RECENT COMMISSION ACTIVITY TO ENHANCE INVESTOR PROTECTIONS

Testimony of William H. Donaldson

Chairman, U.S. Securities and Exchange Commission

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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 recent initiatives to enhance investor protections in our securities markets. Since its creation in 1934, the SEC's mandate has been to protect investors and ensure the integrity of America's securities markets. That mandate has taken on even greater importance in recent years, as increasing numbers of people have become equity investors. With more than 95 million Americans invested in mutual funds, representing approximately 54 million U.S. households, and a combined $6.5 trillion in assets, mutual funds are a vital part of this nation's economy. While much of the public focus over the last few years has been on events surrounding public companies, the Commission has undertaken an aggressive agenda to identify and address challenges in the mutual fund industry, an agenda that helps us to protect this vital segment of our investing public.

I would like to highlight some important actions we have recently taken to help ensure that mutual fund investors have the information they need to make their investment decisions.

Fund Advertising. Just last week, we adopted rule amendments to modernize mutual fund advertising requirements to encourage more responsible advertising. The new amendments require that fund advertisements state that investors should consider a fund's fees before investing. The amendments also require advertisements to include information about the fund's investment objectives and risks, as well as an explanation that the prospectus contains this and other important information about the fund. The amendments also strengthen the antifraud protections that apply to fund advertising and encourage fund advertisements to provide information to investors that is more balanced and informative, particularly in the area of investment performance, so that investors have access to up-to-date performance information.

In addition to rulemaking initiatives, the Commission has engaged in educational efforts to caution investors against the dangers of overemphasizing fund performance in investment decisions. These efforts included publishing an investor alert on the Commission's website that explains the importance of looking beyond past performance in making investment decisions. We also placed a "cost calculator" on our website that allows investors to compute the impact of fees and expenses of various funds on their performance and facilitates comparison of funds.

Fund of Funds. The Commission also last week proposed for public comment new rules under the Investment Company Act that would broaden the ability of one fund to acquire shares of another fund, so called "funds of funds". These funds often are used as asset allocation vehicles for a fund to gain exposure to a sector of the market by investing in another fund. This proposal also included recommended amendments that would improve the transparency of the

expenses of funds that invest in other funds by requiring that the expenses of the acquired funds be aggregated and shown as an additional expense in the fee table of the acquiring funds, thereby giving investors in these funds more complete information about expenses.

Proxy Voting. In January, the Commission adopted rules that require mutual funds to disclose their proxy voting records. These rules enable fund shareholders to monitor their funds' involvement in the governance activities of portfolio companies. Under the rule, funds are required to file their proxy voting record with the Commission, which will make it publicly available through the EDGAR system. The rules also require mutual funds to disclose in their registration statements the policies and procedures they use to determine how to vote proxies related to portfolio securities. Funds have already begun complying with this requirement, and they are required to start filing their proxy voting reports next year.

Sarbanes-Oxley Requirements. In addition to Commission initiatives, mutual funds also are subject to the corporate governance requirements of the Sarbanes-Oxley Act. In each rule we have proposed and/or adopted under the Act, we have applied the corporate governance requirements to both operating companies and mutual funds, with some tailoring for the unique aspects of mutual funds. These rules include the rules on CEO and CFO certification requirements, code of ethics requirements, disclosure of audit committee financial experts, auditor independence and, most recently, audit committee listing standards. This last rule, adopted as part of a broader rulemaking regarding audit committee standards, applies only to listed companies and therefore includes only exchange-traded funds, or listed closed-end funds. The rule directs the exchanges and NASDAQ to prohibit the listing of any security of an issuer in violation of new standards of audit committee responsibility and independence.

Future Mutual Fund Activity

In addition to these rule-making activities, we have a number of other initiatives in the pipeline.

Breakpoint Disclosure. We anticipate taking action to improve the disclosure of breakpoint discounts, which are discounts on front-end sales loads based on the aggregate amount of purchases of a fund's shares. Funds that offer breakpoint discounts must disclose the breakpoints and related procedures in their offering documents. Brokers that sell shares of funds that offer discounts have an obligation to help ensure that shareholders are receiving those discounts. Late last year, however, the staffs of the NASD and the SEC identified concerns regarding breakpoints. The staffs discovered that many fund investors were not receiving the appropriate discounts. The SEC and NASD took swift action – reminding funds and brokers of their obligations, requiring brokers to assess the extent of the problem, and directing the industry to convene a task force to address the problem. In July, a Joint NASD/Industry Report on Breakpoints was released containing recommendations to assure that investors receive available discounts on mutual fund shares subject to front-end sales loads.

The Breakpoint Report contains a number of recommendations to limit the problems associated with the provision of breakpoint discounts, as well as to improve the disclosure of breakpoint opportunities. I have directed the staff to draft a rule for Commission consideration consistent with these recommendations to help ensure that investors receive the appropriate discounts in the future. In addition, the NASD and SEC staffs continue to monitor and quantify the problem and have directed firms that have failed to provide the appropriate breakpoints in the past to compensate and make whole any affected investor. We and the NASD

also will continue to investigate, and where warranted, will bring enforcement actions in this area.

Shareholder Report Disclosure of Operating Expenses. We have also proposed additional disclosure to increase investors' understanding of the expenses they incur when investing in a mutual fund. Under this proposal, mutual funds would be required to disclose in their shareholder reports the "dollar amount" of fund expenses paid by shareholders on a prescribed investment amount -- based on both the fund's actual expenses and return for the period, as well as the fund's actual expenses for the period based on an assumed return of 5 percent per year. By using both these measures, the dollar disclosure would enable investors to determine the amount of fees they paid on an ongoing basis, as well to compare the amount of fees charged by other funds. The goal of the proposal is to educate investors and to encourage cost competition among funds. This proposal also would require more frequent disclosure of portfolio holdings (*i.e.,* quarterly rather than semi-annually) to enhance investor understanding of the securities in the fund's portfolio so that investors can make better asset allocation decisions. I expect the Commission to consider adopting these new requirements in the near future.

Highlighting Broker Incentives and Conflicts of Interest. Another area we are looking at is how to increase investor understanding of the incentives and conflicts that broker-dealers have in offering mutual fund shares to investors. Initiatives we are considering in this area include a comprehensive revision of mutual fund confirmation form requirements. I envision that a revised confirmation would include information about revenue sharing arrangements, incentives for selling in-house funds and other inducements for brokers to sell fund shares that may not be immediately transparent to fund investors.

In addition to its disclosure initiatives, the Commission has focused its rulemaking efforts on fund governance and internal compliance issues. Although we have focused on these issues for some time, recent events in the mutual fund industry underscore the importance of funds' maintaining appropriate measures to ensure their adherence to both the letter and spirit of the federal securities laws.

Mutual Fund Compliance Rule. In February, the Commission published for comment proposed rules aimed at ensuring better compliance with regulations governing mutual funds. These rules would mandate that funds and investment advisers maintain comprehensive compliance policies, and procedures reasonably designed to prevent violations of the federal securities laws. The rules also require that funds designate a chief compliance officer. While the proposal does not enumerate specific elements funds must include in their compliance programs – as funds are too varied in their operations for us to impose a single list of required elements – it is designed to ensure that policies and procedures are in place to lessen the likelihood of securities law violations and detect any violations that do occur.

Consequently, we would expect funds to have policies and procedures to address pricing of portfolio securities and fund shares; processing of fund shares on a timely basis; portfolio management processes, including allocation of investment opportunities among clients; the accuracy of disclosures made to investors in fund prospectuses (disclosures that would include representations regarding market timing policies and procedures); and processes to value client holdings and assess fees based on those valuations.

While we expect that these rules would help protect investors by improving day-to-day compliance with the federal securities laws, the rules should also increase the efficiency and

effectiveness of the Commission's mutual fund examination program. Our oversight is predicated on the assumption that those who manage mutual funds have procedures to comply with the law. While the proposal would codify the prudent compliance practices already followed by most fund complexes, in some cases mutual funds have few compliance controls in place or have gaps in their controls. These proposals are intended to raise the standard of compliance among all mutual funds, and I expect the Commission will consider adoption of these requirements later this fall.

Director Nomination Rules. We have also included mutual funds in initiatives to increase shareholder participation in the director nomination process. Last month we proposed rule changes to strengthen disclosure requirements relating to the nomination of directors and shareholder communications with directors. The proposals apply to both operating companies and mutual funds.

The proposals would require a fund to disclose additional information regarding its process of nominating directors, including whether members of the nominating committee are "interested persons" of the fund; a fund's process for identifying and evaluating candidates; whether a fund considers candidates for director nominees put forward by shareholders; and whether a fund has rejected candidates put forward by large long-term shareholders or groups of shareholders. The proposals would also require a fund to disclose information regarding shareholder communications with directors, including whether the fund has a process for such communications and the procedures shareholders should follow; whether the communications are screened; and whether material actions have been taken as a result of shareholder communications in the last fiscal year.

The proposed rules implement the first part of the recommendations of a Commission Staff Report issued on July 15, 2003, regarding improvements to the proxy process. The enhanced disclosure provided by the proposal should benefit fund shareholders by improving the transparency of the nominating process and board operations, as well as increasing shareholders' understanding of the funds in which they invest. The Staff Report also recommends under certain circumstances that major-long-term shareholders, or groups of shareholders, be provided access to proxy materials to nominate directors where there are objective criteria indicating that shareholders may not have had adequate input in the proxy process. I expect that we will propose rules to implement this recommendation shortly, and that they will apply with equal force to mutual funds.

Updates On Other Issues

I understand the Committee is interested in getting an update on a few other issues for today's hearing, so let me briefly bring you up to speed in those areas.

Hedge Fund Report

Since June of last year, the SEC staff has conducted a comprehensive study focusing on the investor protection implications of the significant growth of hedge funds in recent years. As part of that study, the staff reviewed documents from 65 hedge fund advisers managing more than 650 different hedge funds with more than $160 billion of assets. The staff also visited hedge fund advisers and prime brokers and conducted a series of examinations of registered funds of hedge funds. Finally, the staff benefited from views expressed at a highly successful two-day Roundtable we held at the Commission, during which a variety of experts discussed key

aspects of hedge fund operations, as well as the views contained in approximately 80 public letters we received commenting on the roundtable discussion and hedge fund issues.

When I testified before you in April, the study was still at the fact gathering stage and the staff had not reached any conclusions. Just yesterday, however, the Commission released a staff report (the "Report") that outlines the staff's factual findings, identifies concerns and recommends certain regulatory and other actions to improve the current system of hedge fund regulation and oversight.

Let me emphasize at this time that this is a staff report. The next step is for the Commission to consider these recommendations to determine how we may wish to proceed. Any recommendation that the Commission determines to act upon will require us to go through the appropriate administrative process, so rest assured that investors, market participants, and other interested persons will have ample opportunity to comment upon any of the recommendations that the Commission chooses to pursue. However, I would like to highlight for you today some of the staff's findings and its primary recommendation.

In its Report, the staff identifies a number of areas of concern regarding hedge funds: (i) lack of Commission information about hedge funds and their advisers' activities; (ii) lack of prescribed and uniform disclosure by hedge fund advisers; (iii) valuation and other conflict of interest issues; (iv) the potential for increased investment by less sophisticated investors, directly or indirectly, in hedge funds; and (v) despite the relatively low absolute number, an increase in the number of enforcement actions regarding hedge fund advisers. Many of these concerns arise from the unregulated status of hedge funds, which generally allows them to operate without Commission oversight. Consequently, the primary recommendation of the staff is that the Commission should consider revising its rules to require that hedge fund advisers register under

the Advisers Act. While I am looking forward to studying the staff's Report and the recommendations contained in it before drawing any conclusions, I will say, as I have before, that I believe that the Commission needs to have a means of examining hedge funds and how they operate. Speaking only for myself, I believe that registration of hedge fund advisers would accomplish this.

Canary Investigation

While I am on the topic of hedge funds, let me update you about our involvement in recent allegations regarding a hedge fund's practices in late trading mutual funds, as well as questions concerning funds' permitting market timers to arbitrage the funds, which underscore the importance of the SEC's ongoing review of the hedge fund and mutual fund industries. Both of these activities have the potential to harm long-term investors in mutual funds.

The conduct alleged in the case involving Canary Capital, an unregistered hedge fund, is reprehensible and in violation of fiduciary principles. We have put in motion an action plan to vigorously investigate this matter, assess the scope of the problem and hold any wrongdoers accountable, and we'll do so in close coordination with State regulators.

Already, we have filed a civil action against Theodore Sihpol, a salesperson at Bank of America Securities, who was Canary Capital's primary contact at Bank of America. Our examiners and enforcement staff are actively investigating this matter, not only the extent to which the allegations in this particular case are true, but also whether this conduct occurs at other firms in the securities industry. I want to emphasize that we will aggressively pursue those who have injured investors as a result of illegal late-trading and/or market-timing activity and, where possible, to seek recompense for these investors in connection with mutual fund transactions.

Additionally, the Commission's staff has sent detailed information requests to registered prime brokerage firms, other large broker-dealers, transfer agents, and the 80 largest mutual fund complexes in the country seeking information on their policies and practices relating to market timing and late trading. Specifically, we are using our examination authority to obtain information from mutual funds and broker-dealers 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.

More broadly, I believe that the industry must take steps to review its own conduct. To that end, I sent letters to major trade associations for the mutual fund and broker-dealer industries asking them to notify their members to review and reassess their procedures relating to the handling of mutual fund investments in accordance with applicable law.

While our enforcement efforts are a key tool in protecting the nation's investors, another critical tool is regulation to minimize the potential for abuses to occur in the first place. We will consider what we learn from the investigation to determine whether we should pursue additional regulatory measures to thwart this type of activity. Specifically, our staff is studying whether we need to take additional steps to (1) pursue measures to prevent the circumvention of forward-pricing requirements for fund shares and market timing restrictions, (2) require funds to have written policies and procedures to address short-term trading in their shares, (3) require improved disclosure regarding market timing procedures, (4) provide funds with additional tools to deter market timing activity, and (5) address concerns related to the selective disclosure of fund portfolio information.

NYSE / Corporate Governance

I would now like to turn to an issue that is important both from a regulatory standpoint and from the standpoint of the investing public: the critical need for sound governance practices by self-regulatory organizations. I believe that self-regulatory organizations should be exemplars of good governance. At a minimum, SROs should demand of themselves the same high standards of governance that the New York Stock Exchange and Nasdaq proposed for their listed issuers in the wake of several widely publicized corporate scandals. To further that goal, this past March I directed each self-regulatory organization to undertake a review of its own governance practices.

Since then, disclosure of the pay package awarded to the former Chairman of the New York Stock Exchange has heightened the scrutiny that the Commission, the securities industry, the investing public, and the media are paying to exchange governance standards that reflect the highest commitment to independent and transparent decision-making. Prior to the current controversy, the NYSE and a few other self-regulatory organizations instituted special governance committees to further study how their structures and processes might be improved. I applaud these efforts but I believe that more remains to be done. I have assurances that the NYSE's new interim Chairman, John Reed, will reexamine these governance issues in more depth. I look forward to working with Mr. Reed on this important initiative.

Our securities markets are the strongest in the world. They have earned this position not only because they have the largest issuers, the greatest depth and liquidity, the most capital, and efficient execution systems – they also have a high degree of investor confidence. I intend to assure that investors can have a strong sense of trust and confidence in our exchanges. To this

end, the Commission and its staff will be working diligently with the SROs to craft a regulatory environment that sets a high bar for sound and rigorous governance practices.

Global Settlement

Finally, the Committee requested an update, since my testimony on May 7, on the status of the research analyst global settlement, the SEC's portion of which was filed with a federal court on April 28, 2003. As described in the Commission's May 7 testimony, the global settlement would impose significant monetary relief, require the firms to make structural reforms to their research and investment banking operations, require the firms to provide customers with independent third-party research, and establish an investor education fund.

Since the filing of the proposed settlement agreement with the federal court, U.S. District Court Judge William H. Pauley III has issued a series of orders requesting that the parties – both the Commission and the participating firms – submit additional information to the Court relating to the terms of the settlement. Those orders, dated June 2 and July 3, address a range of issues. Among the issues addressed were:

- the implications for the proposed federal settlement should any state determine not to settle with a firm, and whether there is a timeframe in which each state must act on the proposed state settlements;

- the allocation of the settlement payments between disgorgement and penalties, and whether any firms intend to seek federal tax deductions or third-party indemnification for settlement payments;

- the operations of the Distribution and Investor Education Funds, such as the identity of potentially relevant securities and time periods, the number of shares of each potentially relevant security purchased by each firms' customers, the total dollar volume of such purchases, and whether the Investor Education Fund should have audit procedures.

The Commission and the firms filed responses to the Court's orders, and the proposed global settlement remains pending before the Court. Nevertheless, the Commission staff believes that, in anticipation of the Court's approval of the settlement, firms are moving forward with preparations to implement the settlement requirements. Moreover, the staff of the Commission will respond to any future inquiries from the Court, and will work to have the global settlement implemented as soon as possible.

Conclusion

Thank you again for inviting me to speak on behalf of the Commission and the investing public. We at the Commission take our responsibility of protecting our nation's investors very seriously. I welcome the opportunity to share our current initiatives with you, and I would be pleased to answer any questions that you may have.