REGULATORY REFORMS TO PROTECT OUR NATION'S MUTUAL FUND INVESTORS

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INTRODUCTION

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

Thank you for inviting me to testify today on the Securities and Exchange Commission's initiatives to address problems in the mutual fund and brokerage industries. When I testified before you on September 30th, the discovery of late trading and market timing abuses by personnel at hedge fund Canary Capital had just erupted. I will update you on recent developments since then. First, though, I'd like to share with you the fundamental rights that I believe every mutual fund investor not only should expect, but also to which every investor is entitled. We all – regulators, legislators, investment advisers, mutual fund managers, broker-dealers, the financial press and investors – have spent much time lately wondering how

the current abuses could have happened. I believe that a significant reason is because the industry lost sight of certain fundamental principles – including its responsibilities to the millions of people who entrusted their confidence, the fruits of their labor, their hopes and dreams for the future to this industry for safekeeping. These investors are entitled to honest and industrious fiduciaries who sensibly put their money to work for them in our capital markets. No one can argue with the premise that investors deserve a brokerage and mutual fund industry built on fundamentally fair and ethical legal principles.

Let me outline my visions of "Mutual Fund Investors' Rights" and the critical initiatives underway at the Commission to ensure that these enhanced investor protections continue to be carried out and that our new investor protections are put in place as quickly as possible.

MUTUAL FUND INVESTORS' RIGHTS

1. Mutual Fund Investors Have a Right to an Investment Industry that Is Committed to the Highest Ethical Standards and that Places Investors' Interests First.

Every brokerage and mutual fund firm needs to conduct a fundamental assessment of its obligations to its customers and shareholders. These assessments must be put forth at the highest levels, and implemented so as to reach all employees. Senior management and the boards of directors

must be ready to lay down and vigorously enforce rules that define an immutable code of conduct.

2. Investors Have a Right to Equal and Fair Treatment by Their Mutual Funds and Brokers.

Our examinations and investigations of late trading and market timing abuses have revealed instances of special deals and preferential treatment being afforded to large investors, often to the detriment of small investors. The concepts of equal and fair treatment of all investors and the prohibition against using unfair informational advantages are embedded in various provisions of the federal securities laws, including the Investment Company Act. The SEC will not tolerate arrangements of this kind that violate these fundamental principles.

3. Investors Have a Right to Expect Fund Managers and Broker-Dealers To Honor Their Obligations to Investors in Managing and Selling Funds.

Our examinations and investigations into the current abuses have revealed instances of fund managers placing their interests – and in the case of some portfolio managers, placing their personal interests – ahead of those of fund investors. We also have seen recent examples of abusive activity by broker-dealers and their representatives in connection with the sale of fund shares, including failure to give investors the breakpoint discounts to which

they are entitled, recommendations that investors purchase one class of shares over another in order for the salesperson to receive higher compensation and other sales practice abuses. This cannot and will not be tolerated.

4. Investors Have a Right to the Assurances that Fund Assets Are Being Used for Their Benefit.

Clearly, fund assets, including use of a fund's brokerage commissions, must be used in a manner that benefits fund investors. The Commission must engage in a reassessment of how fund commission dollars are used, including various soft dollar arrangements and the lack of transparency to investors of these payments.

5. Investors Have the Right to Clear Disclosure of Fees, Expenses, Conflicts, and Other Important Information.

Mutual fund investors must have the tools and the information to make intelligent investment decisions. To that end, the Commission will take action to enhance disclosure to fund investors of fees and expenses, and the conflicts that arise as a result of the various arrangements between funds and brokers regarding the sale of fund shares, as well as other important information.

6. *Investors Have a Right to Independent, Effective Boards of Directors Who Are Committed to Protecting Their Interests.*

In the words of the U.S. Supreme Court, independent directors are the "independent watchdogs" that provide a critical and necessary check on fund management. Investors need to be assured that their mutual fund directors have the independence and commitment necessary to carry out this crucial function. We are proposing to set enhanced standards for board independence and are considering other steps in this area.

7. *Investors Have a Right to Effective and Comprehensive Mutual Fund and Broker Compliance Programs.*

Programs designed to ensure compliance with the federal securities laws are an essential tool in the protection of investors. Fund investors need to be assured that all funds, advisers and selling brokers have internal programs to ensure compliance with the federal securities laws. We will complete our pending rule-making to strengthen procedures at mutual funds and advisers.

8. *Investors Should Expect that Aggressive Enforcement Actions Will Be Taken When There Are Violations of the Federal Securities Laws.*

We will continue to take strong and appropriate action against those who violate the federal securities laws. There will be serious consequences to those who violate the federal securities laws.

By holding the industry (and ourselves) to these standards, we can significantly minimize the possibility of future scandals that harm our nation's millions of mutual fund investors, and help restore the confidence of those investors.

SEC RISK MANAGEMENT INITIATIVE

For too long, the Commission has found itself in a position of reacting to market problems, rather than anticipating them. There are countless reasons for this – not the least of which include historically lagging resources and structural and organizational roadblocks. The time for excuses has long passed.

Since coming to the Commission in February, one of my top priorities has been to reevaluate and determine how the Commission deals with risk. Part of this evaluation has been a thorough review of the Commission's internal structures. The results of our work form a new risk management initiative that will better enable the Commission to anticipate, identify, and manage emerging risks and market trends that stand to threaten the Commission's ability to fulfill its mission.

This critical initiative – the first of its kind at the Commission – will enable us to analyze risks across divisional boundaries, focusing on early identification of new or resurgent forms of fraudulent, illegal or questionable

behavior or products. Operating under the "Doctrine of No Surprises," this initiative seeks to ensure that senior management at the Commission has the information necessary to make better, more informed decisions.

The new initiative will be housed within a newly created Office of Risk Assessment, and will be headed by a director who reports directly to the Chairman. The director will coordinate and manage risk assessment activities across the agency, and will oversee a staff of five professionals, who will focus on the key programmatic areas of the agency's mission.

The duties of the Office of Risk Assessment will be focused on the following areas:

- Gathering and maintaining data on new trends and risks from a variety of sources – including external experts, domestic and foreign agencies, surveys, focus groups, and other market data, including both buy-side and sell-side research.
- Analyzing data to identify and assess new areas of concern across professions, companies, industries and markets.
- Preparing assessments and forecasts on the agency's risk environment.

The work of the Office of Risk Assessment will be complemented by a Risk Management Committee, whose primary responsibility will be to review the implications of identified risks and recommend an appropriate course of action.

Additionally, each Division and major Office will have one-to-two risk assessment professionals on staff, who will work closely with the Division Director or Office head as part of risk management teams to conduct risk assessment activities within each division.

I believe this important initiative will fundamentally change the way the Commission assesses risk and will enable us to head off major problems before they occur.

PLAN OF EXECUTION

The SEC is dedicated to the underlying concept inherent in this statement: "Mutual Fund Investors' Rights." Let me outline what the specific initiatives to ensure that Mutual Fund Investors' Rights are realized.

Late Trading and Market Timing Abuses

Late trading and market timing abuses represent the most recent violations against investors' rights. In addition to those abuses, we have seen other violations of investors' rights, including (to name but a few) violations of an investor's right to high ethical standards, fiduciary

protections, clear disclosure, and equal treatment. While we are vigorously pursuing enforcement actions regarding this misconduct, we also are taking a number of regulatory steps immediately to deal specifically with these abuses. On October 9, I outlined a regulatory agenda to confront the abuses head-on to help restore investor confidence in the fairness of mutual fund operations and practices. I asked the staff to submit rulemaking recommendations to the Commission this month to address these issues. As a result, on December 3, the Commission will consider the staff's proposal to require that a fund (or certain designated agents) – rather than an intermediary such as a broker-dealer or other unregulated third party – receive a purchase or redemption order prior to the time the fund prices its shares (typically, 4 PM) for an investor to receive that day's price. This "hard" 4 o'clock cut-off would effectively eliminate the potential for late trading through intermediaries that sell fund shares.

With respect to market timing abuses, we will consider the staff's recommendation that the Commission require additional, more explicit disclosure in fund offering documents of market timing policies and procedures. This disclosure would enable investors to assess a fund's market timing practices and determine if they are in line with their expectations.

The staff's recommendations will have a further component of requiring funds to have specific procedures to comply with their representations regarding market timing policies. Thus, if a fund's disclosure documents stated that it discouraged market timing, the fund would be required to have procedures outlining the practices it follows to keep market timers out of the fund. While our examination staff will use a variety of techniques to police for market timing abuses, the establishment of formal procedures would also enable the Commission's examination staff to review whether those procedures are being followed and whether the fund is living up to its representations regarding curbing market timing activity. The Commission also will emphasize the obligation of funds to fair value their securities so as to avoid "stale pricing" to minimize market timing arbitrage opportunities as an important measure to combat market timing activity.

Also on December 3, the Commission will consider adopting new rules under the Investment Company Act and the Investment Advisers Act that will ensure that mutual funds have strong compliance programs. Specifically, the rules that the Commission will consider would require each investment company and investment adviser registered with the Commission

to: (1) adopt and implement written policies and procedures reasonably designed to prevent and detect violations of the federal securities laws; (2) review these polices and procedures annually for their adequacy and the effectiveness of their implementation; and (3) designate a chief compliance officer to be responsible for administering the policies and procedures and to report directly to the fund's board of directors. A chief compliance officer reporting to the fund's board of directors will strengthen the hand of the fund's board and compliance personnel in dealing with fund management.

Allegations of certain portfolio managers market timing the funds they personally manage or other funds in the fund complex raise issues regarding self-dealing. Recent allegations also indicate that some fund managers may be selectively disclosing their portfolios in order to curry favor with large investors. Selective disclosure of a fund's portfolio can facilitate fraud and have severely adverse ramifications for a fund's investors if someone uses that portfolio information to trade against the fund. You can expect that these issues will also be addressed in the rulemaking recommendations that the Commission will consider on December 3.

The package of reforms that I've just outlined for you is designed to provide immediate reassurances and protection to mutual fund investors. They deserve nothing less than an immediate response from the SEC. These

critical reforms not only will tackle the immediate problem of late trading and market timing abuses that we've seen so far during our investigation, but also will provide powerful tools to prevent the types of abuses identified to date. However, we cannot and will not stop here. We will explore the full range of our authority, not only in the reforms discussed above, but in additional areas to further address market timing abuses.

For instance, while the Commission's actions regarding fair value pricing should address the problem of stale pricing (which facilitates market timing), we will consider more in this area. As such, I've asked the staff to study additional measures for Commission consideration, including considering a mandatory redemption fee imposed on short-term traders and developing a solution to the problem of trading through omnibus accounts.

With respect to the mandatory redemption fee, which would be paid to the fund (and, ultimately to the fund's long-term investors), it is a fee that would apply to short-term traders getting in and out of a fund over a short period of time, for instance 3 or 5 days. Such a fee could decrease the likelihood of market timers profiting from arbitrage activity.

As for omnibus accounts, I believe that there needs to be better information shared between funds and brokers. Mutual fund shares often are purchased and redeemed through omnibus accounts held at intermediaries

such as broker-dealers. Typically, a brokerage firm has one omnibus account with each of the mutual funds with which it does business and through which all of its brokerage customers purchase and redeem shares of those mutual funds. Consequently, these mutual funds do not have information on the identity of the underlying brokerage customer who is purchasing or redeeming the funds' shares.

This arrangement often makes it difficult for funds to fulfill certain of their obligations to their shareholders. In the breakpoint context, omnibus accounts make it difficult for funds to track information about the underlying shareholder that might have entitled the shareholder to breakpoint discounts. In the market timing context, funds are not able to assess redemption fees, limit exchanges or even kick out a shareholder who is market timing through an omnibus account because they don't know the identity of that shareholder. Indeed, many of the market timing abuses identified through our examinations and investigations indicate that shareholders were market timing through omnibus accounts.

The issue is further complicated because brokers are reluctant to release the underlying shareholder information to funds, citing privacy and competitive concerns. The brokers fear that by releasing the names of their

customers who are purchasing fund shares to the funds themselves, the funds then can market directly to those customers, cutting out the brokers.

Requiring broker-dealers and other intermediaries to provide information to funds regarding the funds' investors would allow funds to police for abusive market timing activity and to further provide for appropriate breakpoints. An alternative would be to require that broker-dealers and other intermediaries enforce funds' policies with respect to market timing and the offering of breakpoints.

Study

To assist the staff as it moves forward in considering this issue, I've called upon the NASD to head an Omnibus Account Task Force consisting of members of the fund and brokerage industries, as well as other intermediaries to further study this issue and to provide the SEC staff with information and recommendations. Under the NASD's capable leadership, the Joint NASD/Industry Task Force on Breakpoints was extremely beneficial in dealing with the breakpoint issue and I am confident that, working together with the NASD and the industry, we will be able to develop a proposal that will adequately address the omnibus account issue.

Fund Governance

As I noted, a fundamental right of investors is a strong, effective, independent board of directors. The statutory framework governing mutual funds envisions a key role for boards of directors in light of the external management structure typical for funds. The directors, particularly the "independent directors," are responsible for managing conflicts of interest and representing the interests of shareholders. The problems that recently have come to light underscore the need for enhanced effectiveness of independent directors in carrying out their responsibilities. Toward that end, I believe there are a number of ideas for reform, including:

1. requiring an independent chairman of the fund's board of directors;
2. increasing the percentage of independent directors under SEC rules from a majority to three-fourths;
3. providing the independent directors the authority to retain staff as they deem necessary so they do not have to necessarily rely on the fund's adviser for assistance;
4. requiring boards of directors to perform an annual self-evaluation of their effectiveness, including consideration of the number of funds they oversee and the board's committee structure; and

5. adopting a rule that would require boards to focus on and preserve documents and information that directors use to determine the reasonableness of fees relative to performance, quality of service and stated objectives, including a focus on the need for breakpoints or reductions in advisory fees and comparisons with fees and services charged to other clients of the adviser.

I recognize, however, that while the Commission can adopt rules to enhance and strengthen fund governance, that is not enough. Directors themselves must understand and carry out their responsibilities to protect fund investors. We need to take the necessary steps to educate directors regarding this crucial role and to ensure that they understand their role. Accordingly, in addition to asking the staff to develop these reforms for consideration by the Commission in January, I've also called upon fund independent directors themselves to be active participants in the reform effort. Specifically, I have asked former SEC Chairman David Ruder's non-profit mutual fund director's organization, the Mutual Fund Directors Forum, to develop guidance and best practices in key areas of director decision-making, such as monitoring fees and conflicts, overseeing compliance, and important issues such as valuation and pricing of fund portfolio securities and fund shares. Mr. Ruder and the Board of Directors

of the Forum – an organization geared toward independent directors and that promotes improved fund governance through continuing education programs and other activities that assist independent directors in advocating for fund shareholders – have agreed to develop this guidance and these best practices to assist independent directors. Rest assured, we will continue to consider every viable idea, from whatever source, for improving the way that mutual funds are structured and governed.

In addition to these initiatives, in August of this year the Commission proposed rules regarding disclosure of fund nominating committee functions and communications between fund investors and fund boards, as part of the Commission's broader proposal on nominating committee disclosure. And just last month, the Commission, as part of its broader proxy nomination proposal, proposed rules to improve access of fund shareholders to the director nomination proxy process.

Disclosure

Another fundamental right of mutual fund investors is clear, easy to understand disclosure. At the end of September we adopted amendments to mutual fund advertising rules that require that fund advertisements state that investors should consider fees before investing and that advertisements direct investors to a fund's prospectus to obtain additional information about

fees. The rules also require more balanced information about mutual funds when they advertise performance. The Commission also recently proposed rule amendments regarding fund of funds products that would require these products to include additional disclosure in their prospectus fee table of the costs of investing in underlying funds. The Commission also adopted rules that require funds and advisers to disclose their proxy voting policies and procedures and, in the case of funds, disclose to investors the voting records of the funds.

Another key concept of the disclosure principle is clear, easy to understand disclosure to mutual fund investors of the fees and expenses they pay. I anticipate that in January, the Commission will consider adopting rules that would require "dollars and cents" fee disclosure to shareholders, coupled with more frequent disclosure of portfolio holdings information. This is an important reform, as it will allow investors to determine not only the fees and expenses they are paying on their particular funds, but will also greatly facilitate comparison among different funds. The Commission also will be considering in December a proposal to improve disclosure to shareholders regarding the availability of sales load breakpoints. We also want to provide investors better information on portfolio transaction costs so that they can factor this into their decision-making. Consequently, the staff

is developing for Commission consideration in December a concept release to solicit views on how the Commission should proceed in fashioning disclosure of these costs.

Investors not only deserve to know the fees and expenses their funds pay, they also deserve to know how much their broker stands to benefit from their purchase of a particular fund. Thus, we also plan to improve disclosure about mutual fund transaction costs through the confirmations that broker-dealers provide to their customers. I have directed the staff to prepare a new mutual fund confirmation statement that will provide customers with quantified information about the sales loads and other charges that they incur when they purchase mutual funds with sales loads. I expect that the Commission will consider this proposal before the end of the year. The Commission also will direct the staff to consider how disclosure of quantified information about sales loads and other charges incurred by investors might be disclosed in a document available prior to the sale of fund shares.

To address an investor's right to know about conflicts of interest that brokers may have when selling fund shares, the new mutual fund confirmation statement also will include specific disclosure regarding revenue sharing arrangements, differential compensation for proprietary

funds and other incentives such as commission business for brokers to sell fund shares that may not be readily apparent to fund investors.

To ensure that investors receive the benefits of fund assets to which they are entitled, the Commission will examine how brokerage commissions are being used to facilitate the sale and distribution of fund shares, as well as the use of so-called soft dollar arrangements. Soft dollar arrangements can create incentives for fund advisers to: (1) direct fund brokerage based on the research provided to the adviser rather than on the quality of execution provided to the fund; (2) forgo opportunities to recapture brokerage costs for the benefit of the fund; and (3) cause the adviser to over-trade the portfolio to fulfill its soft dollar commitments to brokers. These are areas that raise complicated issues, but that we will nevertheless examine.

I have also instructed the staff to consider rules that would better highlight for investors the basis upon which directors have approved management and other fees of the fund.

Compliance and Oversight

The Commission long has recognized the importance of strong internal controls. For example, the Commission recently tailored the provisions of the Sarbanes-Oxley Act to apply to mutual funds, including the provisions to improve oversight and internal controls, such as key officer

certifications and code of ethics requirements, thereby ensuring that mutual fund shareholders received the full protections of the Act.

In addition, I should note that the staff in September issued a comprehensive report on hedge funds, making a series of recommendations to improve the Commission's ability to monitor the activity of these vehicles — the most significant being a recommendation to require that hedge fund advisers register under the Investment Advisers Act and thereby become subject to Commission examination and routine oversight. This review of hedge funds, and the staff's recommendations, become all the more important when we consider that we have seen a number of hedge funds allegedly engaging in late trading and market timing of mutual fund shares, serving as the impetus for the current investigations and enforcement actions related to these activities.

We will continue to explore additional approaches that the Commission might pursue to require funds to assume greater responsibility for compliance with the federal securities laws, including whether funds and advisers should periodically undergo an independent third party compliance audit. These compliance audits could be a useful supplement to our own examination program and could ensure more frequent examination of funds and advisers.

Also, as an effective regulator, we must have clear rules as to what is unlawful activity. We will continue to review our rules and regulations to ensure that this is the case, much as we are doing now to combat late trading and market timing abuses.

ACTIONS ON THE ENFORCEMENT FRONT

Again, I believe that these investor rights are critical. Equally critical is effective enforcement of those rights and of the federal securities laws.

When I testified before you in September, I noted that the Commission had taken immediate enforcement action against a senior official at Bank of America. Since then, we have taken a number of additional enforcement actions against those taking part in these trading abuses.

We have charged a senior executive of a prominent hedge fund with late trading, and barred him from association with an investment adviser. We also barred and imposed a $400,000 civil penalty on a mutual fund executive in connection with his alleged role in allowing certain investors to market time his company's funds. We instituted an action against a major investment management firm and two of its portfolio managers who allegedly market timed their own mutual funds. And we charged five brokers and a branch manager with having misrepresented or concealed their

own and their clients' identities in order to facilitate thousands of market timing transactions.

PUTNAM SETTLEMENT

Among its many roles, the Securities and Exchange Commission has two critical missions. The first is to protect investors, and the second is to punish those who violate our securities laws. Last week's partial settlement of the SEC's fraud case against the Putnam mutual-fund complex does both. It offers immediate and significant protections for Putnam's current mutual fund investors, serving as an important first step. Moreover, by its terms, it enhances our ability to obtain meaningful financial sanctions against alleged wrongdoing at Putnam, and leaves the door open for further inquiry and regulatory action.

Despite its merits, the settlement has provoked considerable discussion, and some criticism. Unfortunately, the criticism is misguided and misinformed, and it obscures the settlement's fundamental significance.

By acting quickly, the SEC required Putnam to agree to terms that produce immediate and lasting benefits for investors currently holding Putnam funds. First, we put in place a process for Putnam to make full restitution for investor losses associated with Putnam's misconduct. Second, we required Putnam to admit its violations for purposes of seeking a penalty

and other monetary relief. Third, we forced immediate, tangible reforms at Putnam to protect investors from this day forward. These reforms are already being put into place, and they are working to protect Putnam investors from the sort of misconduct we found in this case.

Among the important reforms Putnam will implement is a requirement that Putnam employees who invest in Putnam funds hold those investments for at least 90 days, and in some cases for as long as one year – putting an end to the type of short-term trading we found at Putnam. On the corporate governance front, Putnam fund boards of trustees will have independent chairmen, at least 75% of the board members will be independent, and all board actions will be approved by a majority of the independent directors. In addition, 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. Putnam has also committed to submit to an independent review of its policies and procedures designed to prevent and detect problems in these critical areas -- now, and every other year.

This settlement is not the end of the Commission's investigation of Putnam. We are also continuing to examine the firm's actions and to pursue

additional remedies that may be appropriate, including penalties and other monetary relief. If we turn up more evidence of illegal trading, or any other prohibited activity, we will not hesitate to bring additional enforcement actions against Putnam or any of its employees. Indeed, our action in federal court charging two Putnam portfolio managers with securities fraud is pending.

There are two specific criticisms of the settlement that merit a response. First, some have charged that it was a mistake not to force the new management at Putnam to agree that the old management had committed illegal acts. In fact, we took the unusual step of requiring Putnam to admit to liability for the purposes of determining the amount of any penalty to be imposed. We made a decision, however, that it would be better to move quickly to obtain real and practical protections for Putnam's investors, right now, rather than to pursue a blanket legal admission from Putnam. The SEC is hardly out of the mainstream in making such a decision. All other federal agencies, and many state agencies (including that of the New York Attorney General), willingly and regularly forgo blanket admissions in order to achieve meaningful and timely resolutions of civil proceedings.

Second, some have criticized the Putnam settlement because it does not address how fees are charged and disclosed in the mutual fund industry. While this issue is serious, the claim is spurious. The Putnam case is about excessive short-term trading by at least six Putnam management professionals and the failure of Putnam to detect and deter that trading. The amount and disclosure of fees is not, and never has been, a part of the Putnam case, and thus it would be wholly improper to try to piggyback the fee-disclosure issue on an unrelated matter.

If our continuing investigation of Putnam uncovers evidence of wrongdoing in the fee-disclosure area, we will not hesitate to act, and the Commission is already moving forward with rulemaking that will address this issue, and others, on an industry-wide basis. Those lacking rulemaking authority seem to want to shoehorn the consideration of the fee-disclosure issues into the settlement of lawsuits about other subjects. But we should not use the threat of civil or criminal prosecution to extract concessions that have nothing to do with the alleged violations of the law.

Criticism of the Commission for moving too quickly misses the significance of the Commission's action. While continuing our broader investigation of Putnam, we have reached a fair and far-reaching settlement that establishes substantial governance reforms and compliance controls that

are already benefiting Putnam's investors. It is a settlement where the Commission put the interests of investors first. As the Commission continues to initiate critical and immediate reforms of the mutual-fund industry, and while we investigate a multitude of other cases involving mutual fund abuses, we will continue to seek reforms that provide immediate relief to harmed investors.

I also want briefly to discuss yesterday's announcement of the Commission's enforcement action against Morgan Stanley arising out of the firm's mutual fund sales practices. Morgan Stanley has agreed to a settlement of the action that calls, in part, for it to pay a total of 50 million dollars, all of which will be returned to investors. The action grows out of an investigation begun in the spring of this year.

The Commission's investigation uncovered two distinct, firm-wide disclosure failures by Morgan Stanley. The first relates to an exclusive program involving sixteen mutual fund families that Morgan Stanley sold to its customers. Under an exclusive program involving sixteen mutual fund families.

Under the program, Morgan Stanley gave these fund families what is sometimes called "premium shelf space." The firm encouraged its sales

force to sell shares of the funds in the program and even paid its salespeople special incentives to sell those funds so that Morgan Stanley would receive from those funds a percentage of the sales price over and above ordinary commissions and loads. Morgan Stanley's customers did not know about these special shelf-space payments, nor in many cases did they know that the payments were coming out of the very funds into which these investors were putting their savings.

Few things are more important to investors than receiving unbiased advice from their investment professionals. Morgan Stanley's customers were not informed of the extent to which Morgan Stanley was motivated to sell them a particular fund.

Our investigation also uncovered, and the enforcement action we have filed includes, another practice at Morgan Stanley involving conflicts of interest in the sale of mutual funds. This practice, which has been the subject of other Commission cases during the last several months, involves the sale of Class B mutual fund shares to investors who were more likely to have better overall returns if they bought Class A shares in the same funds.

I want to emphasize that 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. I also want to note that the potential disclosure failures and breaches of trust are not limited to broker-dealers. We are also looking very closely at the mutual fund companies themselves.

The SEC's Director of Enforcement, Stephen Cutler, will be testifying before you on our enforcement efforts this Thursday, and can answer your specific questions about these and the Commission's other enforcement actions, as well as the results thus far in our ongoing investigation. While he cannot speak to specific entities that the Commission has authorized the staff to investigate, he can brief you on the types of cases you likely will be seeing brought by the Commission in the near future. Let me emphasize, however, that I am appalled at the types and extent of conduct that is being revealed in our examinations and investigations. It is conduct that represents fundamental breaches of fiduciary obligations and betrayal of our nation's investors. I can assure you that we are committed to seeking redress for

investors and meting out the appropriate punishment in these matters to send a strong message that these types of abuses will not be tolerated.

CONCLUSION

As you can see, taken together, the reforms that the Commission has already undertaken and those currently being initiated are both substantial and far reaching. They are designed to address not only the immediate problems of late trading and market timing abuses, but represent a reevaluation of the Commission's oversight of the mutual fund industry as a whole. Most importantly, they put the needs of mutual fund investors first. I appreciate the opportunity to share with you my views, and I would be happy to answer any questions you may have.