TESTIMONY CONCERNING INVESTOR PROTECTION ISSUES REGARDING THE REGULATION OF THE MUTUAL FUND INDUSTRY

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

Thank you for inviting me to testify today at your 10th hearing on mutual fund issues since late trading and market timing abuses came to light last fall. The breadth of your hearings have clearly and effectively illustrated the complexity of the issues the Commission is facing in addressing problems in the mutual fund industry. The hours upon hours that you and the Committee have spent performing critical oversight, and the testimony from witnesses representing all sectors and aspects of the problem, have been immensely valuable as the Commission works to tackle these issues. I thank you and I commend you for your thorough and thoughtful approach.

Like you, I am outraged by the conduct that has come to light in the recent mutual fund scandals. In large part, I believe that the industry lost sight of certain principles – in particular its responsibility to millions of investors who entrusted their life's savings in this industry for safekeeping. As I said last fall when I testified before you, and I believe it bears repeating, these mutual fund investors are entitled to honest and industrious fiduciaries who sensibly put their money to work for them in our capital markets. Investors deserve a brokerage and mutual fund industry built on fundamentally fair and ethical legal principles. This has been the

Commission's urgent and guiding mission as it pursues an aggressive mutual fund reform program to identify and address a range of problems in the industry. The Commission has made significant progress, and will continue to move aggressively to track down and pursue wrongdoers, while expeditiously considering and adopting the outstanding mutual fund rule proposals.

As you have seen through your hearings, and we have witnessed through our rulemaking process, there is a wide variety of views among knowledgeable experts as how best to address mutual fund oversight – views that often conflict with one another, particularly among competitors. That is why our notice and comment process, which Congress so wisely required in Commission rulemakings, is of infinite value to us and to the final product. In a deliberate, structured format, we benefit from a wide spectrum of views and opinions as to how to strengthen our proposed rules and regulations, the practicalities of implementing those rules and regulations, and alternative approaches to address the underlying goals of our proposals.

As you requested, I will address the Commission's recent initiatives to respond to the specific problems of late trading, market timing and selective disclosure abuses. I will also address what the Commission has done and is continuing to do to strengthen the mutual fund regulatory framework overall, as we work to prevent any future breakdowns in the industry.

With more than 91 million Americans invested in mutual funds, representing almost half of all U.S. households, and a combined $7.5 trillion in assets, mutual funds are unquestionably one of the most important elements of our financial system. Investor protection is a top priority at the Commission. We are focusing our attention on pursuing an aggressive program to identify and address a range of problems and challenges in the mutual fund industry – challenges such as strengthening the governance structure of mutual funds, addressing conflicts of interests, enhancing disclosure to mutual fund shareholders and fostering an atmosphere of high ethical standards and compliance within the industry.

Appropriately, the Commission and its staff have been extraordinarily busy addressing challenges with particular focus on addressing the specific problems of late trading, market timing and selective disclosure abuses. In my testimony, I will outline: (1) our aggressive rulemaking agenda – which has immediately tackled late trading and market timing abuses; and our extended efforts to address broader structural problems in the mutual fund regulatory framework; (2) our vigorous inspection and enforcement efforts; and (3) the restructuring of the Commission's overall internal functions and operations to better assess and anticipate risk, particularly vis-a-vis the mutual fund industry.

<u>The Commission's Rulemaking Initiatives</u>

Last month, as part of your hearing series, Paul Roye, the Director of the Commission's Division of Investment Management, testified regarding the aggressive regulatory agenda the Commission has undertaken to combat late trading, market timing and related abuses. In addition, he outlined the aggressive overall regulatory agenda to:
(1) improve the oversight of funds by enhancing fund governance, ethical standards, and compliance and internal controls; (2) address or eliminate certain conflicts of interest in the industry that are potentially harmful to fund investors; and (3) improve disclosure to fund investors, especially fee-related disclosure. In each of these areas the Commission has moved swiftly to propose rules and to vet them through our notice and comment process and, in many instances, through meetings with relevant interested parties. We also are moving promptly to craft final rules but, because of the complexity associated with some of our proposals – such as

our proposal on late trading – we may take additional time before finalizing our proposed rules. More important than acting quickly is making sure we get it right. Let me briefly describe our proposals in each of these areas.

Late Trading & Market Timing

Investors rightfully assume that mutual fund managers and fund directors put the investors' interest first. When the late trading and market timing abuses came to light, it was clear that many of these investors had been let down, as some of those charged with protecting investors had willfully disregarded their responsibilities to act for the benefit of their investors. To put an absolute halt on late trading, the Commission proposed the "hard 4:00" rule. This rule amendment would provide for a secure pricing system that would be largely immune to manipulation by late traders by requiring that orders be placed with the fund or its primary transfer agent or clearing firm by the time set by the funds.

Typically, funds price their shares at 4:00 p.m. Eastern Standard Time. 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. If an investor can place an order to buy or sell fund shares after 4:00 p.m., but still receive the price set at 4:00 p.m., that investor can profit from new information in the market place at the expense of other fund shareholders. Under the current system, various intermediaries, including some pension plan record-keepers – some of whom are not registered with the Commission - can receive the orders by 4:00 p.m. We know that the current system has failed because intermediaries allowed certain, select shareholders to receive the 4:00 p.m. price, even though their orders were placed after 4:00 p.m.; consequently, we needed to devise a new system to minimize the possibility of this abuse in the future.

To date, the Commission has received more than 1,000 comment letters on this proposal, many raising concerns about how the proposal might adversely impact certain fund investors such as 401(k) plan participants and investors in earlier time zones across the country. As an alternative to the proposal, some have advocated a system of controls that would better prevent and detect late trading; others have recommended the use of more sophisticated technology to create tamper-proof time stamping of trade tickets that would help eliminate, or at least better detect, late trading. The staff is analyzing this information to determine whether there is an effective alternative to the hard 4:00 rule proposal that would not disadvantage certain investors and would not distort competition in the marketplace. It may very well turn out that we adopt a combination of some of the alternatives that have been presented to us during the notice and comment process. Again, the hard 4:00 rule proposal illustrates the effectiveness of the Commission's rulemaking process, whereby we, and indeed the investing public, are the beneficiaries of a wide range of views and perspectives, and possible solutions.

To address market timing, especially so-called "arbitrage market timing," the Commission has stressed that "fair value pricing" is critical to reducing effectively or eliminating the profit that many market timers seek and the dilution of shareholder interests. However, because fair value pricing can be subjective, the Commission also intends to continue to monitor funds' fair value pricing practices and has proposed improved fair value pricing disclosure; enhanced disclosure regarding a fund's anti-market timing policies and practices; and, to reduce the possibility of abusive market timing, that funds impose a mandatory two percent redemption fee when investors redeem their shares within five days of purchase. If the Commission moves forward with adopting the mandatory redemption fee proposal, I feel that it must contain exceptions – for example, exceptions for individual investors who have suffered an unforeseen hardship and for money market funds and funds that specifically cater to market timers. Along with the mandatory redemption fee, the Commission also proposed a process that, for the first time, would give mutual funds a weekly pass-through of buyer and seller information from intermediaries. That process, which is often lost in discussion, is a critical piece of the proposal that would allow funds to identify market timers and apply the funds' anti-market timing procedures.

Fund Governance, Ethical Standards, and Compliance

In an effort to enhance oversight of the industry, the Commission proposed a comprehensive rulemaking package to bolster the effectiveness of independent directors and solidify the role of the fund board as the primary advocate for fund shareholders. The proposal would enhance the independence of fund boards by including a requirement for an independent board chairman and a board comprised of 75 percent independent directors. Board and chairman independence is just part of what we are considering to restore overall accountability to the fund board.

In an effort to reinforce the fundamental importance of integrity in the investment management industry, the Commission recently proposed that all registered investment advisers adopt codes of ethics. 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 personnel comply with federal securities laws and report their securities transactions.

In the area of improving compliance and the oversight of fund boards, the Commission, in December, adopted a rule requiring that funds and their investment advisers have comprehensive compliance policies and procedures in place, including appointing a designated chief compliance officer. In the case of a fund, the chief compliance officer would be answerable to the fund's board and could be terminated only with the board's consent. This rule will have a far-reaching, positive impact on mutual fund operations and compliance programs by ensuring that funds have a primary architect and enforcer of compliance policies and procedures for the fund and, perhaps more importantly, a compliance officer who can be the eyes and ears of the board of directors. This requirement will provide fund boards with a powerful tool to identify and prevent misconduct that could potentially harm funds and their shareholders. Funds must begin compliance with this final rule by October of this year.

Conflicts of Interest

In addition to taking steps to enhance mutual fund oversight and ethical standards, the Commission has also undertaken a series of initiatives aimed at certain conflicts of interest that exist now between mutual funds and those who distribute fund shares. For example, 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. This would eliminate a practice that potentially compromises best execution of a fund's portfolio trades, increases portfolio turnover and corrupts broker-dealers' recommendations to their customers.

At the same time, the Commission sought comments as to whether other changes should be made to rule 12b-1 or even if it should propose to abolish the rule altogether. For instance, should we continue to permit 12b-1 fees to be used in lieu of a front-end sales load? Should distribution costs be taken directly out of a shareholder's account rather than out of fund assets, so that each shareholder pays his or her own distribution related costs? Should long-term shareholders even be bearing distribution costs? We are anxious to review the comments we receive on these questions as we move forward in our reconsideration of rule 12b-1.

The Commission also has proposed improved disclosure regarding a portfolio manager's relationship with the fund. The proposals include disclosure regarding the persons managing the fund, 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 a fund's portfolio manager.

Disclosure to Fund Investors

Improved disclosure – particularly disclosure about fund fees, conflicts and sales incentives – had been a stated priority for the Commission's mutual fund program in the months before the trading abuses came to light. Consequently, the Commission took steps to significantly improve the information required for individual shareholders. First, the Commission adopted a requirement that shareholder reports include dollar-based expense information so that investors can easily compute the dollar amount of expenses paid on their investment in a fund. This is an important step in providing shareholders with critical information about their mutual fund investments. Some have questioned whether we should have required more information – that is individualized account information to each shareholder. While the staff and the Commission considered this alternative, we were convinced that the dollar-based expense information that the Commission ultimately adopted was the better course, as it allowed for comparability. We have ongoing efforts to continue examining the entire mutual fund disclosure regime to see if it is as good as it can be; however, with respect to this particular rule – which will go into effect in July – I firmly believe we must give the rule a good chance to operate before we contemplate changing it.

In other efforts to improve disclosure for investors, the Commission has

- issued a concept release on methods to calculate and improve the disclosure of funds' portfolio transaction costs;
- proposed to make more transparent in shareholder reports how fund boards evaluate investment advisory contracts;
- proposed new fund confirmation forms and new point-of-sale disclosure that would greatly enhance the information that broker-dealers provide their customers in connection with mutual fund transactions, and highlight the conflicts that broker-dealers face in recommending mutual fund investments; and
- proposed improved prospectus disclosure to address the wide-scale failure on the part of broker-dealers to provide appropriate breakpoint discounts on front-end load mutual fund purchases.

While neither I nor my fellow Commissioners have finalized our positions regarding each of these rule proposals, we all agree that the areas they address are of critical importance to the protection of mutual fund investors. The staff is reviewing and analyzing the comments received on these various rule proposals in order to finalize its recommendations for the Commission's consideration in adopting the rules. We have received comment letters from fund shareholders, Senators, Congressmen, fund complexes, directors, officers, and broker-dealers to name just a few. While not all commenters have agreed with the staff's proposals, just as the Commissioners do not always agree with one another, a healthy, intellectual, reasoned debate will better inform the staff and improve the final product as we move toward final adoption of these rules.

And, just as we embarked on an aggressive agenda to propose these rules, we will be just as aggressive in our agenda for considering the final rules. This spring and summer, the Commission will be considering all of these outstanding mutual fund rulemaking proposals: market timing disclosure, breakpoint disclosure, the fund governance package, the investment advisers code of ethics rule, disclosure regarding the factors considered by the fund's board in approving the advisory contract, the proposed amendments to rule 12b-1, the hard 4:00 close, portfolio manager disclosure, the mandatory two percent redemption fee and flow through of information between funds and intermediaries, and new confirmation form and point of sale disclosure. However, while it is important that we consider adoption of these rules in an expeditious manner, it is equally important that we give interested parties an opportunity to comment and our staff sufficient time to consider fully possible unintended consequences and vet alternative approaches to our proposals so that we adopt the final rules that best address the problems we seek to solve.

Inspections and Enforcement Efforts

Complementing our regulatory reforms are vigorous inspection and enforcement programs for detecting wrongdoing and enforcing the federal securities laws. As I have mentioned before, the mutual fund abuses that we have witnessed represent a fundamental betrayal of American investors, and the Commission has punished, and will continue to punish, the malefactors swiftly and with every tool available to us. The detection and enforcement piece of the Commission's agenda relating to mutual funds currently is focused primarily on four types of misconduct, each of which may show that the interests of financial services firms or their employees were being placed above the interests of investors.

The first area of priority is late trading and abusive timing of mutual fund shares. Since the disclosure of these practices last September, the Commission has conducted a broad investigation and has brought numerous enforcement actions charging hedge fund managers, broker-dealers, investment advisers, and their associated persons with engaging in such abuses to the detriment of fund investors. While our examinations and investigations are ongoing, the enforcement actions we have brought thus far have involved some of the most well-known names in the mutual fund industry, including Putnam Investments, Invesco Funds Group, Alliance Capital Management, Massachusetts Financial Services, FleetBoston Financial, and Bank of America. The settlements obtained by the Commission in several of these cases have resulted in significant corporate governance and compliance improvements, as well as substantial payments that will be used to compensate harmed investors.

Among these recent settlements was the Commission's order against Massachusetts Financial Services, Inc. ("MFS"). On February 5, 2004, the Commission filed a settled enforcement action against MFS, its chief executive officer, and its president and chief equity officer, for violating the federal securities laws by allowing widespread market timing trading in certain MFS mutual funds in contravention of those funds' public disclosures. The Commission censured MFS and ordered it to pay $225 million, consisting of $175 million in disgorgement and $50 million in penalties. The Commission's Order further requires MFS to undertake certain compliance and mutual fund governance reforms designed to enhance the independence of mutual fund boards of trustees and strengthen oversight of MFS's compliance with the federal securities laws.

For their roles in the misconduct, the Commission prohibited MFS's CEO and president from serving as an officer or director of any investment adviser and from serving as an employee, officer, or trustee of any registered investment company for three years. In addition, the Commission's order places certain restrictions on the duties the CEO and president can perform during that period. The Commission also suspended both the CEO and president from association with any investment adviser or registered investment company for nine months and six months, respectively, and ordered each to pay a penalty of $250,000 and disgorge over $50,000 in ill-gotten gains derived from MFS's market timing practices. All of the money paid by MFS, its CEO and its president will be distributed to harmed shareholders.

Our second area of examination and enforcement priority focuses on mutual fund sales practices, including fee disclosure issues in connection with the sale of mutual funds. In particular, we are looking at what prospective mutual fund investors are – or are not – being told about revenue sharing arrangements and other incentives provided by mutual fund companies to broker-dealers selling their funds. Customers have a right to know how their broker-dealer is being paid to sell a particular fund. And when these payments are being made from fund assets, customers should understand that their own investment dollars are being used to foot the bill for the mutual funds' premium "shelf space" at the selling broker's office. Such fees may increase costs to investors as well as create conflicts of interest between investors and the financial professionals with whom they deal. The Commission brought the first case targeting these undisclosed payments in November 2003 against Morgan Stanley. In settling the matter, Morgan Stanley agreed to pay $50 million in disgorgement and penalties. We are continuing to examine and investigate industry participants for similar practices. The potential disclosure failures and breaches of trust spotlighted in the Morgan Stanley case are not necessarily limited to Morgan Stanley, or even to broker-dealers.

The Enforcement staff is also looking very closely at the role and responsibilities of mutual fund companies themselves in these arrangements. In fact, last week, the Commission filed a settled action against MFS related to the company's use of mutual fund assets – namely, brokerage commissions on mutual fund transactions –to pay for the marketing and distribution of mutual funds in the MFS Fund Complex (MFS Funds). The Commission issued an order that found MFS failed to adequately disclose to the Boards of Trustees and to shareholders of the MFS Funds the specifics of its "shelf-space" arrangements with brokerage firms and the conflicts created by those arrangements. As part of the settlement, MFS agreed to a series of compliance reforms and to pay a penalty of $50 million, which will be distributed to the MFS Funds. In addition, as I previously stated, the Commission has proposed to ban the use of brokerage commissions to compensate broker-dealers for the distribution of fund shares.

Our third area of priority in the mutual fund examination and enforcement arena is the sale of different classes of mutual fund shares. Many mutual funds offer multiple classes of shares in a single portfolio. For each class of shares, a mutual fund uses a different method to calculate and collect distribution costs from investors. Class A fund shares are subject to an initial sales charge ("front-end load"); discounts on front-end loads are available for large purchases of Class A shares. Since the sales fee is paid up front, Class A shares incur lower (or no) "rule 12b-1 fees," fees the mutual fund pays for distribution costs, including payments to the broker-dealers and their registered representatives selling fund shares.

Last July, the Commission brought an action against Prudential Securities for abuses in this area. In that case, the Commission found that Prudential's supervisory system for overseeing practices in this area was inadequate. Prudential had in place policies and procedures requiring registered representatives to advise their clients of the availability of different classes of mutual funds and fully explain the terms of each. Prudential branch managers were also expected to approve all purchases greater than $100,000 and confirm the suitability of the choice of fund class. The Commission found, however, that Prudential failed to adopt a sufficient supervisory system to enable those above the branch manager to determine whether these policies and procedures were being followed. In resolving the Commission's action, Prudential was censured and agreed to pay disgorgement and a civil penalty. The Commission's action against the registered representative and branch manager, which charges them with fraud, is pending.

The fourth examination and enforcement priority area with respect to mutual funds is to address the failure of firms to give their customers the discounts available on front-end loads for large purchases of Class A shares. Last year, examiners at the SEC, NASD, and NYSE completed an examination sweep and outlined the results in a public report. This sweep culminated in the filing, on February 12, 2004, of enforcement and disciplinary actions against a total of 15 firms for failure to deliver mutual fund breakpoint discounts during 2001 and 2002. The 15 firms agreed to compensate customers for the overcharges, pay fines in an amount equal to their projected overcharges that total over $21.5 million, and undertake other corrective measures. The NASD has ordered all firms to repay their customers any amounts overcharged.

While these are areas of focus in the mutual fund arena, the Examination staff, in coordination with the Enforcement staff, are continually on the look out for additional mutual fund practices that may be vulnerable to or ripe for abuse. Accordingly, the staff is closely examining, among other things, the status of funds closed to new investors that nevertheless continue to charge rule 12b-1 fees, the portfolio pricing practices of high yield bond funds, the role of pension consultants in pension plans' selection of particular money managers, the use of "fair value" pricing, the use of affiliated service providers, and the fees charged by certain index funds. And in all of the foregoing areas, the Commission is intently focused on the roles and conduct of mutual fund directors. Have they adequately discharged their responsibilities? Have they properly overseen the mutual fund management company on behalf of mutual fund shareholders?

<u>Internal Restructuring</u>

The third key element in enhancing the protection of our nation's mutual fund investors – indeed of enhancing the protection of all of our nation's investors – is the internal restructuring of the Commission's management and functions. One of my primary goals since coming to the Commission has been to help restore the Commission's credibility as the investors' watchdog. This, of course, means reforming how the Commission operates. I'll briefly summarize these reforms for you.

Last year, following a thorough internal review of how the agency deals with risk, we initiated a new risk management program and laid the groundwork for the Office of Risk Assessment and Strategic Planning, the first of its kind at the Commission. The first phase has been to organize internal risk teams for each major program area. This framework has already been put into place and allows for a bottom up approach to assessing risk. A good example of this is through our Office of Compliance Inspections and Examinations. We have empowered our examiners, through OCIE's internal risk management team, to look at potential problems in the mutual fund and broker dealer industries and to examine formally for these potential problem areas.

The new Office of Risk Assessment will work in coordination with the internal risk teams and will push the agency to identify proactively potential problem areas within the mutual fund and broker-dealer industries, focusing on early identification of new or resurgent forms of fraudulent, illegal, or questionable activities. In addition to fostering better communication and coordination between Divisions and Offices within the Commission, the risk assessment initiative will help to ensure a process whereby senior managers at the Commission have the information necessary to make better, more informed decisions and to adjust operations and resources to address these new challenges.

We also have greatly enhanced our examination program, as our Director of the Office of Compliance, Inspections and Examinations, Lori Richards, shared with you a few weeks ago. In 2003, budget increases allowed us to increase our staff for fund examinations by a third, to approximately 500 staff. These new resources, coupled with the Office's new risk-based examinations approach, should greatly improve our ability to detect abusive behavior and possible violations of the law.

In addition to the overarching risk assessment effort has been the creation of a number of multi-divisional task forces designed to bring together staff from various divisions and offices to brainstorm, evaluate and create strategies to proactively undertake issues of potential concern in protecting the nation's securities markets.

Four of these task forces will tackle issues that will help us better protect mutual fund investors and monitor the mutual fund industry. They are the Chairman's Task Forces on: Soft Dollar Arrangements; College Savings Plans (or 529 plans); Enhanced Mutual Fund Surveillance; and Disclosure Regime. The Task Forces will meet with the relevant interested parties – such as individual investors, industry representatives, fellow regulators and others – to gather critical intelligence and data, and ultimately work toward addressing problem areas.

Let me start with the Task Force on Soft Dollars, because I know this issue is of particular concern to some of you on the Committee, and I want to assure you that it is also a very high priority for the Commission in the context of our mutual fund reforms.

The Task Force on Soft Dollars, comprised of SEC staff from five divisions and offices, has already met with a number of industry representatives as it tackles this complicated issue. Its goal is to fully understand all aspects of how soft dollars are used, and the pros and cons of various alternative reform approaches, including possible unintended consequences. While I would like to have those recommendations as soon as possible, I also want to ensure that the Task Force has adequate time to fully consider the issue and the benefit of meeting with interested persons so that it can come to us with the best and most informed recommendations possible.

Like so many of the issues we're facing, the area of soft dollars is complex, and we must be cautious as we move forward with reforms in this area. I believe that at the very least, the Commission, through the rule-making process, should consider narrowing the definition of qualifying "research" under the safe harbor so that only "real" research that has valid, intellectual content, qualifies. I would also expect the Task Force to consider whether the costs of research and execution should be quantified and other ways in which the costs of research could be made more transparent. Some have advocated a distinction between third-party research and proprietary research. My view is that we should not draw such distinctions, but the Task Force will also consider this issue and provide recommendations. As you are aware, the Securities Exchange Act contains a statutory safe harbor, Section 28(e) of the Exchange Act, which protects use of soft dollars. So, the Task Force will also consider whether Section 28(e) of the Exchange Act should be repealed. While I have not yet reached that conclusion, if the Task Force and the Commission ultimately arrive at that conclusion, I will not hesitate to seek Congress' assistance in that endeavor.

Because there are growing concerns with disclosure and transparency with respect to 529 tuition savings plans, or college savings plans, we have established a task force on college savings plans. This task force is charged with examining the issue of college savings plans, including a focus on the structure and sale of college savings plans and disclosures to plan participants, particularly with respect to fees and expenses. More specifically, I have asked the Task Force to review disclosure and transparency for investors in these plans, the extent of the Commission's oversight of these plans and whether the costs and fees associated with these plans outweigh the tax advantages of these plans for families saving for their children's educations.

Another critical area where the Commission will be more proactive is mutual fund surveillance. In this vein, we have formed a Task Force on Self-Reporting Regimes for Mutual Funds to look at both the frequency of reports made by mutual funds to the Commission and the categories of information to be reported. Further, this Task Force will examine how new technologies can best be used to enhance our oversight responsibilities. The Task Force will draw on the expertise of our fellow regulators at the NYSE, NASD, and NASAA, as well as others knowledgeable in the area of surveillance and reporting.

Another critical area for Commission review is our disclosure regime. Because the federal securities laws are largely disclosure based, investors receive a large volume of disclosure documents, especially when they invest in a mutual fund. The Task Force on Disclosure will examine the value of the various disclosures provided by mutual funds, brokers and issuers to investors as required by our rules and regulations. The Task Force will also explore what types of disclosures best serve investors, the timing of the disclosures, delivery versus access to the disclosures and how best to harness technological advances in assisting investors. In addition, the Task Force will analyze whether there is data that the Commission should collect and publish on a periodic basis that would be useful to investors in making comparisons among the various investment options available to them. This Task Force will reach out to investors to help guide it through the important task of ensuring that investors are receiving the proper mix of disclosure in a format that is meaningful to them.

Hedge Funds

Before closing, I would note that hedge funds have played significant roles in some of the most notorious mutual fund scandals that have come to light recently – the Bank of America/Canary Hedge Fund case is one example. So I would like to summarize my personal concerns related to hedge funds, with the caveat that my views on hedge funds are my own and do not reflect the views of the entire Commission.

The issues surrounding hedge funds are an excellent example of how the Commission can be proactive and work to enhance enforcement in problem areas before they spread. The Commission is responsible for enforcing the federal securities laws, policing the securities markets, and ensuring fraud prevention and detection. This is the Commission's responsibility regardless of whether we are talking about mutual funds, self regulatory organizations, public companies, hedge funds, or other market participants. Hedge funds have become one of the fastest growing segments of the investment management business – with assets fast approaching $1 trillion – at a time when returns on other investments have not kept the same pace.

Other government entities – primarily the Federal Reserve Board and the Treasury – are responsible for monitoring potential systemic risks, and the safety and soundness issues raised by the structure of these vehicles. While their oversight priorities are of great import to our banking system, these agencies are not responsible for enforcing the federal securities laws and protecting investors. The data they collect is aimed at the discharge of their prudential responsibilities. Any regulatory action the Commission ultimately takes will focus on the protection of investors, rather than safety and soundness issues.

I would also like to address the need for protecting investors in the hedge fund context. One of the points I often hear about not regulating hedge funds is that hedge fund investors are wealthy and sophisticated individuals who do not need protecting. This is not the point. Hedge fund managers are, directly and indirectly, providing advisory services for many U.S. investors – with a significant impact not only on those investors, but on the operation of the U.S. securities markets. The Commission is the only government agency that is charged with protecting those investors and policing those markets. Further, hedge funds are being purchased by intermediaries on behalf of millions of ultimate smaller investor beneficiaries – retirees, pensioners, and others not generally thought of as the traditional hedge fund investor – through their pension plans or funds of hedge funds, again making it critical for investors that the Commission have basic information and a resulting insight as to how many hedge fund managers are deploying assets under management; how they handle conflicts of interest, how they account for results and value their investments, and most importantly, what impact their market activities have on the other participants in our equity markets.

Moreover, hedge funds often promise performance in all types of market conditions, and typically include hefty performance fees for their managers. This combination can motivate unscrupulous hedge fund managers to attempt behavior or conduct that circumvents or crosses the legal boundaries of the securities laws.

As we move forward to debate this issue, there are a few questions that I think we need to consider: How are hedge fund managers pricing the securities in their portfolios? What practices are in place regarding hedge funds' use of and access to inside information? How do hedge fund managers conduct their securities trading? What prevents hedge funds from front-running mutual funds or other large investors? What are hedge funds' activities regarding initial public offerings? How hedge funds answer these questions not only has an impact on the investors in the hedge funds, but more importantly has a significant impact on all investors in our markets, including those investors that have exposure to hedge funds indirectly, whether through their retirement and pension plans or through funds of hedge funds.

It troubles me that the Commission, under the current rules, is limited in its ability to gather information that could provide answers to these questions, and could help protect millions of investors. I fundamentally believe that the Commission has a legitimate interest in obtaining the information, and imposing appropriate recordkeeping and other regulatory requirements, if needed, to protect investors receiving advisory services from hedge fund managers. Further, what we have found in the mutual fund scandals supports this concern. We have seen hedge fund managers engaged in illegal behavior that results in taking advantage of the long-term retail investors in these funds. Critics cannot have it both ways – on the one hand, to demand that the Commission be proactive and prevent and detect emerging, but as of yet unforeseen, harms and abuses, but on the other hand, to handicap our ability to obtain information that facilitates our identification of such abuses.

Let me be clear: I believe hedge funds play a vital role in our financial markets, and I would reject any regulatory proposal that would in any way impede the ability of hedge funds to function as they currently do, so long as we have the ability to ensure that their managers are not taking advantage of millions of investors. This is a point the Commission staff made clear in its report on hedge funds last fall.

Mindful of the balance between fulfilling our responsibility to protect investors and protecting hedge funds' vital role in our financial markets, I have asked the staff to move forward with a rulemaking proposal that would enhance the Commission's ability to prevent, detect and deter abusive, fraudulent conduct in the hedge fund segment of the investment management industry. As part of this rulemaking, and building on the risk assessment capability we are developing in the agency – including our new risk identification and mapping programs, we could consider both a form of registration for hedge fund managers and an oversight regime different from that which we use for other, more heavily regulated industries, like mutual funds. They could be specifically tailored to the unique dynamics of these types of managers. We could thus better target our inquiries on those hedge fund managers where there is some reasonable concern that they may be violating the securities laws.

As with all rulemaking proposals, this one will have to be voted upon by the Commission and would go through the notice and comment process so as to consider the views of all interested persons on this subject. I intend to ensure that the Commission's consideration of the hedge fund issue is thoughtful and thorough, and that any proposal will be fully and appropriately vetted.

Conclusion

As my testimony – taken together with previous testimony from the Commission staff – demonstrates, the Commission has embarked on an aggressive regulatory and enforcement agenda to combat the current ills plaguing the mutual fund industry. I believe our efforts will help ensure that there are strong safeguards in place to minimize the possibility of future illegal, fraudulent or harmful activity. We have ample regulatory authority with which to carry out this agenda, and – due in large part to your support and your constructive approach – we have been able to pursue this agenda in an expedited manner.

Please allow me to once again complement the Committee, Mr. Chairman, for its thoughtful and thorough approach to the oversight of these issues. The significant number of hours that you and the staff have spent conducting oversight hearings, and questioning witnesses from all segments of the industry, has been immensely helpful to the Commission, and represents a constructive approach to analyzing the complexity of the problems that have plagued the mutual fund industry. The Commission – and indeed the mutual fund investor – has benefited from your approach and your efforts, and I thank you.

If, as the Commission moves ahead with its mutual fund reforms, there are critical issues that we do not have the ability to address, the Commission will immediately seek your assistance to do so; however, I do not believe that legislation is necessary at this time.

Thank you again for inviting me to speak on behalf of the Commission to discuss our efforts to protect the investing public. I would be happy to answer any questions that you may have.