank's April 2004 Financial Markets Conference.

Such a structure,[7] combined with the existing requirement that the fund board have an independent general counsel and the proposed requirement that the board have a compliance officer, would at long last begin to redress the gross imbalance reflected in the scale of manager interest and shareholder interest that has so eroded the attractiveness of the mutual funds as an investment medium.

How the Mutual Fund Scale Should Look



Clearly, the management company has been driving the mutual fund car, and the fund shareholder has been consigned to the back seat, often to the rumble seat. But the 1940 Act, places the shareholder in the front seat, and raises the question as to whether the manager should even be riding in the fund car. I have too much love for the great potential of the mutual fund industry to effectively serve our Nation's families to accept, as the Federal Reserve Study does, the conclusion that mutual funds should continue to be mired in a "permanent morass" that puts the manager's interests ahead of the shareholder's. National policy demands that the mutual fund industry either operate in the lawfully-prescribed manner, or move to repeal the provisions of the law that are not now being honored.

On that point, I am confident that you know where I stand. While we're at it, let's build a better world for mutual funds in the years ahead.

[7] It may well be appropriate to limit the application of this structure to the largest fund groups, say, those with more than $20 billion in assets and more than 20 individual funds.