Testimony Concerning Initiatives to Address Concerns in the Mutual Fund Industry

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Chairman Fitzgerald, Ranking Member Akaka and Members of the Subcommittee:

I. Introduction

On behalf of the Securities and Exchange Commission (the "SEC" or the "Commission"), I appreciate the opportunity to discuss possible regulatory responses to recent allegations of abusive practices in the mutual fund industry and initiatives to improve the regulatory framework governing mutual funds. With over 95 million Americans invested in mutual funds, representing approximately 54 million U.S. households, and a combined $7 trillion in assets, mutual funds are unquestionably one of the most important elements of our financial system.

The conduct alleged in the various cases brought by the Commission, as well as the New York Attorney General and the Secretary of the Commonwealth of Massachusetts represents reprehensible conduct that is in violation of the anti-fraud and other provisions of the securities laws, as well as of basic fiduciary principles. The Commission has put in motion an action plan to vigorously investigate those matters,

assess the scope of the problem and hold any wrongdoers accountable. My colleague Stephen Cutler, the Director of the Commission's Enforcement Division, will outline for you the steps the Commission has taken to address the alleged misconduct. While our enforcement efforts are a key tool in protecting the nation's investors, another critical component is a regulatory framework designed to prevent or minimize the possibility of these abuses from happening in the first place. At Chairman Donaldson's behest, the staff is progressing quickly to draft rules to directly address market timing and late trading abuses, as well as other issues raised in these cases, and is actively working on initiatives to strengthen the mutual fund regulatory framework.

II. Late Trading, Market Timing and Other Abusive Activity

On October 9, Chairman Donaldson outlined a regulatory agenda to confront late trading and market timing abuses to help restore investor confidence in the fairness of mutual fund operations and practices. The Commission is also addressing the practices of intermediaries that sell fund shares, as a number of the issues that the Commission is addressing in the mutual fund area flow in large measure from the intermediaries or middlemen who are in the chain of distribution for selling fund shares.

A. Late Trading

Before I discuss the regulatory reforms that the staff is preparing for Commission consideration with respect to late trading, I would like first to define it for you. "Late trading" refers to the practice of placing orders to buy or sell mutual fund shares *after* 4:00 p.m. east coast time, when most mutual funds calculate their net asset value

("NAV"), but receiving the price based on the prior NAV already determined at 4:00 p.m. Late trading also refers to the practice of placing conditional trades prior to 4:00 p.m. with the option of withdrawing or confirming the trades after 4:00 p.m.

Late trading enables the trader to profit from market events that occur after 4:00 p.m. but that are not reflected in that day's price. In particular, the late trader obtains an opportunity for a virtually risk-free profit when he learns of market moving information and is able to purchase mutual fund shares at prices set *before* the market moving information was released.

Current Commission rules prohibit late trading by requiring funds, their principal underwriters, dealers and others authorized to consummate transactions in fund shares to assign the next computed net asset value to any order to purchase or redeem a fund's shares, a process that is known as forward pricing. The forward pricing requirement is also typically reflected in dealer or selling agreements between funds and those who sell their shares.

Given the concern over recent allegations of late trading in fund shares, and circumvention of the forward pricing requirement by some intermediaries, Chairman Donaldson has requested that the staff prepare rulemaking recommendations to prevent or curb late trading abuses in the future. The Chairman requested that the staff submit these recommendations to the Commission this month. The staff diligently is working to meet the Chairman's timetable with the goal of recommending considered and comprehensive proposals designed to eliminate or significantly minimize the potential for

late trading abuses and assure fund investors that the value of their investments will not be diluted through this practice.

In preparing our rule proposals, the staff is examining the feasibility of requiring that a fund (or certain designated agents) – rather than an intermediary such as a broker-dealer or an unregulated third party – must receive a purchase or redemption order prior to the time the fund prices its shares for an investor to receive that day's price. For most funds, this approach would mean that the fund would have to receive the order by approximately 4:00 p.m., east coast time, for the investor to receive that day's price. A rule amendment along these lines could effectively eliminate the potential for late trading through intermediaries that sell fund shares and would put control of the process squarely on the fund, or its designee such as an affiliated transfer agent or principal underwriter. While this approach could minimize late trading opportunities, the staff is gathering information from a variety of mutual fund market participants to understand fully the ramifications, implications and feasibility of such a change.

The staff also is considering addressing late trading issues in connection with a recommendation that the Commission adopt its proposed compliance policies and procedures rule, which was proposed in February of this year. This rule, if adopted by the Commission, would require funds and investment advisers to (i) have comprehensive compliance policies and procedures in place reasonably designed to prevent violations of the federal securities laws, (ii) annually review those policies and procedures, and (iii) designate a chief compliance officer, accountable to the board of directors of the fund.

The staff is strongly considering recommending that the Commission also expressly indicate that funds should have procedures and controls in place to guard against the late trading of their shares. While these were the kinds of policies and procedures contemplated by the rule proposal, having an express obligation to have such policies and procedures could further prevent abuses in this area.

The rule is designed to ensure that funds and advisers have policies and procedures in place that will lessen the likelihood of securities law violations, detect any violations that do occur, and provide guidance on appropriate responses to such violations for fund officers. These rules would help protect investors by improving day-to-day compliance with the federal securities laws, they should also increase the efficiency and effectiveness of the Commission's mutual fund examination program which tests funds internal controls and procedures. The requirement to have a chief compliance officer reporting to the fund's board of directors should enhance the ability of fund directors to effectively monitor compliance of the funds and their service providers with the federal securities laws.

B. Market Timing

In addition to late trading concerns, recent events have also exposed abuses related to market timing, including the alleged overriding of stated market timing policies by fund executives to benefit large investors at the expense of small investors, or to benefit the fund's adviser. There also have been allegations of fund management personnel market timing funds that they manage or other funds in the fund complex.

Mutual funds that invest in overseas securities markets are particularly vulnerable to market timers who take advantage of time zone differences between the foreign markets on which international funds' portfolio securities trade and the U.S. markets which generally determine the time that NAV is calculated. Thus, market timers frequently purchase or redeem shares of mutual funds that invest internationally based on events occurring after foreign market closing prices are established, but before the funds' NAV calculation, typically at 4:00 p.m. Market timers generally then purchase or redeem the fund's shares the next day, for a quick profit at the expense of long-term fund shareholders. Funds that invest in small cap securities and other types of specialty investments, including high yield funds, also can be the targets of market timers.

Although market timing itself is not illegal, mutual fund advisers have an obligation to ensure that mutual fund shareholders are treated fairly and that one group of shareholders (*i.e.*, market timers) is not favored over another group of shareholders (*i.e.*, long term investors). In addition, when a fund states in its prospectus that it will act to curb market timing, it cannot knowingly permit such activities.

The staff has been working with the mutual fund industry to address the negative impact of market timing on long-term shareholders. Last year, the staff issued an interpretive letter permitting funds to provide for delayed exchanges of shares from one fund to another in order to combat market timing.[1] Permitting delayed exchanges can deter market timing, since market timers seek to effect transactions on a specific day to take advantage of perceived market conditions. In addition, in a letter issued in 2001, the

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[1] See Letter to the Investment Company Institute (pub. avail. Nov. 13, 2002).

staff clarified funds' obligations to fair value their portfolio securities, including international securities, if a significant event occurs between the time that a security's closing price on an exchange is established and the time that the fund calculates its NAV.[2] Fair valuation addresses the problem of a portfolio security's market closing price not accurately reflecting its value because of a significant intervening event.

Again, Chairman Donaldson has instructed the staff to submit its recommendations related to market timing to the Commission this month. In particular, Chairman Donaldson requested that the staff prepare recommendations to require explicit disclosure in fund offering documents of market timing policies and procedures. Many funds currently disclose their policies on these matters but such disclosure is not mandatory. The disclosure requested by Chairman Donaldson would enable investors to assess a fund's market timing practices and determine if they are in line with the investors' expectations. The disclosure requirement would permit flexibility among funds to adopt policies and procedures that are best suited to the funds' investments and the needs of its investors. For example, some funds welcome market timers, and other funds such as money market funds cannot be timed because of their stable net asset value. These funds would not be required to adopt policies to prevent market timing, but instead would be required to disclose their open policy with respect to these practices, if relevant.

The rule recommendations requested by Chairman Donaldson would have a further component of requiring funds to have procedures to comply with their

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[2] See Letter to Craig S. Tyle, General Counsel, Investment Company Institute, (pub. avail. April 30, 2001).

representations regarding market timing policies and procedures. 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. 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 market timing activity.

Allegations of portfolio managers market timing the funds they manage or other funds in the fund complex, raise issues regarding insider trading, as well as the need for, and adherence by fund personnel to, policies and procedures to prevent the misuse of material, non-public information. We expect that the issue will also be addressed in the rulemaking recommendations to be submitted to the Commission later this month.

Chairman Donaldson also indicated that, in addition to promoting new rules to address market timing – including the adoption of the compliance policies and procedures rule, the Commission should emphasize the obligation of funds to fair value their securities to minimize market timing arbitrage opportunities. As I stated earlier, in 2001 the staff reminded the fund industry of funds' obligation to fair value their holdings under certain circumstances. In making this reminder, the staff cited Commission precedent. However, recent events warrant a reiteration of the Commission's views regarding fair value pricing.

Finally, Chairman Donaldson also stated that, in connection with its rulemaking initiatives, the Commission should reinforce the obligation of fund directors to consider the adequacy and effectiveness of mutual fund market timing practices and procedures. As with other fund policies, directors should assess the effectiveness, and oversee the implementation, of fund policies related to market timing.

C. Selective Disclosure

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. Consequently, Chairman Donaldson has asked the staff to consider whether additional requirements are necessary to reinforce funds' and advisers' obligations to prevent the misuse of material, non-public information, including selective disclosure of portfolio holdings information.

D. Other Possible Actions

Chairman Donaldson has also asked the staff to consider whether funds should have additional tools available to thwart market timing activity. These include: (1) requiring funds to impose redemption fees on market timers; (2) allowing redemption fees of higher than 2 per cent; (3) expanding options to delay exchanges; and (4) allowing funds to retain gains from short-term trading activity. Moreover, the Chairman has asked whether additional requirements are necessary to reinforce funds' and advisers'

obligations to comply with their fiduciary obligations. We will carefully consider any regulatory recommendations from the Investment Company Institute's task force on abusive short-term trading of fund shares, as well as those from the task force on late trading activity. Chairman Donaldson has emphasized that he will not hesitate to call for other regulatory measures if we discover additional information in the course of our investigation that merits regulatory action. The Commission is committed to moving swiftly and aggressively to take all necessary steps to protect mutual fund investors from abusive and harmful activity.

III. Other Commission Initiatives

Our highest regulatory priority at this time is to address abusive activity in the mutual fund industry. The staff and Commission have also been working on other initiatives designed to assist mutual fund investors in making the best investment decisions for themselves and to bolster confidence in mutual funds. These initiatives seek to improve disclosure to fund investors, as well as improve fund governance and shareholder participation in the governance of funds.

A. Fund Advertising

In September, the Commission adopted rule amendments to modernize mutual fund advertising requirements to encourage more responsible advertising. The new amendments, which go into effect on November 15, 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. The Commission also placed a "cost calculator" on the SEC website that allows investors to compute the impact of fees and expenses of various funds on their performance and facilitates comparison of funds.

B. Fund of Funds

The Commission also in September 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.

C. 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.

D. Breakpoint Disclosure

The staff anticipates making recommendations to the Commission that would 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.[3]

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. Chairman Donaldson has 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. The SEC and the NASD also will continue to investigate, and where warranted, will bring enforcement actions in this area.

E. Shareholder Report Disclosure of Operating Expenses

The Commission also has 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

[3] Report of the Joint NASD/Industry Task Force on Breakpoints, July 2003.

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.

F. Highlighting Broker Incentives and Conflicts of Interest

Another area that the staff is examining is how to increase investor understanding of the incentives and conflicts that broker-dealers have in offering mutual fund shares to investors. Initiatives the staff is considering in this area include a comprehensive revision of mutual fund confirmation form requirements. A revised confirmation could include information about revenue sharing arrangements, incentives for selling proprietary funds and other inducements for brokers to sell fund shares that may not be immediately transparent to fund investors.

G. Fund Governance

The Commission is engaged in efforts to enhance the independence and effectiveness of independent directors of mutual funds. Mutual funds are governed by a board of directors that typically consists of a majority of independent directors. Because independent directors of funds must play a critical role in overseeing the funds' operations and fund shareholders rely on independent directors to protect their interests, it is imperative that funds, like public corporations, have mechanisms in place that provide

independent directors with sufficient disclosure of important information, particularly with respect to conflicts of interest. If adopted, we believe that the Commission's rule proposal requiring funds to have chief compliance officers and requiring that these officers report directly to fund boards, including the independent directors, will help to facilitate this upward flow of information. We note that the audit committee listing standards of the Sarbanes-Oxley Act already require, among other things, that listed companies, including exchange-traded funds, establish compliance procedures. The staff endorses the provisions of HR 2420 that would extend the audit committee listing rule requirements to mutual funds.

In the past year, as outlined below, the Commission has adopted other rules that we believe enhance fund governance, including the effectiveness of independent directors.

1. ***Sarbanes-Oxley Requirements.*** Mutual funds are subject to the corporate governance requirements of the Sarbanes-Oxley Act. In each rule that the Commission has proposed or adopted under the Act, it 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.

2. ***Director Nomination Rules.*** The Commission has included mutual funds in initiatives to increase shareholder participation in the director nomination process. In August, the Commission 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, and would implement the first part of the recommendations of a Commission Staff Report issued on July 15, 2003, regarding improvements to the proxy process.[4] 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.

To implement the second part of the staff's proxy nomination recommendations, the Commission, last month, proposed rule amendments to permit shareholders of both funds and operating companies greater access to proxy materials for the purpose of nominating directors. The proposed rules represent an effort by the Commission to strengthen the proxy process, for fund shareholders' direct benefit, while at the same time carefully balancing concerns about fund operations and fund governance requirements.

Under the proposal, funds would be required to include in their proxy materials the names and certain other information regarding shareholder nominees for fund directorships, where there are particular indications that long-term shareholders (*i.e.*, those who have been invested in a fund continuously for at least three years), with significant investments in the fund, need enhanced access to further an effective proxy process. Any nominating shareholder or group of shareholders would be required to

[4] Review of the Proxy Process Regarding the Nomination and Election of Directors (July 15, 2003).

represent that its nominee to a fund board is “independent,” or not an “interested person” as defined in the Investment Company Act. The proposed rules would also enable fund shareholders to engage in limited solicitations to form nominating shareholder groups and engage in solicitations in support of their nominees without disseminating a proxy statement. Comments on the Commission’s proposal are due December 22nd, and we will review those comments with an eye toward ensuring that fund investors have appropriate opportunities to nominate their representatives to fund boards.

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In conclusion, I would like to reiterate that the protection of our nation’s millions of mutual fund investors is of paramount importance to the Commission and the staff. I can assure you that it is of the utmost importance to the Commission to deal immediately with the reprehensible abuses that have taken place, and we are committed to rooting out the problems, punishing the perpetrators, and putting the proper rules in place so that these abuses do not happen in the future. Again, I appreciate the opportunity to be here today and I would be happy to answer any questions that you may have.