Testimony Concerning Recent Commission Activity To Combat Misconduct Relating to Mutual Funds

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Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee:

I. Introduction

Thank you for inviting me to testify today on behalf of the Securities and Exchange Commission concerning alleged abuses relating to the sale of mutual funds. With more than 95 million Americans invested in mutual funds, representing approximately 54 million U.S. households, and a combined $7 trillion in assets, mutual funds are a vital part of this nation's economy and millions of investors' financial security. For that reason, I share the outrage and disappointment of the Commission, Chairman Donaldson, the investing public, and so many others, at the misconduct that recently has come to light. It is intolerable when investment professionals -- who have a duty to serve the best interests of their customers -- instead put their own interests first. That way of thinking is antithetical to the responsibilities investment advisers, broker-dealers, and their employees owe to mutual fund investors. Mutual fund investors have a right to expect fair treatment, and when they do not receive it, we at the Commission will demand it on their behalf.

Accordingly, the Commission has undertaken an aggressive agenda to identify and address problems in the mutual fund industry. That agenda has both an enforcement component, which I will discuss, and a regulatory component, which Chairman Donaldson discussed in his testimony before this Committee two days ago.

The enforcement piece of the Commission's agenda relating to mutual funds currently is focused primarily on four types of misconduct, each of which may result in the interests of financial services firms or their employees being placed above the interests of investors. I will touch on each briefly, and then turn to the Commission's response to the recent revelations of serious misconduct relating to the trading of mutual funds.

The first area of priority, which I will discuss in detail in a moment, is late trading and timing of mutual fund shares.

Our second area of priority focuses on fee disclosure issues in connection with the sale of mutual funds. In particular, we are looking at what prospective mutual fund investors are – or are not – being told about revenue sharing arrangements and other incentives doled out by mutual fund companies to brokers selling their funds. Do customers understand that their broker is being paid to sell a particular fund? And when these payments are being made from fund assets, do customers understand that their own investment dollars are being used to foot the bill for the mutual funds' premium "shelf space" at the selling broker's office? Such fees may increase costs to investors as well as create conflicts of interest between investors and the financial professionals with whom they deal.

The Commission brought its first case in this area earlier this week. In that action, against Morgan Stanley DW (Morgan Stanley), the Commission found that the firm had not adequately disclosed that certain mutual funds Morgan Stanley offered to its customers were part of something it called the "Partners Program." Under the Partners Program, a select group of mutual fund families paid Morgan Stanley substantial fees for preferred marketing of their funds. To incentivize its sales force to deliver the preferred marketing Morgan Stanley promised its partners, Morgan Stanley paid increased compensation to individual registered representatives and branch managers on sales of those funds' shares. But, when Morgan Stanley's customers purchased the preferred mutual funds, they were not told about the Partners Program, and were therefore not in a position to understand the nature and extent of the conflicts of interest that may have affected their transactions. The Commission found Morgan Stanley also made inadequate disclosures in a second area, which I will discuss in a moment.

Morgan Stanley agreed to settle this action by paying $25 million in disgorgement and prejudgment interest, and civil penalties totaling $25 million. All $50 million will be placed in a Fair Fund under the Sarbanes-Oxley Act and will be returned to investors. In addition, Morgan Stanley has undertaken to, among other things, place on its website disclosures regarding the Partners Program and provide customers with a disclosure document that will disclose specific information concerning the Partners Program.

The abuses that are addressed in this case are significant and are not necessarily limited to Morgan Stanley. So-called shelf-space payments have become popular with brokerage firms and the funds they are selling. Thus, the Commission is conducting an examination sweep of some 15 different broker-dealers to determine exactly what payments are being made by funds, the form of those payments, the "shelf space" benefits that broker-dealers provide, and most importantly, just what these firms tell their investors about these practices.

The potential disclosure failures and breaches of trust spotlighted in the Morgan Stanley case are not limited to broker-dealers. We are also looking very closely at the role of mutual fund companies themselves. In that regard, I want to return to and finish with a point that I alluded to earlier. The aspect of the Morgan Stanley case that I find perhaps most troubling is this: Morgan Stanley said to the fund families that are part of the Partners Program: "You can pay us in one of two ways – either the fund management company can pay us in cash; or the mutual funds you manage can defray the fund management company's obligation by giving us a multiple of that amount in the form of extra commission business on fund portfolio transactions." Faced with that choice, some fund companies -- rather than reaching into their own pocket to pay what they owed – reached into the pockets of their mutual fund shareholders and paid in commission dollars instead. You can be certain that we are pursuing that issue, among others, as our investigation continues, and our exam sweep goes forward.

Our third area of priority in the mutual fund arena is the sale of different classes of mutual fund shares. Many mutual funds offer multiple classes of shares in a single portfolio. For each class of shares, a mutual fund uses a different method to collect sales charges from investors. Class A fund shares are subject to an initial sales charge ("front-end load"); discounts on front-end loads are available for large purchases of Class A shares. Since the sales fee is paid up front, Class A shares incur lower (or no) "rule 12b-1 fees," fees the mutual fund pays for distribution costs, including payments to the broker-dealers and their registered representatives selling fund shares.

Class B shares, by contrast, are not subject to an up-front sales charge. Instead, they become subject to a sales charge (a "contingent deferred sales charge" or "CDSC") only if they are redeemed before the end of a specified holding period. Because Class B share investors do not pay an up-front sales fee, the funds pay higher rule 12b-1 fees on Class B shares to defray the associated distribution expenses. As a result, brokers typically earn larger payments on Class B shares than on Class A shares. In addition, long-term mutual fund shareholders may pay higher sales charges if they hold B shares rather than A shares, particularly when discounts, as discussed below, are available on the A shares.

The Commission has brought three enforcement actions involving the sales of Class B shares to investors who were not made aware by their registered representatives that they could purchase Class A shares of the same mutual fund at a discount (sometimes called a "breakpoint" discount). Indeed, in this week's Morgan Stanley case, the Commission found that Morgan Stanley's disclosures to customers concerning B shares were inadequate. To address this violation, the relief we obtained in this case includes an agreement by Morgan Stanley to convert to Class A shares and otherwise make whole those customers who would have been entitled to a breakpoint discount had they purchased A shares in the first place. In addition, Morgan Stanley has agreed to retain an independent consultant to conduct a review of, and to provide recommendations concerning, its disclosures, policies and procedures and its plan to offer to convert Class B shares to A shares. The firm is required to adopt the recommendations of the independent consultant.

Earlier this year, the Commission brought an action against Prudential Securities for abuses in this area as well. In that case, filed in July, the Commission found that Prudential's supervisory system for overseeing practices in this area were inadequate. Prudential had in place policies and procedures requiring registered representatives to advise their clients of the availability of different classes of mutual funds and fully explain the terms of each. Prudential branch managers were also expected to approve all purchases greater than $100,000 and confirm the suitability of the choice of fund class. The Commission found, however, that Prudential failed to adopt a sufficient supervisory system to enable those above the branch manager to determine whether these policies and procedures were being followed. Under Prudential's system, branch office managers were solely responsible for ensuring that registered representatives followed the firm's mutual fund policies and procedures. As a result, when the registered representatives' branch manager failed to abide by and enforce Prudential's policies and procedures, the firm had no way of detecting the lapse. In resolving the Commission's action, Prudential was censured and agreed to pay disgorgement and a civil penalty. The Commission's action against the registered representative and branch manager, which charges them with fraud, is pending.

The fourth priority area is to address the failure of firms to give their customers the discounts available on front-end loads for large purchases of Class A shares. Earlier this year, examiners at the SEC, NASD, and NYSE completed an examination sweep and outlined the results in a report, "Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds."[1] Together with the NASD, we have under active investigation instances in which it appears that investors were entitled to receive breakpoint discounts based on the size of their purchase of Class A shares, but where the firms failed to provide discounts.

Before I turn to abuses that have more recently come to light, I will mention two types of misconduct, harmful to mutual fund investors, where the Commission has both an active and aggressive track record and a roster of current investigations. The first is the area of fund disclosures concerning the effect of hot IPO shares on fund performance, and the second is pricing and valuation practices of mutual funds.

The Commission has brought three actions in the last several years charging registered investment advisers with failing to disclose the substantial positive effect that holding or trading hot IPO shares had on their funds' performance, and, critically, the risk that such exceptional performance could not be sustained. In one case, the investment adviser also did not disclose that a portfolio manager, who managed multiple mutual

[1] The report is available at: http://www.sec.gov/news/studies/breakpointrep.htm.

funds, allocated securities purchased in initial public offerings -- especially "hot" IPOs – in a manner that had the overall effect of favoring one fund over three others he managed. The adviser did not disclose this practice, notwithstanding the fund's prospectus disclosure that investment opportunities would be allocated equitably among the fund complex's funds.

These cases are an unfortunate part of an all-too-common theme – mutual funds and their advisers often are reluctant or unwilling to disclose to investors important performance-related information to which they are not only entitled, but which they must have in order to make fair and reasoned investment decisions. With respect to valuation, the problem more typically is a failure on the part of funds and their advisers to *adhere* to the policies and procedures that they *have* disclosed. We are actively looking at two situations in which funds dramatically wrote down their Net Asset Values in a manner that raises serious questions about the funds' pricing methodologies.

This brief overview of the Commission's enforcement agenda with respect to mutual funds is intended to give you a sense of the scope of our activities. I recognize, however, that today's hearing was prompted by recent revelations involving late trading and timing of mutual funds. Accordingly, I will now turn to that subject.

II. SEC Response to Misconduct Relating to Mutual Funds

As you well know, the conduct of mutual funds and the financial intermediaries with and through which they do business, recently came to the public's attention when New York Attorney General Eliot Spitzer announced an action involving abusive mutual fund trading practices by a hedge fund, Canary Capital Partners, LLC.   The Canary action identified two problematic practices – late trading of mutual funds and timing of mutual funds. Late trading refers to the practice of placing orders to buy or sell mutual fund shares after the time at which the funds calculate their net asset value ("NAV") -- typically 4:00 p.m. Eastern Time ("ET") -- but receiving the price based upon the prior NAV already determined as of 4:00 p.m. Late trading violates a provision of the federal securities laws that dictates the price at which mutual fund shares must be bought or sold and defrauds innocent investors in those mutual funds by giving to the late trader an advantage not available to other investors.

"Timing" abuses refer to excessive short-term trading in mutual funds in order to exploit inefficiencies in mutual fund pricing. Although market timing itself is not illegal, mutual fund advisers have an obligation to ensure that mutual fund shareholders are treated fairly, and they should not favor one group of shareholders (i.e., market timers) over another group of shareholders (i.e., long term investors). In addition, when a fund states in its prospectus that it will act to curb market timing, it must meet that obligation.

Abusive market timing can dilute the value of mutual fund shares to the extent that a trader may buy and sell shares rapidly and repeatedly to take advantage of inefficiencies in the way mutual funds prices are determined. Dilution could occur if fund shares are overpriced and redeeming shareholders receive proceeds based on the overvalued shares. In addition, short-term trading can raise transaction costs for the fund, it can disrupt the fund's stated portfolio management strategy, require a fund to maintain an elevated cash position, and result in lost opportunity costs and forced liquidations. Short-term trading can also result in unwanted taxable capital gains for fund shareholders and reduce the fund's long-term performance. In short, while individual shareholders may profit from engaging in short-term trading of mutual fund shares, the costs associated with such trading are borne by all fund shareholders.

Following the announcement of the Canary Capital case, the Commission put in motion an action plan to vigorously investigate the matter, assess the scope of the problem, and hold any wrongdoers accountable. Specifically, the Commission is proceeding on three fronts, utilizing its enforcement authority, its examination authority, and its regulatory authority. I will address the first two areas of the Commission's efforts.

A. Recent Enforcement Efforts Relating to Mutual Fund Trading

In the enforcement area, we are working aggressively to pursue wrongdoing, and are doing so in coordination with State regulators. Thus far, the Commission has brought actions against persons associated with three different types of entities – broker-dealers, hedge funds, and mutual funds – each of which can play a role in harming long-term mutual fund investors. Our actions to date address allegations of both late trading and market timing. I will briefly summarize those actions.

On September 16, the Commission filed a civil action against Theodore Sihpol, a salesperson at Bank of America Securities ("BOA"), who was Canary Capital's primary contact at Bank of America. Specifically, the Commission issued an administrative order instituting proceedings in which the Division of Enforcement (the "Division") alleges that Sihpol played a key role in enabling certain hedge fund customers of BOA to engage in late trading in shares of mutual funds offered by Bank of America, including the Nations Funds family of funds and other mutual funds. Based on the conduct alleged in the Commission's Order, the Division alleges that Sihpol violated, and aided and abetted and caused violations of, the antifraud, mutual fund pricing and broker-dealer record-keeping provisions of the federal securities laws. In its action, the Division is seeking civil penalties, disgorgement and other relief, which may include permanently barring Sihpol from the securities industry.[2] Simultaneous with the issuance of the Commission's order, Sihpol surrendered in connection with Attorney General Spitzer's filing of a two-count complaint charging him with larceny and securities fraud.

Less than three weeks later, the Commission and the New York Attorney General announced criminal and civil actions against Steven B. Markovitz, formerly an executive and senior trader with the prominent hedge fund firm Millennium Partners, L.P. In the New York Attorney General's criminal action, Markovitz pleaded guilty in State Supreme Court to a violation of New York's Martin Act. The SEC's administrative order finds that Markovitz committed securities fraud. In partial settlement of the SEC's

2 In connection with the SEC's order, a hearing will be scheduled before an administrative law judge to determine whether the allegations contained in the order are true and to provide Sihpol an opportunity to respond to them.

action, without admitting or denying the SEC's findings, Markovitz consented to cease and desist from violations of certain provisions of the federal securities laws, and to be permanently barred from associating with an investment adviser or from working in any capacity with or for a registered investment company. The SEC also is seeking disgorgement and civil penalties in amounts to be determined later.

According to the criminal charges and the SEC findings, Markovitz engaged in late trading of mutual fund shares on behalf of Millennium, one of the nation's largest hedge fund operators, with more than $4 billion under management. With the assistance of certain registered broker-dealers, Markovitz placed mutual fund orders after 4:00 p.m. ET, but obtained the prices that had been set as of 4:00 p.m. ET. By SEC rule, Markovitz's post-4:00 p.m. orders should have received the prices set on the following day. This illegal trading allowed Millenium to take advantage of events that occurred after the markets closed.

In its first action against a mutual fund executive for permitting market timing, on October 16, the Commission and the New York Attorney General announced the arrest, conviction, and lifetime industry bar of James P. Connelly, Jr., former Vice Chairman and Chief Mutual Fund Officer of Fred Alger & Company, Inc., a prominent mutual fund firm. Connelly pled guilty to the crime of Tampering with Physical Evidence. The criminal charges against Connelly stem from his repeated efforts to tamper with an ongoing investigation of illegal trading practices in the mutual fund industry, including by directing subordinates to delete emails called for by subpoenas.

In its administrative order, the SEC found that Connelly approved agreements that permitted select investors to "time" certain mutual funds managed by Alger, a practice that violates an adviser's fiduciary duties and adversely affects the value of the fund being timed. In this case, the timing arrangements were also inconsistent with Alger's public disclosures in prospectuses and Statements of Additional Information filed with the SEC. According to the Commission's order, Connelly was involved in timing arrangements at Alger from the mid-1990s until 2003. By early 2003, Connelly was requiring that investors seeking timing capacity agree to maintain at least 20% of their investment at Alger in buy-and-hold positions, sometimes referred to as "sticky assets."

Connelly has been ordered to cease and desist from future violations of various provisions of the federal securities laws; has been barred from association with any broker, dealer or investment adviser; has been barred from serving in various capacities with respect to any registered investment company; and is subject to a $400,000 civil penalty.

On October 28, the Commission brought actions against Putnam Investment Management LLC ("Putnam") and two former Putnam Managing Directors and portfolio managers, Justin M. Scott and Omid Kamshad, in connection with the personal trading by those Managing Directors in Putnam mutual funds. The Commission filed a civil injunctive action against Justin M. Scott and Omid Kamshad charging each of them with securities fraud. The complaint alleges that Scott and Kamshad, for their own personal accounts, engaged in excessive short-term trading of Putnam mutual funds for which they were portfolio managers. According to the complaint, Scott and Kamshad's investment decision-making responsibility for those funds afforded them access to non-public information about the funds, including current portfolio holdings, valuations and transactions. The complaint further alleges that Scott and Kamshad's short-term trading violated their responsibilities to other fund shareholders, that Scott and Kamshad failed to disclose their trading and that, by their trading, they potentially harmed other fund shareholders. In this action, the Commission is seeking injunctive relief, disgorgement, penalties, and such equitable relief as the court deems appropriate.

The Commission also issued an administrative order instituting proceedings against Putnam. Subsequently, on November 13, the Commission issued another order against Putnam reflecting a partial settlement with the firm. In connection with that agreement, Putnam committed to undertake significant and far-reaching reforms relating to excessive short-term and market timing trading by its employees. Putnam also agreed to a process for calculating and paying restitution to investors. The amount of civil penalty and other monetary relief to be paid by Putnam remains open and will be determined at a later date.

In its Order against Putnam, the Commission found that Putnam committed securities fraud by failing to disclose potentially self-dealing securities trading by several of its employees. The Commission also found that Putnam failed to take adequate steps to detect and deter such trading activity through its own internal controls and its supervision of investment management professionals. Putnam has agreed to admit these findings for purposes of the penalty phase of the administrative proceeding, which has not yet taken place.

The reforms that Putnam agreed to implement, pursuant to the Commission's Order, are all designed to prevent the sort of violations found by the Commission. They can be broken down into three important areas: (1) restrictions on employee trading; (2) enhancements of compliance policies, procedures, and staffing, including relating to employee trading; and (3) corporate governance, including fund board independence.

Among the reforms Putnam will implement relating specifically to employee trading is a requirement that employees who invest in Putnam funds hold those investments for at least 90 days, and in some cases, as long as one year.

In the compliance area, Putnam will:

- Require Putnam's Chief Compliance Officer to report to the fund boards' independent trustees all breaches of fiduciary duty and violations of the federal securities laws;
- Maintain a Code of Ethics Oversight Committee to review violations of the Code of Ethics and report breaches to the fund boards of trustees;

- Create an Internal Compliance Controls Committee to review compliance controls and report to the fund boards of trustees on compliance matters;

- Retain an Independent Compliance Consultant to review Putnam's policies and procedures designed to prevent and detect breaches of fiduciary duty, breaches of the Code of Ethics, and federal securities law violations by Putnam and its employees; and

- At least once every two years, Putnam will have an independent, third party conduct a review of the firm's supervisory, compliance and other policies and procedures in connection with the firm's duties and activities on behalf of and related to the Putnam funds.

In the area of corporate governance, Putnam agreed:

- That the fund boards of trustees will have an independent chairman;

- That the fund boards of trustees will consist of at least 75% independent members;

- That no board action may be taken without approval by a majority of the independent directors; and that Putnam will make annual disclosure to fund shareholders of any action approved by a majority of the fund board's independent trustees, but not approved by the full board;

- That the fund boards of trustees will hold elections at least once every five years, starting in 2004; and

- That the fund boards of trustees will have their own, independent staff member who will report to and assist the fund boards in monitoring Putnam's compliance with the federal securities laws, its fiduciary duties to shareholders, and its Code of Ethics.

In sum, the reforms Putnam will undertake as part of the Commission's order are intended to provide real, substantial, and *immediate* protections for mutual fund investors. The required enhancements to the board oversight and compliance functions at Putnam should strengthen *all* aspects of Putnam's fund operations and provide investors with uncompromised representation by their fiduciaries in the boardroom and at the management company. In addition, the Division of Enforcement fully intends to seek substantial penalties and/or other monetary payments from Putnam, over and above the restitution Putnam already is bound by the Commission's order to make. And, of course, the Commission's investigation of Putnam and its employees is active and ongoing. If additional misconduct comes to light, the Commission will bring additional enforcement actions.

On November 4, in conjunction with the Secretary of the Commonwealth of Massachusetts, the Commission announced still another enforcement action, this one against five Prudential Securities brokers and their branch manager. The Commission alleged in a civil action that the defendants defrauded mutual funds by misrepresenting or concealing their own identities or the identities of their customers so as to avoid detection by the funds' market timing police. This allowed them to enter thousands of market timing transactions after the funds had restricted or blocked the defendants or their customers from further trading in their funds. The Commission is seeking injunctive relief, disgorgement, penalties, and such equitable relief as the court deems appropriate.

B. The Commission's Use of Examination Authority

As I noted, the Commission's response to the revelations of misconduct in the mutual fund area is multi-pronged. The second area of authority that we are utilizing aggressively is the Commission's examination authority, which entitles us to obtain promptly information and records from regulated entities. Accordingly, immediately following the Canary announcement, relying on the Commission's examination powers, the Commission's staff sent detailed requests for information and documents to 88 of the largest mutual fund complexes in the country and 34 broker-dealers, including prime brokerage firms and other large broker-dealers. These written requests sought information on each entity's policies and practices relating to market timing and late trading. In the case of mutual funds and broker-dealers, we have obtained information regarding their pricing of mutual fund orders and adherence to their stated policies regarding market timing. We also have sought information from mutual funds susceptible to market timing regarding their use of fair value pricing procedures to combat this type of activity.

The examination staff is still analyzing the information received as a result of these requests, and in many cases has sought additional details. Nevertheless, some firms' responses have warranted aggressive follow-up, and thus, Commission examiners have been dispatched to conduct onsite inspections and interviews at a number of firms. Responses from some other firms have already led to referrals to the enforcement staff for further investigation. All told, SEC staff across the country are looking at the activities and practices of dozens of mutual fund and broker-dealer firms.

As I noted earlier, the Commission's examination and enforcement staff are examining and investigating other industry practices, such as the sale of B shares to investors, payments for "shelf space," and the failure to give breakpoint discounts.

III. Conclusion

The Commission's investigations of mutual fund trading and sales practices abuses are continuing on multiple fronts. I want to emphasize that we will aggressively pursue those who have violated the law and injured investors as a result of sales practice and related disclosure abuses, failure to give breakpoint discounts, improper valuation practices, illegal late-trading, market-timing, self-dealing, or any other illegal activity we uncover. Those responsible for these practices *will* be identified and *will* be held fully accountable.

Wherever possible, the Commission also will seek recompense for investors in connection with mutual fund fraud. We will, of course, continue to work closely and cooperatively with state officials who also are taking steps to protect investors.

I would be happy to answer any questions that you may have.