TESTIMONY CONCERNING THE STATE OF THE SECURITIES INDUSTRY

William H. Donaldson
Chairman, U.S. Securities and Exchange Commission

Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs

March 9, 2005

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

Thank you for inviting me to testify today on the state of the securities industry. I am glad to have the opportunity to answer any questions you may have concerning the securities industry generally. I understand, though, that you are particularly interested in the Commission's recent initiatives regarding market structure, credit rating agencies, mutual funds and the implementation of the Sarbanes-Oxley requirements, and I plan to address these in detail in my opening remarks. As you know, the Commission has been devoting considerable resources to initiatives in each of these areas over the past few years. I welcome your continuing interest in these issues of such fundamental importance to the fairness and efficiency of the U.S. securities markets.

I. Regulation NMS

I will begin with a status report on Regulation NMS, a broad set of proposals designed to modernize and strengthen the regulatory structure of the U.S. equity markets. At present, the Commission is in the final stages of a particularly extensive and open rulemaking process that included publication of the original Regulation NMS proposal in February of last year, public hearings in April, a supplemental request for comment in May, and a reproposal in December. In fact, Regulation NMS is the product of more than five years of study and hard work by the Commission that included multiple public hearings and roundtables, an advisory committee, three concept releases, the issuance of temporary exemptions intended in part to generate useful data on policy alternatives, and a constant dialogue with industry participants and investors. The comment period on the reproposal of Regulation NMS expired on January 26, and the staff is in the midst of evaluating the comments and preparing a final package of rules for Commission consideration. I would expect the Commission to take action on Regulation NMS within the next several weeks.

In developing Regulation NMS, the Commission has been guided by the fundamental principles for the national market system that were established by Congress in 1975. In particular, the national market system is premised on promoting fair competition among markets, while at the same time assuring that all of those markets are linked together, through facilities and rules, in a system that promotes interaction between the orders of buyers and the orders of sellers in a particular security. As a result, the national market system incorporates two distinct types of competition – competition among markets and competition among orders. Over the years, the Commission's often difficult task has been to maintain the right balance between these two types of competition as technology and trading practices evolve.

The Commission has expended considerable effort to strike the appropriate balance in developing the proposals in each of the four substantive areas addressed by Regulation NMS – trade-throughs, market access, sub-penny quoting, and market data. Of these, the proposed trade-through rule has by far generated the most attention, and I would like to focus my remarks on that aspect of Regulation NMS. I would note, however, that the Commission has not yet taken final action on any part of Regulation NMS, and my fellow Commissioners and I are in the process of weighing and considering a number of different policy considerations, which each of us must do in deciding how ultimately to vote on the Regulation NMS proposals when they are put before the Commission.

Let me begin by emphasizing three important policy goals I believe would be furthered by the Trade Through Rule. First, the Rule would provide an effective backstop, on an order-by-order basis, to a broker's duty of obtaining best execution for market orders. Retail investors typically expect their market orders to be executed at a price no worse than the relevant quotation at time of order execution, yet it can be difficult for investors to monitor whether their orders in fact are executed at the best price. The Trade Through Rule, in combination with a broker’s duty of best execution, is designed to benefit retail investors by generally prohibiting the practice of executing orders at inferior prices.

Second, the Trade Through Rule is designed to promote fair and orderly markets and investor confidence by providing greater assurance that limit orders displaying the best prices are not bypassed by trades at inferior prices. Retail investors, in particular, may feel unfairly treated when they are the "most willing" buyer or seller and yet their best-priced limit orders are traded through. By protecting the best-priced orders, the Rule is designed to promote a fair playing field for both small and large investors in the U.S. equity markets.

Finally, the Trade Through Rule is designed to encourage the use of limit orders and thereby contribute to greater market depth and liquidity. Displayed limit orders are the building blocks of public price discovery and efficient markets. Although there are many types of liquidity, displayed limit orders represent, by far, the most transparent and readily accessible source of liquidity. They also provide an essential benchmark that guides the use of other types of liquidity, such as undisplayed trading interest, matching systems, and dealer capital commitments. As a result, the enhanced displayed liquidity and public price discovery elicited by the Trade Through Rule should contribute to more efficient trading throughout the equity markets.

Turning to the proposed Rule itself, I should stress that the Trade Through Rule, if adopted by the Commission, would take a substantially different and more comprehensive approach than the existing SRO and ITS trade-through rules. The Trade

Through Rule would, for the first time, establish a uniform trade-through rule for <u>all</u> national market system (NMS) stocks. As a uniform rule, it would cover both exchange-listed stocks, which are governed by existing SRO trade-through rules, and Nasdaq stocks, which have never been subject to a trade-through rule. Furthermore, the Rule would only protect <u>automated</u> quotations – in essence, those quotations against which an incoming order can execute immediately and without human intervention. It would <u>not</u> protect manual quotations. In so doing, the Trade Through Rule would correct a significant problem with the existing trade-though rules, which treat all quotes alike and effectively force fast markets to route orders to slow markets, where they can sometimes languish unfilled while the market moves away. The reproposed Trade Through Rule also would incorporate a series of discrete exceptions – including those that accommodate sweep orders, address rapidly-changing or "flickering" quotes, and allow for "self-help" when a market experiences a systems malfunction – that are designed to assure the rule works in a relatively frictionless manner. Finally, the Trade Through Rule would eliminate significant gaps in the coverage of the existing trade-through rules – such as the exemptions for off-exchange block trades and 100-share quotes – that have seriously undermined the extent to which the SRO rules protect limit orders and promote fair and orderly trading.

I should note that the reproposal asked for comment on two alternatives to the scope of the automated quotations in each market that would be protected. The first alternative – the "Market BBO" alternative – would protect the best displayed bids and offers on each exchange, Nasdaq, and the NASD's Alternative Display Facility. The second alternative – the "Voluntary Depth" alternative – would protect not only the best quotes, but also orders below the best bid and above the best offer that a market <u>voluntarily</u> chooses to display in the consolidated quotation stream.

That said, I should point out that some Commissioners and commenters have questioned the need for a Trade-Through Rule on the listed markets, where they believe that the current trade-through rule is ineffective. These same Commissioners and some commenters question whether the trade-through rule should be extended to Nasdaq, which they believe operates well without one. In their view, improved access to, and connectivity among, the competing markets, coupled with vigorous enforcement of best execution obligations, will best achieve fair, efficient, and liquid markets, and make a Trade-Through Rule unnecessary. I have asked the staff to give serious consideration to all viewpoints as they develop final recommendations for Commission consideration.

Commission staff is in the midst of evaluating the more than 1500 comment letters received on the two Trade Through Rule alternatives, as well as other aspects of the Regulation NMS reproposal. As I noted earlier, I have asked the staff to complete their analysis and prepare a recommendation for Commission consideration in short order. While the issues raised by the trade-through rule and other components of Regulation NMS are extremely complex and, in some cases, controversial, they have been thoroughly analyzed and debated over the course of many years, and I believe the time for action has arrived. I can assure you that the Commission will carefully consider the comments received on Regulation NMS – including many from you and your colleagues – and that we are committed to achieving a result that furthers the important policy objectives I have described without burdening the efficient operation of the markets.

II. Credit Rating Agencies

I will now turn to the Commission's recent work with respect to credit rating agencies. By way of background, the Commission originally used the term "Nationally Recognized Statistical Rating Organization" or "NRSRO" with respect to credit rating agencies in 1975 solely to differentiate between grades of debt securities held by broker-dealers as capital to meet Commission capital requirements. Since that time, ratings by NRSROs have become benchmarks in federal and state legislation, domestic and foreign financial regulations and privately negotiated financial contracts.

In the last few weeks, (1) the Commission staff has issued a no-action letter to A.M. Best, a privately owned and operated credit rating agency; (2) the Commission has proposed a rule that would define the term "NRSRO" with the goal of providing greater transparency to the process for identifying NRSROs; and (3) the current NRSROs are discussing with Commission staff a voluntary framework of standards to address important issues such as potential conflicts of interest. I will now discuss each step in detail.

AM Best

Last Thursday, on March 3, the Commission staff issued a no-action letter to A.M. Best providing assurance that the staff will not recommend enforcement action if ratings from A.M. Best are used by broker-dealers for purposes of the net capital rule. In effect, the no-action letter adds A.M. Best to the group of credit rating agencies considered "NRSROs." Prior to A.M. Best, eight credit rating agencies had received NRSRO no-action letters from the Commission staff. However, consolidation during the 1990s, reduced the number of pre-A.M. Best NRSROs to four firms: Dominion Bond Rating Service; Fitch; Moody's; and Standard & Poor's.

Proposed Rule Defining NRSRO

On March 3, the Commission voted to issue a rule proposal that would define the term "NRSRO" for purposes of Commission rules. The goal of the proposal is to provide greater clarity and transparency to the process of determining whether a credit rating agency's ratings should be relied on as NRSRO ratings for purposes of Commission rules. The definition and interpretations of the definition would provide credit rating agencies with a better understanding of whether they qualify as an NRSRO.

The rule proposal builds on earlier Commission work with respect to the role of credit rating agencies. This work included public Commission hearings, a report required by the Sarbanes-Oxley Act, and a 2003 concept release. Panel participants at the public hearings included NRSROs, non-NRSRO credit rating agencies, broker-dealers, buy-side firms, issuers, the academic community, and SEC Commissioners. Most participants favored the regulatory use of credit ratings issued by NRSROs as a simple, efficient benchmark of credit quality, and stated that standards for NRSROs were necessary for this concept to have meaning.

In addition, the Commission conducted a study of credit rating agencies and submitted a report to the President and Congress under the Sarbanes-Oxley Act of 2002 on January 24, 2003. The report considers the role of credit rating agencies and their importance to the securities markets, impediments faced by credit rating agencies in performing that role, measures to improve information flow to the market from credit rating agencies, barriers to entry into the credit rating business, and conflicts of interest faced by credit rating agencies.

Finally, the Commission issued a concept release in June 2003 to further study issues raised in the Sarbanes-Oxley report. The concept release examined whether credit ratings should continue to be used for regulatory purposes under the federal securities laws, and, if so, the process of determining whose credit ratings should be used, and the level of oversight to apply to such credit rating agencies. One conclusion that the Commission has drawn from its examination of the topic is that market participants would be well served by a clearer set of standards for determining whether or not a credit rating agency is an NRSRO.

The Commission's rule proposal of March 3 responds to a number of issues raised by commenters to the concept release. The proposal retains the NRSRO concept and proposes a definition of "NRSRO." Moreover, the Commission would interpret the elements of the definition to provide greater clarity as to the meaning of the term. In addition, in light of the longstanding reliance by broker-dealers, issuers, investors, and others on the existing no-action process, if the Commission adopted a definition of NRSRO, the Commission plans to continue to make its staff available to provide no-action letters, as appropriate. No-action letters would be granted for a specified period of time, after which the no-action relief would need to be reconsidered.

The Commission notes that this proposal is intended only to address the meaning of the term "NRSRO" as it is used by the Commission; it does not attempt to address many of the broader issues raised in response to the 2003 Concept Release, such as whether the NRSRO designation raises barriers to entry to the credit rating business, except for making clear that credit rating agencies that confine their activities to limited sectors of the debt market or to limited (or largely non-U.S.) geographic areas can qualify as NRSROs. The Commission believes that to conduct a rigorous program of NRSRO oversight, more explicit regulatory authority from Congress is necessary. We believe that a well-thought-out regulatory regime could provide significant benefits in such areas as record-keeping and addressing conflicts of interest in the industry. It will be important to ensure that the public does not misconstrue any regulatory authority over credit rating agencies as a statement that the government has vouched for the accuracy or quality of a credit rating.

The Voluntary Framework

Finally, the current NRSROs have sought to craft a framework for voluntary oversight by the Commission. Discussions are ongoing concerning the precise terms of a framework. It is not clear at this time what form that framework might take. It is hoped that the framework will enhance oversight of NRSROs from current levels by providing a means by which the Commission staff can assess on an ongoing basis whether an NRSRO continues to meet the "NRSRO" definition.

It is important to recognize that even if the industry does adopt such a framework, it would not give the Commission the same authority that actual legislative authority could. For example, if a credit rating agency failed to observe a provision of the voluntary framework, the Commission would not be able to bring an enforcement action. Moreover, the framework does not envision direct inspections by Commission staff, and the Commission would instead be in a position of relying on inspections conducted by third parties hired by the credit rating agencies. Accordingly, if Congress believes more extensive Commission oversight is appropriate than possible with a voluntary framework, legislation may be needed even if the industry does in fact adopt a voluntary framework.

Congressional attention would be especially useful because the question of whether to impose a regulatory regime on the credit rating industry raises a number of important policy considerations that would need to be examined, including First Amendment issues. The Commission welcomes Congressional attention and, of course, would stand ready to work with Congress on crafting appropriate legislation if Congress determines that such legislation is necessary.

III. Mutual Fund Rulemaking

I turn now to another area of significant Commission focus and reform activity – mutual funds. Last year, in the wake of the mutual fund late trading and market timing scandals, the Commission undertook an aggressive mutual fund reform agenda. The reforms were designed to (1) improve the oversight of mutual funds by enhancing fund governance, ethical standards, and compliance and internal controls; (2) address late trading, market timing and certain conflicts of interest; and (3) improve disclosures to fund investors, especially fee-related disclosures. It is my hope and expectation that, taken together, these reforms will minimize the possibility of the types of abuses we witnessed in the past 18 months from occurring again.

When I last testified before this Committee on mutual fund reform on April 8, 2004, we had taken final action on just two of our mutual fund reform initiatives, although many were in the proposal stage. Today, I am pleased to announce that we have adopted 10 of our initiatives and expect to complete the few remaining matters on our reform agenda in the coming months. I would like to review for you the significant steps we have taken to strengthen and improve the mutual fund regulatory framework.

A. Enhancing Internal Oversight

Fund Governance Reforms: With respect to enhancing mutual fund governance and internal oversight, a centerpiece of the Commission's reform agenda was the fund governance initiative. In July 2004, the Commission adopted reforms providing that funds relying on certain exemptive rules must have an independent chairman, and 75 percent of board members must be independent. [1] In addition, the independent directors to these funds must engage in an annual self-assessment and hold separate "executive sessions" outside the presence of fund management. The Commission also clarified that these independent directors must have the authority to hire staff to support their oversight efforts. These fund governance reforms will enhance the critical independent oversight of the transactions permitted by the exemptive rules. Funds must comply with these requirements by January 16, 2006.

As I have said before, I believe that a management company executive who sits as chair of a fund's board is asked to do the impossible – serve two masters. There are times when the executive's duties to the management company and its shareholders simply conflict with what is in the best interest of fund investors. This is the case, for instance, when fund boards review many of the transactions permitted by our exemptive rules. I believe that an independent chairman and a 75% majority of independent directors level the playing field on behalf of fund investors and blunt the control and dominance that many management companies historically have exerted in fund boardrooms. Our fund governance reforms will also facilitate the effective implementation of other mutual fund initiatives the SEC has adopted and will put forward.

Compliance Policies and Procedures and Chief Compliance Officer Requirement: One of the most important of these initiatives, adopted in December 2003, requires that funds and their advisers have comprehensive compliance policies and procedures and appoint a chief compliance officer. In the case of a fund, the chief compliance officer is answerable to the fund's board and can be terminated only with the board's consent. The chief compliance officer must report to the fund's board regarding compliance matters on at least an annual basis. Funds and advisers were required to comply with these new requirements beginning October 5, 2004. We believe that making these changes to the mutual fund compliance infrastructure, and the increased focus on compliance that comes from the new chief compliance officer requirement will help to minimize the kinds of compliance weaknesses that led to the mutual fund scandals.

Code of Ethics Requirement: In July 2004, the Commission adopted a new rule that requires registered investment advisers, including advisers to funds, to adopt a code of ethics that establishes the standards of ethical conduct for each firm's employees. The code of ethics rule represents an effort by the Commission to reinforce the fundamental importance of integrity in the investment management industry. Investment advisers were required to comply with the new code of ethics requirement as of February 1, 2005.

---

[1] Commissioners Glassman and Atkins dissented, raising several concerns regarding the need for and effectiveness of this rulemaking.

B. <u>Addressing Late Trading, Abusive Market Timing and Directed Brokerage for Distribution</u>

Late Trading/Hard 4:00 Proposal: To address the problems associated with late trading (which involves purchasing or selling mutual fund shares *after* the time a fund prices its shares—typically 4:00—but receiving the price that is set *before* the fund prices its shares), the Commission proposed the so-called "hard 4:00" rule. This rule would require that fund orders be received by the fund, its designated transfer agent or a clearing agency by 4:00 p.m. in order to be processed that day.

We have received numerous comments raising concerns about this approach. In particular, we are concerned about the difficulties that a hard 4:00 rule might create for investors in certain retirement plans and investors in different time zones. Consequently, our staff is focusing on alternatives to the proposal that could address the late trading problem, including various technological alternatives. The technological alternatives could include a tamper-proof time-stamping system and an unalterable fund order sequencing system. These technological systems could be coupled with enhanced internal controls, third party audit requirements and certifications.

Our staff has been gathering information from industry representatives to better understand potential technological systems that could be used to address the late trading problem. Given the technological implications of any final rule in this area, it is important that we get it right. Thus, I have instructed the staff to take the time necessary to fully understand the technology issues associated with any final rule. Consequently, the Commission likely will not consider a final rule in this area until mid-2005.

Market Timing/Redemption Fee Rule: Last week, the Commission adopted a "voluntary" redemption fee rule, which permits (but does not require) funds to impose a redemption fee of up to 2%. The rule requires that fund boards consider whether they should impose a redemption fee to protect fund shareholders from market timing and other possible abuses. The voluntary rule represents a change from the "mandatory" approach proposed by the Commission. Many commenters opposed a mandatory redemption fee rule because of concerns that investors would inadvertently trigger the fee's application and because a 2% redemption fee may not be appropriate in all cases.

When the Commission adopted the new rule, we also requested comment on whether to require that any redemption fee imposed by a fund conform to certain uniform standards. This standardization may facilitate imposition and collection of redemption fees throughout the fund industry. I am hopeful that we will quickly reach a decision on this part of the rule, after we hear back from commenters.

The new rule also mandates that funds be able to access information from intermediaries operating omnibus accounts, so that funds can identify shareholders in those accounts who may be violating a fund's market timing policies. Under these arrangements, the intermediaries and funds would share responsibility for enforcing fund market timing policies. I should also note that fair value pricing remains critical to eliminating arbitrage opportunities for market timing.

Directed Brokerage Ban: In September 2004, the Commission adopted amendments to rule 12b-1 under the Investment Company Act to prohibit mutual funds from directing commissions from their portfolio brokerage transactions to broker-dealers to compensate them for distributing fund shares. The Commission's concern was that this practice can compromise best execution of portfolio trades, increase portfolio turnover, conceal actual distribution costs and inappropriately influence broker-dealer recommendations to investors. In adopting the ban, the Commission determined that directing brokerage for distribution represented the type of conflict that was too significant to address by disclosure alone. The directed brokerage ban went into effect December 13, 2004.

C. Improving Disclosures to Fund Investors

Improved mutual fund disclosure—particularly disclosure about fund fees, conflicts and sales incentives—has been a stated priority for the Commission's mutual fund program throughout my tenure as Chairman, even before the mutual fund scandals came to light. As such, disclosure enhancements have been an integral part of our reform initiatives. As part of our mutual fund reform agenda, we have adopted the following disclosure reforms, all of which have become effective.

Shareholder Reports: In February 2004, the Commission adopted significant revisions to mutual fund shareholder reports. These revisions include dollar-based expense disclosure, quarterly disclosure of portfolio holdings and a streamlined presentation of portfolio holdings in shareholder reports. These requirements became effective in August 2004.

Disclosure Regarding Market Timing, Fair Valuation and Selective Disclosure of Portfolio Holdings: In April 2004, the Commission adopted amendments requiring funds to disclose (1) market timing policies and procedures, (2) practices regarding "fair valuation" of their portfolio securities and (3) policies and procedures regarding the disclosure of their portfolio holdings. Each of these disclosures specifically addresses abuses that came to light in the mutual fund scandals. These requirements became effective in May 2004.

Breakpoint Discounts: In June 2004, the Commission adopted rules requiring mutual funds to provide enhanced disclosure regarding breakpoint discounts on front end sales loads, in order to assist investors in understanding the breakpoint opportunities available to them. This initiative addresses the failure on the part of many broker-dealers to provide sales load discounts to mutual fund investors who were entitled to them. The requirement became effective in July 2004.

Board Approval of Investment Advisory Contracts: Also in June 2004, the Commission adopted rules requiring that shareholder reports include a discussion of the reasons for a fund board's approval of its investment advisory contract. The disclosure is intended to focus directors' and investors' attention on the importance of the contract review process and the level of management fees. This requirement became effective in August 2004.

Disclosure Regarding Portfolio Manager Conflicts and Compensation: In August 2004, the Commission required that funds provide additional information regarding portfolio manager conflicts and compensation, including information about other investment vehicles managed by a fund's portfolio manager, a portfolio manager's investment in the funds he or she manages and the structure of the portfolio manager's compensation. These requirements became effective in October 2004.

Point of Sale/Fund Confirmations: In addition to these adopted reforms, last week, on March 1, the Commission requested additional comment on a proposal requiring brokers to provide investors with enhanced information regarding costs and broker conflicts associated with their mutual fund transactions. The proposal would require disclosure at two key times – first at the point of sale, and second at the completion of a transaction in the confirmation statement. We tested our proposal with investor focus groups, and based on the very helpful feedback we received from these focus groups, we issued our request for additional comment. We also are sensitive to the concerns expressed by brokerage industry commenters about the costs associated with our original proposal. Our staff therefore is examining more cost-effective methods of providing investors with the disclosures they need. I am hopeful that the Commission can move quickly on this initiative after we have an opportunity to review the comments that respond to our recent request for input.

D. Upcoming Mutual Fund Initiatives

Having outlined the Commission's progress on our mutual fund reform agenda, I would like to highlight some additional mutual fund related initiatives that are on the horizon.

Portfolio Transaction Costs Disclosure: In December 2003, the Commission issued a concept release requesting comment on measures to improve disclosure of mutual fund transaction costs. In many cases, investors do not understand how the costs associated with the purchase and sale of a mutual fund's portfolio securities affect their bottom-line investment in the fund. These transaction costs can include the payment of commissions and spreads as well as costs associated with soft dollars and other brokerage arrangements. Transaction costs also can encompass costs that are difficult to quantify, such as opportunity costs and market impact costs. Using feedback that we received in response to our concept release, our staff is preparing a proposal to improve disclosure of mutual fund transaction costs.

Soft Dollars: I believe it is necessary to examine the nature of the conflicts of interest that can arise from soft dollars, which involve an investment adviser's use of brokerage commissions to purchase research and other products and services. Consequently, I have formed a Commission Task Force that is reviewing the use of soft dollars, the impact of soft dollars on our nation's securities markets and whether soft dollars further the interests of investors. In addition, the Task Force is reviewing whether we can improve disclosure to better inform investors about the use of soft dollars and whether there are enhanced disclosures that can be made to fund boards to enable them to better evaluate funds' use of soft dollars. The Task Force also is examining the definition of "research" as used in section 28(e) of the Securities Exchange Act of 1934. Soft dollar arrangements present many of the same concerns irrespective of whether research is provided on a proprietary basis, or by an independent research provider, and I expect that any recommendations from the staff would accord similar treatment to both types of arrangement.

Rule 12b-1: When the Commission proposed to ban directed brokerage for distribution under rule 12b-1, it also requested comment on the broader question of whether rule 12b-1 (which allows mutual fund assets to be used to promote the sale of fund shares) should be revised more broadly or even eliminated. The Commission received numerous comments on this issue. The Commission adopted rule 12b-1 over 20 years ago, and the mutual fund industry has evolved significantly since then. The idea of using rule 12b-1 fees as a substitute for a sales load--which in many cases they have come to be--is different than the use of 12b-1 fees for advertising and marketing purposes, which was envisioned when the rule was adopted. In light of these changes in the industry and in the use of 12b-1 fees, the future of rule 12b-1 is a topic that should receive a thorough and reasoned review.

Mutual Fund Disclosure Reform: As I outlined above, the Commission has adopted a number of new mutual fund reform initiatives designed to improve the disclosures made to fund investors. Each of these disclosure reforms was merited. However, I believe it is time to step back and take a top-to-bottom assessment of our mutual fund disclosures. I have asked the staff to carry out a comprehensive review of the mutual fund disclosure regime and how we can maximize its effectiveness on behalf of fund investors. The staff also will examine how we can make better use of technology, including the Internet, in our disclosure regime. Throughout this review process, we will solicit input from mutual fund investors.

IV. Sarbanes-Oxley Implementation

Two years ago, when I came on board at the Commission, the country was still reeling from its disappointment with cooked books, indefensible lapses in audit and corporate governance responsibilities, and intentional manipulation of accounting rules. These lapses led to staggering financial losses and a crisis in investor confidence. The resulting Sarbanes-Oxley Act called for the most significant reforms affecting our capital markets since the Securities Exchange Act of 1934. The Act established the foundation necessary to improve financial reporting and the behavior of companies and gatekeepers, and we have completed the rule-making to implement these critically important reforms. Key requirements have taken hold including:

- CEO and CFO certifications of the material completeness and accuracy of SEC periodic filings;

- Enhanced disclosure of off-balance sheet transactions;
- Electronic reporting within two business days of insider transactions;
- Increased disclosure of material current events affecting companies;
- Strengthened rules regarding the independence of auditors and audit committees;
- Establishment of the PCAOB;
- Issuance of the first PCAOB inspection reports on the large accounting firms;
- Issuance of important auditing standards by the PCAOB; and
- For the first time, as required by Section 404 of the Act, public reporting on internal controls and their effectiveness - by both management and auditors.

I would like to focus for a moment on the Section 404 requirement for management and a company's auditor to report on the effectiveness of internal controls over financial reporting. This section of Sarbanes-Oxley may have the greatest long-term potential to improve financial reporting. It may also well be the most urgent financial reporting challenge facing a large share of corporate America and the audit profession in 2005. I expect that we will begin to see a number of companies announce that they or their auditors have been unable to complete their assessments or audits of controls, and additional companies announce that they have material weaknesses in their controls.

For this initial pass, that result should not, by itself, necessarily be motivation for immediate or severe market reactions. Section 404 is a disclosure provision, and investors will benefit from receiving full disclosure regarding any material weaknesses that are found – full disclosure about the nature of any material weakness, their impact on financial reporting and the control environment and management's plans for remediating them. This disclosure will allow investors and markets to make the appropriate judgments about what companies and auditors find. Section 404 will work as intended if it brings this information into public view, and in that event the disclosure of material weaknesses in internal controls should be the beginning and not the end of the analysis for investors and markets. The goal should be continual improvement in controls over financial reporting and increased investor information and confidence. This should lead to better input for management decisions and higher quality information being provided to investors.

While these benefits are clear, it is also important that we evaluate the implementation of our rules and the auditing standard issued by the Public Company Accounting Oversight Board (PCAOB) to ensure that these benefits are achieved in the most sensible way. We have been very sensitive to the implementation of all aspects of the Sarbanes-Oxley Act, and especially to this very significant aspect. This has included several measured extensions over this past year to accommodate the first wave of reporting.

In addition, in order to assess SEC and PCAOB rules for Section 404 now that we will have the first year of actual experience under the rules, the Commission will hold a roundtable discussion this April and is currently soliciting written feedback from the public regarding registrants' and accounting firms' implementation of these new reporting requirements. Through the roundtable and this feedback, we will be closely listening to and assessing the experiences with the management and auditor internal control requirements, including seeking to identify best practices for the preparation of these reports and evaluating whether there are ways to make the process more efficient and effective, while fully preserving the benefits of the requirements. Throughout this process the Commission and its staff will closely coordinate with the PCAOB and its staff, and we will seriously consider whether any additional guidance is necessary or appropriate. We are actively engaged in other activities to evaluate and assess the effects of the recent reforms, including the internal control reporting rules. For example, we have announced we are establishing the Securities and Exchange Commission Advisory Committee on Smaller Public Companies. The advisory committee will conduct its work with a view to protecting investors, considering whether the costs imposed by the current regulatory system for smaller public companies are proportionate to the benefits, and identifying methods of minimizing costs and maximizing benefits. In addition, and at the request of Commission staff, a task force of the Committee of Sponsoring Organizations (COSO) has been established and anticipates publishing additional guidance this summer in applying COSO's framework to smaller companies. Our actions have not been limited to smaller companies. We also are cognizant of the regulatory challenges our foreign registrants face. For all of these reasons, we recently extended the compliance date for internal control reporting for an additional year for smaller and foreign public companies. Review of the first year experiences of our larger registrants also should help smaller and foreign issuers in preparing their first reports.

V. Conclusion

This testimony covers a broad spectrum of serious and very complex issues the Commission is currently dealing with. There are a number of other substantive activities underway at the Commission as well, but I have tried to limit my update to the things I understand are foremost on your minds. I thank the Members of this Committee for your interest and attention to the important issues affecting the securities markets today, and for the support you have shown the Commission and its staff. Together, we have made significant progress over the last several years in re-building public confidence in our markets. This concludes my prepared testimony. I would be glad to try and answer any questions you may have.