Testimony

of

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Testimony Concerning the Securities and Exchange Commission's Recent Regulatory Actions to Protect Mutual Fund Investors

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

I. Introduction

It is both a pleasure and an honor to testify before you today. On behalf of the Securities and Exchange Commission (the "Commission"), I am pleased to discuss the Commission's recent regulatory actions to protect mutual fund investors. To address the various abuses that have come to light in recent months, the Commission has embarked on a dramatic overhaul of the regulatory framework in which mutual funds operate. The Commission's regulatory actions, taken together with its recent enforcement proceedings and actions by state securities regulators, are intended to prevent and deter the types of market timing, late trading and sales practice abuses that have dominated the headlines in recent months. Equally important, the Commission's rulemaking initiatives are aimed at restoring the trust and confidence of investors that are crucial to the continued success of the mutual fund industry and preserving their key role in our country's economy.

Approximately 95 million investors have entrusted over $7 trillion dollars to mutual funds. As mutual fund investments increasingly fund the most important personal goals in Americans' lives, from retirement and education savings to charitable giving, our nation's investors rightfully look to fund managers and fund directors to act in their interests. Sadly, these investors have been let down, as some of those charged with protecting investors have willfully disregarded their responsibilities to act for the benefit of their investors.

The Commission has committed its unceasing effort to holding accountable those who violate the federal securities laws to abuse fund investors. The Commission is equally devoted to enhancing the mutual fund regulatory framework so that it best serves fund investors.

II. Commission's Regulatory Agenda

Under Chairman Donaldson's leadership, the Commission is pursuing an aggressive mutual fund regulatory agenda that is focused on four main goals: (1) addressing late trading, market timing and related abuses; (2) improving the oversight of funds by enhancing fund governance, ethical standards, and compliance and internal controls; (3) addressing or eliminating certain conflicts of interest in the industry that are potentially harmful to fund investors; and (4) improving disclosure to fund investors, especially fee-related disclosure. Outlined below is an overview of the Commission's recent regulatory actions in each of these areas.

A. Initiatives to Address Late Trading, Abusive Market Timing and Related Abuses

Late Trading: Every day hundreds of thousands of investors purchase or redeem shares of mutual funds. The price they pay (or receive) turns on when the order is submitted and to whom. Typically, funds price their shares at 4:00 p.m. Investors submitting orders before 4:00 p.m. receive that day's price; investors submitting orders after 4:00 p.m. get the next day's price. This is a simple, but very important concept known as "forward pricing." If you can place an order to buy or sell fund shares after 4:00 p.m., and still receive the price set at 4:00 p.m., you can profit from new information in the market place at the expense of other fund shareholders. The Commission's recent review of the largest brokers that sell fund shares identified numerous instances of late trading of fund shares. It is just plain cheating, and something that clearly violates existing Commission rules.

The current rules permit a large number of intermediaries that accept or transmit trades in fund shares to determine whether the order will receive that day's 4:00 p.m. price. Typically, investor trades are accepted throughout the business day by fund transfer agents, as well as brokers, banks, and retirement plan administrators -- so-called fund intermediaries. These intermediaries pass on orders to fund companies in batches at the end of the day after 4:00 p.m. They are only supposed to pass on orders they receive before 4:00 p.m. This system, which was first created 35 years ago, relies heavily on the honesty of fund intermediaries to segregate orders based on the time they are received and then playing by the rules.

We know today that this system failed. In order to help favored customers, certain intermediaries have "blended" legitimate (pre-4:00 p.m. orders) with late trades (post-4:00 p.m. orders). In some cases, fund managers participated in the scheme; but in many cases they were the victims of dishonesty along with fund investors. The problem is that fund companies have no way of identifying a late trade when it is bundled with legitimate trades and submitted to the fund company in the evening hours. There are potentially enormous profits to be gained by late trading, and all of those profits come out of the pockets of mutual fund investors.

To address this abuse, the Commission proposed the so-called "hard 4:00" rule. This proposal would require that a fund or a certified clearing agency, such as NSCC – rather than an intermediary such as a broker-dealer or other unregulated party – receive a purchase or redemption order prior to the time the fund prices its shares (which, as previously stated, is typically 4:00 p.m.) for an investor to receive that day's price. We believe that this rule amendment will provide for a secure pricing system that would be highly immune to manipulation by late traders.

We are currently analyzing the comment letters we received during the comment period on this proposal, which closed on February 6th. While we believe the proposed rule amendment would virtually eliminate the potential for late trading through intermediaries that sell fund shares, it is clear from the comments that some believe that the hard 4:00 rule is not the preferred approach. They argue that it will require the intermediaries to have cut-offs for orders well before 4:00 p.m. and limit investor opportunities to place orders for fund transactions, particularly in the 401(k) context. Consequently, we are studying other approaches to addressing this issue. We do not want to adversely impact fund investors if there are alternatives that effectively – truly effectively – address late trading abuses.

<u>Market Timing</u>: The Commission has taken a number of steps to address abusive market timing of mutual funds. Short-term trades in mutual fund shares impose costs on funds and their long-term investors. Some market timers attempt to purchase and redeem

fund shares to take advantage of market actions they believe will occur in the future. Other types of market timers attempt to more directly take advantage of the fund's long-term shareholders by exploiting how funds calculate their net asset value. These "arbitrage market timers" buy and sell shares of funds if they believe that the fund's calculation of net asset value significantly lags behind the current value of a fund's portfolio securities, typically in international funds or other funds that invest in thinly traded securities. Over time, the long-term shareholders in a fund will, in effect, pay the costs of the short-term shareholders' transactions and have the value of their fund shares diluted through the activity of arbitrage market timers.

<u>Fair Value Pricing</u>: To help prevent "arbitrage market timing", the Commission has stressed that "fair value pricing" is a critical tool in effectively reducing or eliminating the profit that many market timers seek. The Investment Company Act requires funds to calculate their net asset values using the market value of portfolio securities when market quotations are readily available. If a market quotation for a portfolio security is not readily available (or is unreliable), the fund must establish a "fair value" for that security, as determined in good faith by the fund's board of directors. Fair value pricing can minimize market timing, and eliminate dilution of shareholders' interests. In a recent release adopting the new compliance procedures rule, the Commission reiterated the obligation of funds to fair value their securities to reduce market timing arbitrage opportunities. Additionally, the Commission has proposed improved disclosure of a fund's policies and procedures regarding fair value pricing. SEC staff are currently gathering information regarding funds' fair value pricing practices and evaluating whether to recommend additional measures to improve funds'

fair value pricing. The Commission has also sought public comment on the need for additional guidance or rulemaking in this area.

Mandatory Redemption Fee: In a further effort to reduce the profitability of abusive market timing, the Commission late last month put forth a proposal that would require funds to impose a mandatory two percent redemption fee when investors redeem their shares within five business days. This fee would be payable to the fund, for the direct benefit of fund shareholders, rather than to the management company or any other service provider.

The two percent fee is designed to strike a balance between two competing policy goals of the Commission – preserving the redeemability of mutual fund shares and reducing or eliminating the ability of shareholders who frequently trade their shares to profit at the expense of their fellow shareholders. Combined with fair value pricing, the Commission felt that the rule would make market timing less profitable, and therefore reduce the incentive to engage in market timing. The Commission is considering whether a two percent redemption fee is an appropriate approach to addressing short-term trading, including abusive market timing.

Enhanced Disclosure Related to Abusive Activities: The Commission also has proposed enhanced disclosure requirements in order to combat abuses in the areas of market timing and the related issue of selective disclosure of portfolio holdings. These enhancements are intended to deter abusive practices and to enable investors to better understand a fund's policies in these areas.

The Commission proposed amendments to require more open and unambiguous disclosure with respect to the methods that mutual funds use to combat market timing activity. Among other changes, the Commission's proposed reforms would:

- Require a mutual fund to describe in its prospectus the risks that frequent purchases and redemptions of fund shares may present for other fund shareholders;
- Require that a mutual fund state in its prospectus whether the fund's board of directors has adopted policies and procedures with respect to frequent purchases and redemptions of fund shares. If the board has not adopted any such policies and procedures, the fund's prospectus would be required to state the specific basis for the view of the board that it is appropriate for the fund not to have such policies and procedures; and
- Mandate that a fund describe with specificity any policies and procedures for deterring frequent purchases and redemptions of fund shares, and any arrangements that exist to permit frequent purchases and redemptions of fund shares. This description must include any restrictions on the volume or number of purchases, redemptions, or exchanges that a shareholder may make, any exchange fee or redemption fee, and any minimum holding period that is imposed before an investor may make exchanges into another fund. Moreover, a fund would be required to indicate whether each restriction applies uniformly in all cases, or whether the restriction will not be imposed under certain circumstances, and to describe any such circumstances with specificity.

Selective Disclosure of Portfolio Holdings: The Commission also proposed amendments intended to provide greater transparency of fund practices with respect to the disclosure of a fund's portfolio holdings. Specifically, a fund would be required to describe its policies and procedures with respect to the disclosure of its portfolio securities, including any arrangements to make available information about the fund's portfolio securities, the identity of any persons who receive such information, and any compensation or other consideration received by a fund or its investment adviser in connection with such arrangements. These amendments do not alter the requirement that a mutual fund or investment adviser may disclose a fund's portfolio of investment securities only if the disclosure of such information is consistent with the antifraud provisions of the federal securities laws and the fiduciary duties owed to fund shareholders.

This new disclosure requirement should have the effect of requiring fund management to carefully assess the propriety and circumstances under which portfolio holding information is divulged, as well as inform fund investors of the fund's policies in this area.

B. Initiatives to Enhance Fund Oversight

The recent mutual fund scandals have highlighted the need to improve oversight of the industry, and the Commission has undertaken several initiatives on this front. These initiatives are designed to strengthen the hand of the fund's board and to provide the directors, particularly the independent directors, additional tools with which to protect fund investors, as well as reinforce ethical standards.

Fund Governance: In January, the Commission proposed a comprehensive rulemaking package to bolster the effectiveness of independent directors and enhance the role of the fund board as the primary advocate for fund shareholders. The proposals included a requirement for (i) an independent board chairman; (ii) 75 percent independent directors; (iii) independent director authority to hire, evaluate and fire staff; (iv) quarterly executive sessions of independent directors outside the presence of management; (v) an annual board self-evaluation; and (vi) preservation of documents used by boards in the contract review process.

This significant overhaul of the composition and workings of fund boards is intended to establish, without ambiguity, the dominant role of independent directors on a fund's board. With an independent board chairman and with independent directors representing at least 75 percent of a fund's board, independent directors will set the board agenda as well as have the power to control the outcome of board votes.

The very nature of external management that characterizes the U.S. fund industry creates conflicts of interest, particularly when personnel of fund advisers may be tempted by opportunities to benefit the adviser over fund shareholders. While not a guarantee that all conflicts of interest will be resolved in the best interests of shareholders, a board composed of an independent chairman and a super-majority of independent directors is more likely to be an effective check on management, particularly when so much of the board's responsibility involves policing the management company's conflicts of interest.[1] As Chairman Donaldson recently commented, " a fund board can be more effective when

[1] At the open meeting at which the Commission proposed the rule, Commissioners Glassman and Atkins questioned whether an independent chairman would in fact provide a more effective check on management and thus be more effective in promoting shareholder interests.

negotiating with the fund adviser over matters such as the management fee, if it were not at the same time led by an executive of the adviser with whom the board is negotiating."

By empowering independent fund directors to retain staff, in conjunction with the role envisioned for the newly-required chief compliance officer, the Commission's proposals emphasize the importance of boards relying on experts other than advisory personnel to provide information in appropriate circumstances. In addition, reinforcing the ability of the board to hire staff recognizes that directors often must make decisions on issues about which they may need to seek out expertise, such as the fair value pricing of portfolio securities.

Boards would also be required to perform a thorough self-evaluation in order to identify structural changes and processes that might enable the board to be a more potent advocate for shareholder interests. Boards would be required to assess periodically whether they are organized to maximize their effectiveness. As part of this evaluation, boards would consider the number of fund boards on which individual board members sit, as well as consider the nature and effectiveness of their board committee structures.

As part of its effort to enhance fund governance, the Commission has proposed to mandate that funds keep copies of the materials directors considered when reviewing the fund's advisory contract each year. This amendment is designed to give the Commission's examinations staff access to the information on which directors rely when performing this crucial function. This requirement also could have the effect of focusing directors on this key information, since they would be aware that it will be subject to Commission scrutiny.

Adviser Codes of Ethics and Fund Transactions Reporting: The Commission recently proposed that all registered investment advisers adopt codes of ethics. Investment advisers are fiduciaries, and owe their clients a series of duties enforceable under the Investment Advisers Act's antifraud provisions. This bedrock principle, which historically has been a core value of the money management business, appears to have been lost on a number of advisers and advisory personnel.

The Commission believes that prevention of unethical conduct by advisory personnel is part of the answer to avoiding the problems we have encountered recently. Consequently, the code of ethics would set forth standards of conduct for advisory personnel that reflect the adviser's fiduciary duties, as well as codify requirements to ensure that an adviser's supervised persons comply with the federal securities laws, and require that supervised persons receive and acknowledge receipt of a copy of the code of ethics. In addition, the code of ethics must include provisions that address the safeguarding of material nonpublic information about client transactions, reporting promptly any violations of the code of ethics, and mandating pre-clearance of personal investments in initial public offerings and private offerings.

Finally, the ethics code is designed to address conflicts that arise from the personal trading of advisers' employees. A principal feature of the code of ethics rule is a requirement that certain advisory personnel, referred to as access persons, must report their personal securities holdings and transactions, including transactions in any mutual fund managed by the adviser or an affiliate. The rule would close a loophole in the Investment Company Act under which investment company personnel have not been required to report trading in shares of funds they manage. This loophole became apparent when, unfortunately, fund personnel were discovered market timing their own funds.

Compliance Policies and Compliance Officer: In an action we expect to have a far-reaching positive impact on mutual fund operations and compliance programs, the Commission in December adopted rules that require funds and their investment advisers to have comprehensive compliance policies and procedures in place, and to designate a chief compliance officer. In the case of a fund, the chief compliance officer would be answerable to the fund's board and fired only with the board's consent.

The compliance officer has dual roles: first, as the primary architect and enforcer of compliance policies and procedures for the fund; second, and perhaps more importantly, as the eyes and ears of the board on all compliance matters. The chief compliance officer, at the behest of the board, is expected to strengthen the board's hand of compliance oversight into the details of the operations of funds and advisers, where compliance lapses and abuses often germinate and remain hidden from even the most watchful board. In order to support the "watchdog" role of the compliance officer, the rules require the chief compliance officer to meet in executive session with the independent directors at least once each year, outside the presence of fund management and the interested directors. This executive session will create an opportunity for open dialogue between the chief compliance officer and the independent directors and encourage the compliance officer to speak freely about any sensitive compliance issues, such as any reservations about the cooperativeness or compliance practices of fund management. To insulate a chief compliance officer from the pressures, real or perceived, brought to bear by fund management, a fund's board, including a majority of the independent directors, must approve the chief compliance officer's compensation, as well as any changes in compensation.

To further encourage a culture of compliance among fund officers and personnel of fund advisers, the compliance rule calls for funds and advisers to adopt policies and procedures designed to lessen the likelihood of securities law violations. The adequacy of these policies and procedures must be reviewed at least annually in order to ensure that fund directors assess whether internal controls and procedures are working well and whether certain areas can be improved.

An active and independent board of directors, supplied with reliable information as to the effectiveness of compliance programs and procedures, can serve as an important check against abuse and fraud on the part of fund management.

C. Initiatives Aimed at Conflicts of Interest

In addition to the matters outlined above, the Commission is undertaking a series of initiatives aimed at certain conflicts of interest involving mutual funds and those who distribute fund shares.

<u>Directed Brokerage</u>: Last month the Commission voted to propose an amendment to rule 12b-1 to prohibit the use of brokerage commissions to compensate broker-dealers for distribution of a fund's shares. Effectively, this proposal would ban so-called directed brokerage practices by mutual funds. When rule 12b-1 was adopted by the Commission in 1980, the Commission thought that it would be relatively benign to permit funds to consider distribution when making brokerage allocation decisions. However, in recent years, it has become clear that the practice of directing a fund's brokerage to a broker or dealer as compensation for distribution of a fund's shares presents opportunities for

abuse. Advisers to funds are allocating brokerage commissions to pay for distribution when they could seek lower commission rates, rebates to the fund, or reduce custody, transfer agency or other fund costs. The use of directed brokerage to pay for distribution benefits fund advisers by increasing their advisory fees, which generally are based on the size of fund assets, and lowering the amount they have to spend on distribution out of their own assets. The conflicts of interest that surround the use of brokerage commissions (which, of course, are fund assets) to finance distribution can harm funds and their shareholders. Directed brokerage practices potentially could compromise best execution of portfolio trades, increase portfolio turnover, conceal actual distribution costs and corrupt broker-dealers' recommendations to their customers. Therefore, the Commission has proposed to ban these types of arrangements.

Rule 12b-1: At the same time, the Commission voted to request comment on the need for additional changes to rule 12b-1. Over time, rule 12b-1 has come to be used in ways that exceed its original purpose. Consequently, the Commission is seeking comment on whether rule 12b-1 continues to serve the purpose for which it was intended and whether it should be repealed. To address concerns that rule 12b-1 fees have replaced sales loads in many cases, the Commission also requested comment on an alternative approach to rule 12b-1 that would require distribution-related costs to be deducted directly from shareholder accounts rather than from fund assets. Under this approach, a shareholder would pay the same sales load regardless of when the load is paid. An investor could pay the load at the time of purchase or over the period of the investment, with any remaining load paid upon redemption. This approach may have a number of advantages: first, actual sales charges would be clear to investors; second, existing shareholders would not pay for sales to new investors; and third, long-term shareholders would not pay 12b-1 fees that may exceed their fair share of distribution costs.

Soft Dollars: Chairman Donaldson has made the issue of soft dollars a priority and has directed the staff to explore the problems and conflicts inherent in soft dollar arrangements and the scope of the safe harbor contained in Section 28(e) of the Securities Exchange Act. The Divisions of Market Regulation and Investment Management are working together to conduct this review. A primary area of focus is whether the current definition of qualifying "research" under the safe harbor is too broad and should be narrowed by rulemaking. The Commission has also sought public comment on whether it would be possible to require mutual fund managers to identify the portion of commission costs that purchase research services from brokers so as to enhance the transparency of these arrangements.

D. Initiatives to Improve Fund Disclosure, Including Fee-Related Information

The Commission is quickly progressing on its continued effort to improve fund disclosures and highlight for investors fee-related information. This effort began long before mutual fund scandals hit the headlines, and Chairman Donaldson has identified improved disclosure as a priority for the Commission's mutual fund program.

Shareholder Reports Disclosure: The level of a fund's expenses, over time, has a significant impact on a fund shareholders' investment experience. The Commission has wrestled for years with the problem of how to convey expense information to investors in a cost-effective way that permits investors to compare funds and to understand and appreciate the effect that expenses have on their investment. Last month, the

Commission voted to significantly revise mutual fund shareholder report disclosures to assist investors in understanding these expenses. Shareholder reports will now be required to include dollar-based expense information for a hypothetical $1,000 investment. Using that information, investors can then estimate the dollar amount of expenses paid on their investment in a fund. Shareholder reports also will contain the dollar amount of expenses an investor would have paid on a $1,000 investment in the fund, using an assumed rate of return of five percent. Using this second dollar-based number, investors can compare the level of expenses across various potential fund investments. Increased transparency of fees should enhance fee-based competition in the fund industry.

This initiative also includes significantly improved disclosure to investors about a fund's investments. The recent amendments will replace a one-size-fits-all approach to portfolio holdings disclosure, where all funds deliver their full portfolio schedules to all their shareholders twice a year, with a layered approach that will make more information available, while permitting investors to tailor the amount of information they receive to meet their particular needs. The additional quarterly disclosure of fund portfolio holdings will enable interested investors, through more frequent access to portfolio information, to better monitor whether, and how, a fund is complying with its stated investment objective. The amendments also require shareholder reports to include tables, graphs, or charts that concisely, and in a user-friendly format, effectively convey key information about a fund's portfolio. Finally, management's discussion of fund performance is now required to appear in annual shareholders reports, and should assist investors in assessing the fund's performance over the prior year. This package of initiatives will provide better information to investors regarding fund costs, investments, and fund performance.

At the same time as it adopted these revisions, the Commission proposed to require disclosure in fund shareholder reports about how fund boards evaluate investment advisory contracts. A fund's board of directors plays a key role in negotiating and approving the terms of the advisory contract between the fund and the investment adviser who is charged with its management. The Commission is proposing to make this process more transparent to fund shareholders. The disclosure would include discussion of the material factors considered by the board and the conclusions with respect to those factors that formed the basis for the board's approval or renewal of the advisory contract. In making this proposal, the Commission is seeking to promote insightful disclosure of the board review process, rather than meaningless boilerplate that is not helpful to investors. Transparency of fees, informed investors and independent, vigorous boards of directors will allow the market to determine appropriate fee levels. This proposal should encourage fund boards to consider investment advisory contracts more carefully and encourage investors to consider more closely the costs and value of the services rendered by the fund's investment advisers.

Fund Advertising: In September, the Commission adopted amendments to raise the standards for mutual fund performance advertising. The amended rules require that fund advertisements state that investors should consider fees, as well as investment objective and risks, before investing and that advertisements direct investors to a fund's prospectus to obtain additional information about fees, investment objectives and risks.

The rules also require more balanced information when mutual funds advertise performance, as well as provide ready access to more timely performance information.

Mutual Fund Confirmation Form and Point of Sale Document: In a major proposal issued in January, the Commission proposed significant revisions to mutual fund confirmation forms and also proposed the first-ever point of sale disclosure document for brokers selling mutual fund shares. Together, these two proposals would greatly enhance the information that broker-dealers provide to their customers in connection with mutual fund transactions.

The proposals call for disclosure of targeted information, at the point of sale and in transaction confirmations, regarding the costs and conflicts of interest that arise from the distribution of mutual fund shares. The point of sale document would provide information to investors prior to transactions in mutual fund shares regarding the distribution-related costs that the customers would be expected to incur in connection with the transaction, including information regarding sales loads, asset-based sales charges and services fees paid out of fund assets, whether the broker-dealer receives revenue sharing payments or portfolio brokerage commissions from the fund complex, as well as whether it pays differential compensation in connection with different classes of shares or proprietary products. The new mutual fund confirmation form incorporates and quantifies these same disclosures. In an effort to ensure that these disclosure documents will be as meaningful as possible to investors, the Commission has directed the staff to gather information from investors – through educational summits, focus groups and other means – so that the Commission has meaningful input from the actual investors who will benefit from these disclosures.

Breakpoints Disclosure: In light of the wide-scale failure to provide appropriate breakpoint discounts on front-end load mutual fund purchases, the Commission in December proposed improved prospectus disclosure about fund breakpoints. This disclosure is designed to highlight for investors the availability of breakpoint discounts and implements recommendations made by a Joint NASD/Industry Taskforce that convened to study and make recommendations to improve the identification and processing of breakpoint opportunities for fund investors.

Transaction Costs Concept Release: Also in December, the Commission issued a concept release requesting comment on methods to calculate and improve the disclosure of funds' portfolio transaction costs. Transaction costs can represent a significant portion of the overall expenses incurred by a mutual fund. Although transaction costs are taken into account in computing a fund's total return, there is a concern that investors do not fully understand the impact of transaction costs on their fund investments because those transaction costs are not separately disclosed in a fund's expense table. However, there is no agreed-upon, uniform method for the calculation of fund transaction costs. Thus, the Commission issued its concept release to elicit helpful commentary to guide us as we pursue this issue.

Portfolio Managers: Finally, on March 11, the Commission is considering new proposals to improve disclosure to fund shareholders about their portfolio manager's relationship with the fund. These proposals include disclosure regarding the structure of portfolio manager compensation, ownership of shares of the funds that a manager advises, and comprehensive disclosure of specific investment vehicles, including hedge funds and pension funds, that are also managed by the mutual fund's portfolio manager.

This proposal will also require clear disclosure as to who is managing a fund, addressing the current requirement that allows advisers to use a portfolio management team to avoid identifying the principal managers of the fund.

III. Conclusion

As should be evident, the Commission has been extremely busy in proposing and adopting rules that are designed to protect our nation's mutual fund investors. Our focus has been directed not only on addressing the harms of late trading, abusive market-timing and related abuses, but also on strengthening the mutual fund oversight and regulatory framework to minimize the possibility that these and other potential abuses arise in the future and on taking steps to provide meaningful and useful disclosure to facilitate informed decision-making on the part of mutual fund investors. Again, I would like to thank you for the opportunity to be here today to discuss the Commission's recent regulatory actions to protect mutual fund investors. I would be pleased to answer any questions you may have.