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New Challenges in the Regulation of Collective Investment
Schemes

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IOSCO ANNUAL CONFERENCE
PANEL 1: NEW CHALLENGES IN THE REGULATION OF CIS
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Good afternoon. Unfortunately, Cyndi Fornelli, the SEC's Deputy Director of Investment Management, could not be here today. Unlike Cyndi, I must confess that CIS regulation is not my direct area of expertise. Instead, as the Director of the SEC's Office of International Affairs, I have mostly been involved in policy discussions of CIS regulation when it touches on international issues or when it involves discussions brought up by real experts, such as Greg Tanzer and Jean-Paul Servais, at IOSCO meetings. Nevertheless, I have followed developments in the CIS industry and in CIS regulation with the devotion of a securities regulator who's eventual retirement decisions will depend greatly on how well-regulated CIS managers are over the next 20 or 30 years. Consequently, I am extremely pleased to have the opportunity to address a topic of interest and concern to so many, and

which is of the utmost priority to the SEC and other regulators throughout the world.

But before moving any further, I must issue the standard SEC disclaimer that the Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views that I express are mine and do not necessarily reflect those of the Commission or other members of the SEC's staff.

Overview

As you all well know, over the past several months, the mutual fund industry in the United States has been rocked by a series of CIS managerial abuses. The scandals have included late trading of mutual fund shares, inappropriate market timing, and the misuse of non-public information about fund portfolios. These abuses are particularly alarming because they affect a part of the securities industry where individual investors are most exposed.

These abuses are extremely troubling for most Americans. The reason is simple: It's not just your occasional securities regulator like me who is invested in these funds. Indeed, more than 91 million Americans are invested in collective investment schemes. This represents almost half of all US households, and amounts to approximately 7.5 trillion dollars in assets.

Clearly, mutual funds are one of the most important elements of our financial system. They play a similarly important role in the economies of many other countries. Economists point out that, in a global market where IOSCO members work tirelessly to improve market efficiency and transparency, "beating the market" becomes less important than diversifying portfolio risk. And mutual funds have proven to be an efficient and inexpensive way in which ordinary retail investors can diversify their risks while enjoying rates of return associated with direct investments in the capital market. However, this all depends on the honesty and integrity of mutual fund managers.

As Chairman Donaldson recently stated in his testimony before the US Senate: “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.” And, I might add, without this honesty and industriousness, it is not just investors who will suffer: issuers, market intermediaries and the entire market itself will suffer if investors call into question the integrity of the system.

To this end, the SEC’s response to the mutual fund scandals has been swift and forceful. First, the Commission, along with state securities regulators and other federal law enforcement officials, is aggressively investigating and prosecuting unlawful conduct involving a number of fund advisers, broker-dealers and other service providers.

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 and Bank of America. The settlements obtained by the

SEC 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. These enforcement actions send an important message to fund managers and all market participants that, while financial fraud and wrongdoing may not always be prevented, they *will* be uncovered and those who engage in these activities *will* have enforcement actions taken against them.

Second, the SEC is undertaking a broad spectrum of regulatory actions designed to improve the mutual fund regulatory framework. These actions have focused on four key areas:

1. Combating 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 that are potentially harmful to fund investors; and
4. Improving disclosure to fund investors, especially fee-related disclosure.

I would like to spend the bulk of my time today discussing the first two areas, which have become priorities for many of the world's securities regulators.

Late Trading and Market Timing

The first of these – “late trading” and “market timing” – are terms that have quickly become part of every regulator's vernacular. When the late trading and market timing abuses came to light, it became apparent that some fund managers, advisers, brokers and other intermediaries were woefully failing to meet their fiduciary responsibilities to investors. Indeed, in some cases, they blatantly put their own self-interest and that of a few selected clients ahead of a majority of the funds' investors. The SEC has acted quickly to curb such abuses.

Late Trading

First, the term “late trading” comes from the SEC's current “forward pricing” rule, under which funds must sell and redeem their shares at a price based on the Net Asset Value next computed after receipt of an

order. In the United States, this price is typically calculated at 4PM when the major US stock exchanges close. The concept is simple: investors submitting orders before 4PM buy or sell CIS shares based on the price of the share's underlying assets as of 4PM; investors submitting orders after 4PM buy or sell the CIS's shares based on the price of the underlying assets as of 4PM *the next day*.

However, as everyone involved in securities markets knows, some events – particularly earnings announcements – always seem to happen at 4:15PM. If an unethical fund manager were to allow an investor to place an order at, say, 4:20PM, but take the order as if it were placed at 3:59PM – well, it would be as if that investor had an unerring crystal ball that saw into the future. Only, we wouldn't call it “clairvoyance” – we would call it fraud, because the returns of those investors who legitimately placed their orders before 4PM would be diluted by the late trader. Unfortunately, in the United States, this is precisely what happened.

To eliminate this practice and decrease the potential for market manipulation, the Commission proposed what has been termed the “hard 4PM” rule. The proposed rule would require that all order, even those bulked together by intermediaries, be placed with the fund itself, its primary transfer agent or a registered clearing firm, by 4PM. Submitting an order to a broker or other intermediary by 4PM would no longer be considered sufficient.

To date, the SEC has received over 1,000 comment letters on this proposal, ranging from industry comments to letters from pension plan participants and individual retail investors. They have raised competitiveness concerns, as well as concerns that investors in earlier time zones might be disadvantaged. Many alternatives have been suggested, including systems of controls that would better prevent and detect late trading, as well as more sophisticated technology to create tamper-proof time stamping of trade tickets. The SEC staff is carefully analyzing these comments, and may incorporate some into the final rule. The SEC places considerable value on this public notice and comment

process, and, as always, we particularly welcome feedback from the foreign community on our proposals.

Market Timing

The Commission has also issued proposed disclosure reforms intended to shed more light on market timing and selective disclosure of portfolio holdings. The “market timing” can be more problematic than late trading. A market timer attempts to profit from the fact that a mutual fund’s shares may be priced but once per day, while new information is released to the market on a constant basis. A market timer typically buys and sells shares of a mutual fund in rapid succession. One of the advantages of mutual funds is their liquid nature, and there is not necessarily anything wrong with an investor buying shares in a CIS and, for one reason or another, quickly changing his or her mind and wanting to sell. Nonetheless, doing this on a regular basis can substantially raise operating costs for the CIS, as the fund must pay brokerage and other expenses associated with the redemptions. CIS operators often try to discourage market timing by pushing some of these costs back onto the

market timer through early redemption fees or otherwise prohibiting rapid redemptions. However, in the recent mutual fund scandals, the SEC discovered that some mutual fund managers were waiving these fees and ignoring their own prohibitions where favored clients were involved – and never disclosing this activity to other investors.

While not prohibiting market timing, the SEC's new disclosure requirements address abusive practices of funds whose prospectuses were misleading about efforts to limit market timing arbitrage. Among other things, the rules require a mutual fund to:

- State in its prospectus whether or not the fund's board of directors has adopted policies and procedures with respect to frequent purchases and redemptions of fund shares and, if not, explain why;
- Describe in its prospectus the risks, if any, that frequent purchases and redemptions of fund shares may present for other shareholders;
- and,

- Describe any policies and procedures for deterring frequent purchases and redemptions of fund shares, and any arrangements to permit frequent purchases and redemptions of fund shares.

The rule also reemphasizes the obligation of mutual funds to fair value their securities in circumstances where market quotations are unreliable – for example, if an event that will affect the value of the security has occurred since the 4PM closing price. Failure to fair value can result in the mispricing of a fund’s shares. Mutual funds that invest in foreign securities are particularly vulnerable to market timers who may take advantage of time zone differences.

As a companion to the market timing proposal, the Commission also proposed new rules that would require mutual funds to impose a two percent redemption fee on the redemption of shares purchased within the previous five days. The redemption fee would be retained by the fund. The rule is designed to require short-term shareholders to reimburse the mutual fund for costs incurred when they use the fund to implement

short-term trading strategies, such as market timing. The staff is considering whether to include certain exceptions in the rule – for example, for individual investors who have suffered an unforeseen hardship necessitating an immediate redemption.

Fund Compliance, Governance, and Ethical Standards

I would now like to move to another area that has received a great deal of attention: fund compliance, governance, and ethical standards.

Compliance Procedures

Rules and regulations, of course, are meaningless if they are not enforced. And internal firm compliance systems frequently are the first step in enforcing securities laws. Recognizing this, our Commission has adopted new rules designed to ensure that funds and advisers have strong systems of control in place to prevent, detect and correct promptly any violations of the federal securities laws. The rules require investment companies and advisers to:

- Adopt written compliance procedures;

- Review the adequacy of those procedures annually; and
- Designate a chief compliance officer responsible for their administration.

We anticipate that these rules will focus the minds of fund managers and act as an internal deterrent to the types of activities we have recently seen, as well as other potential abuses.

Corporate Governance

The issue of fund governance has also received considerable attention from our Commission. Mutual funds, like issuers, take in investor funds. In doing so, CIS operators are fiduciaries and invest these funds on behalf of and for the benefit of their investors. Fund boards of directors are a necessary mechanism by which funds can be assured that their managers are fulfilling these fiduciary duties. And, in our Commission's opinion, a fund's board of directors is most effective where it is functionally independent of those managers it is meant to oversee. To strengthen board independence and effectiveness and to improve the ability CIS boards to protect the interests of fund

shareholders, the SEC has proposed rules that, among other things, would:

- Increase the percentage of independent directors on a fund's board from 50% to 75%;
- Require that the board's chairman be an independent director; and
- Require the board to assess its own effectiveness at least once per year.

Ethical Standards

Finally, 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. Requiring such codes is occasionally criticized as a toothless rule. And, of course, this would be true if codes were all that is required. However, the SEC believes that such codes, when combined with the Commission's other reforms, will help focus the minds of CIS operators and their employees and act as a reminder of their fiduciary responsibilities – and the penalties for failing to fulfill these duties.

Other Reforms: Conflicts of Interest and Improved Disclosure

In addition to taking steps to enhance mutual fund oversight and ethical standards, the Commission also has undertaken a series of initiatives aimed at addressing certain conflicts that may exist between mutual funds and the intermediaries who distribute fund shares. For example, the Commission proposed a rule amendment to prohibit the use of brokerage commissions to compensate brokers-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 brokers' recommendations to their customers.

The SEC also has sought to improve disclosure, particularly regarding fund fees, conflicts and sales incentives. Among other things, the Commission has issued a concept release on methods to calculate and improve the disclosure of funds' portfolio transaction costs.

Conclusion

To conclude, I would like to suggest that the problems facing the mutual fund industry, both in the United States and around the world, are not simple ones. Indeed, they raise complex issues, requiring careful analysis and consideration. That does not mean, however, that we need to be slow in acting. Indeed, the SEC's response has been swift and aggressive, on both the regulatory and enforcement fronts.

As we continue to explore a constructive approach to outstanding mutual fund issues, including abusive sales practices and fee disclosure, we look forward to communicating with and learning from our foreign counterparts, who are encountering many of these same issues in their countries. Our collective efforts will help ensure that there are strong safeguards in place to minimize the possibility of future illegal, fraudulent or harmful activity. I believe that IOSCO can, and should, play an important role in exploring some of these issues.

Thank you.