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THE STATE OF THE SECURITIES INDUSTRY

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

THE EXAMINATION OF THE STATE OF THE SECURITIES INDUSTRY, FOCUSING ON RECENT INITIATIVES REGARDING MARKET STRUCTURE, CREDIT RATING AGENCIES, MUTUAL FUNDS, AND THE IMPLEMENTATION OF THE SARBANES-OXLEY REQUIREMENTS

MARCH 9, 2005

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C O N T E N T S

WEDNESDAY, MARCH 9, 2005

WITNESS

THE STATE OF THE SECURITIES INDUSTRY

WEDNESDAY, MARCH 9, 2005

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:10 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

I would like to welcome back to the Committee, Chairman Donaldson of the Securities and Exchange Commission. Mr. Chairman, you spend a lot of time with us, but this is the nature of the Banking Committee and also the SEC, as you well know. I appreciate your willingness to spend time with us. This morning's hearing is an opportunity for the Committee to learn more about the SEC's current regulatory initiatives.

For the past 18 months, the SEC has pursued an aggressive agenda of reform in the mutual fund industry. While continuing to bring enforcement actions against wrongdoers, the SEC has enacted a comprehensive set of new rules aimed at improving fund governance, eliminating market timing and late trading, and enhancing disclosures to investors. To date, the SEC has adopted 10 rules, and additional rules are pending regarding soft dollars, 12b–1 fees and point of sale disclosures. In addition to completing its rulemaking, the SEC continues to examine other fund industry products and practices, such as the role of pension consultants, 529 education plans, and the sale of periodic mutual fund products to military servicemen and women. Clearly, there is more work to be done in this area, Mr. Chairman, and I look forward to hearing about recent developments and perhaps some future actions that you are contemplating.

I commend the SEC for its response to the problems in the mutual fund industry. Through your leadership and the hard work of the SEC staff, I believe that investors have begun to regain their confidence, Mr. Chairman, in the mutual fund industry.

A month ago, this Committee held a wide-ranging hearing on credit rating agencies. We examined the competitive landscape of the industry, the transparency of the ratings process, and the conflicts of interest. We also considered the SEC's process for granting the "NRSRO" designation and whether the SEC should implement an oversight regime. Last week, the SEC proposed a rule that would define the criteria and process for obtaining the NRSRO designation. This proposal, I believe, is a first step toward addressing some of the issues identified here at this Committee, but I have additional concerns regarding industry practices, the scope of the SEC's authority, Mr. Chairman, and the appropriate level of SEC regulation.

Another prominent pending before the SEC is the adoption of Regulation NMS. This proposed regulation would effect the most significant changes in the last 30 years to the structure of our stock markets. Since you last testified before the Committee on Regulation NMS, the Commission has revised its proposal concerning the application of the trade-through rule. This debate has engendered considerable controversy, and it is critical that the final outcome establish a framework, Mr. Chairman, that enables our markets to remain fair, efficient, and competitive. I look forward to your discussion of Regulation NMS.

Mutual funds, credit rating agencies, and Regulation NMS are just a few of the many important issues pending before the Commission. This morning, I anticipate a wide-ranging discussion and examination of the SEC's actions.

Mr. Chairman, you and your staff certainly have a busy agenda. I appreciate your and the SEC staff's efforts to protect investors and to ensure the integrity of our capital markets, and we look forward to your testimony here today.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you, Chairman Shelby. I join with you in welcoming Chairman Donaldson back before the Committee on today's hearings on the state of the securities industry.

Chairman Shelby, I want to commend you on your commitment to having this Committee perform its oversight responsibilities, which is, of course, a very important part of our agenda, sometimes not fully appreciated by the public or even by some Members of Congress in terms of the role that it plays. This hearing provides an important opportunity to review developments in the securities industry and the efforts of the Commission to promote the integrity and efficiency of our markets and to ensure the protection of our investors.

When we compare the condition of the securities industry of today with that of a few years ago, we see a number of improvements. Technological advances are increasing the speed and efficiency of markets while reducing costs. Securities underwritings are increasing. Municipal bond investors have access to near real-time pricing data. Corporate boards and managers increasingly focus on improving transparency, disclosure, financial integrity, and governance. As a consequence, investors have more confidence in our capital markets. I have frequently stated that I regard our capital markets as a major economic asset of the Nation.

The SEC has been active in its enforcement and in its rulemaking as it seeks to implement recent legislation to address problems that continue to exist in the industry and to otherwise protect investors. Chairman Donaldson and his fellow Commissioners have improved the effectiveness and morale of the Commission. Chairman Shelby has instituted his Polishing the Jewel program and other initiatives, and I want to commend him on that. We understand it has had a marked uplifting impact on the employees of the Commission.

Mr. Chairman, in closing, I want to commend once again the process that the SEC uses in developing and promulgating its regulations. Some people may take this for granted, but it is an important part of wise policymaking is to have a fair and open process available to all interested participants. As we know, the staff of the Commission considers issues, often for very substantial periods of time. Before recommending a proposed rule on a particular complex issue, a concept release soliciting public comment may be issued prior to formulating a rule proposal.

When the SEC proposes a rule, it provides a period for public comment. The SEC assesses the public reaction to the proposal, and as it deems appropriate may extend the comment period or solicit additional comments on particular points. It did so, for example, with Reg NMS, which you made reference. The SEC goes through a process of carefully assessing the public comments. Simultaneously, it may hold public hearings or roundtables on the issue to gain additional information. The staff will meet with interested parties.

Sometimes, the comment process leads the Commission to make additional proposals, and the SEC may again publish and solicit comment, as it did just last December with Reg NMS. Once again, there is careful review of the comments before a final rule is published.

Actually, at a hearing last year, we had a panel before us, quite a number of industry participants with different views on Reg NMS, but all agreed, in response to question, that the process had been very fair and very open. And I have to say I think this sets a standard in terms of how to develop public policy, and I want to commend Chairman Donaldson, his fellow Commissioners, and the staff at the Commission for the openness, the fairness, and the thoroughness of their process, and as a consequences, I think the thoughtfulness that goes into their decisionmaking.

These are very complex issues, and it is very rare that it is all one way or all the other. I mean, there is always a very nuanced response that has to be made, and I say to all interested parties, I think the process the Commission has developed over the years, and to which it holds, makes a very important contribution to working out some reasoned answers to very difficult problems.

Thank you very much, Mr. Chairman.

Chairman SHELBY. Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman.

I would also like to join both you and Senator Sarbanes in welcoming Chairman Donaldson to the Banking Committee, and I would like to thank you, Mr. Chairman, for holding this hearing to discuss several securities issues pending before the Securities and Exchange Commission. All of these issues are of great importance to the securities industry, investors, and could very well change the Commission's daily operations and interactions, and I am glad that the Committee is having this discussion today.

The Commission has certainly taken on a lot in the past couple of years on tough issues that impact the way the industry operates and the manner in which the public views the investment world. I was pleased to hear that the Commission extended the compliance date for banks with respect to the implementation of the pushout provisions in Title II of the Gramm-Leach-Bliley Act. I am hopeful that this extra time for comment will prove beneficial as the Commission further considers the interests of many of the community banks and thrifts throughout the country as well as the State of Colorado.

I have concerns, however, that while I also look forward to hearing from Chairman Donaldson about Regulation NMS, the restructuring of the national market system has been a long time coming, and I believe that the appropriate changes are necessary for our markets to keep up with the changing demands of technology and investors. I have concerns, however, that the Commission may be moving too quickly toward a final rule when there still seems to be so many concerns on all sides of the issue.

Again, I would like to thank you, Chairman, in advance for appearing before the Committee today to discuss significant pending securities issues at the SEC, and I look forward to your testimony and the discussion today.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you.

Senator Stabenow.

STATEMENT OF SENATOR DEBBIE STABENOW

Senator STABENOW. Thank you, Mr. Chairman, and welcome. We are always glad to have you, Chairman Donaldson. I know that these are very busy times for you and the SEC, and I would like to commend you on a number of fronts for your efforts.

The job that you and the Commission perform is absolutely vital to maintaining a robust and vibrant economy, as you know, and providing working men and women the peace of mind that they need to become investors in the American Dream. As you testify today, I will listen especially closely to your comments on Regulation B, the so-called "pushout rule." The small and medium-sized banks in my State of Michigan are very concerned about the costs and consequences of having to implement a regulation that they feel runs counter to the intentions of the Gramm-Leach-Bliley Act.

I understand that just yesterday, the Commission postponed implementation of the regulation until September 30, so between now and the end of September, I look forward to working with you and with the Commission in providing a common sense approach to the issue of securities activities inside our small and medium-sized commercial banks. I am also very interested in hearing your comments about how we can better secure our financial markets and make them fair for the common investor.

As we continue moving toward a future where more and more households are invested in the market, I know that you share a concern that we ensure that the average investor, the investor who does not have access to levers of power on Wall Street, can invest without fear that the mutual fund they are investing in or the brokerage house that they hired are covertly working against them by gaming the system. We have seen results of this in 2003, and I am very glad to see that the SEC is making a concerted effort to address many of these problems.

But I also believe that those efforts may be at risk because of budgetary pressures, and I am very committed to doing all that I can to fully fund the enforcement activities of your agency. The Budget Committee, of which I am a Member, is marking up the President's budget proposal today, and at the markup, I am going to be supporting an amendment by Senator Jon Corzine to protect your enforcement funds from the deep cuts that are, unfortunately, being proposed in so many parts of our Federal budget. If we are to help our constituents secure their retirement future and encourage the American public to save, then, we must give them the peace of mind of knowing there is a level playing field and that they are not at a disadvantage when putting their money into the market.

So again, I welcome you. I appreciate all of your efforts and the efforts of the Commission, and I look forward to your testimony.

Chairman SHELBY. Senator Hagel.

COMMENTS OF SENATOR CHUCK HAGEL

Senator HAGEL. I would just like to welcome Chairman Donaldson and I look forward to his testimony, Mr. Chairman.

Chairman SHELBY. Senator Bennett.

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman.

Chairman Donaldson, we are glad to have you here. We always appreciate your willingness to subject yourself to these kinds of inquisitions. I will be particularly interested in discussing with you the questions of the implementation timing and specifics of the implementation of the FASB rule with respect to expensing of stock options. I continue to be concerned about naked short selling and the impact of the rule you have adopted. I have information, at least from my constituents, that the rule has not been effective in stopping naked short selling, and we might spend a little time on that. And then, I would appreciate what you might have to tell us with respect to deregistration on the part of European companies who say that Sarbanes-Oxley is simply too burdensome, and they would prefer to no longer be listed on American markets in order to avoid those expenses.

So those are the three items that are on my mind, and I look forward to an exchange with you on them. Thank you, Mr. Chairman.

Chairman SHELBY. Chairman Donaldson, welcome again to the Committee. Your written statement will be made part of the record in its entirety. You proceed as you wish.

STATEMENT OF WILLIAM H. DONALDSON
CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Chairman DONALDSON. Good morning, Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. Thank you for inviting me to testify. I am glad to have the opportunity to answer any questions you may have concerning the securities industry generally, and getting, back to your specific questions, I understand that you are particularly interested in the Commission's recent initiatives regarding market structure, credit rating agencies, mutual funds, and the implementation of the Sarbanes-Oxley requirements. I plan to address these in detail. As you know, the Commission has devoted considerable resources to initiatives in each of these areas.

Let me begin with a status report on Regulation NMS, a broad set of proposals designed to modernize and strengthen the regulatory structure of the U.S. equities markets. The Commission has expended considerable effort to strike the appropriate balance in developing the proposals in each of the four substantive areas addressed by Regulation NMS: Trade-throughs, market access, subpenny quoting, and market data.

Of those, the proposed trade-through rule has by far generated the most attention, and I would like to focus my remarks on that aspect of Regulation NMS. I would note, however, that the Commission has not yet taken final action on any part of Regulation NMS, and my fellow Commissioners and I are in a process of weighing and considering a number of different policy issues which each of us must consider in deciding how ultimately to vote on Regulation NMS proposals when they are put before the Commission.

Let me begin by emphasizing three important policy goals I believe would be furthered by the trade-through rule. First, the rule would provide an effective backstop on an order-by-order basis to a broker's duty of obtaining best execution for market orders. Retail investors typically expect their market orders to be executed at a price no worse than the relevant quotation at the time of the order execution. Yet, it can be difficult for investors to monitor where their orders, in fact, are executed and whether they are executed at the best price.

The trade-through rule, in combination with a broker's duty of best execution, is designed to benefit retail investors by generally prohibiting the practice of executing orders at inferior prices. Second, the trade-through rule is designed to promote fair and orderly markets and investor confidence by providing greater assurance that limit orders displaying the best prices are not bypassed by trades at inferior prices.

Retail investors, in particular, may feel unfairly treated when they are the most willing buyer or seller, and yet their best-priced limit orders are traded through. By protecting the best-priced orders, the rule is designed to promote a fair playing field for both small and large investors.

Finally, the trade-through rule is designed to encourage the use of limit orders and thereby contribute to greater market depth and liquidity. Displayed limit orders are the building blocks of public price discovery and efficient markets. Although there are many types of liquidity, displayed limit orders represent, by far, the most transparent and readily accessible source of liquidity. They also provide an essential benchmark that guides the use of other types of liquidity, such as undisplayed trading systems, matching systems, and dealer capital commitments. As a result, the enhanced displayed liquidity and public price discovery elicited by the trade-through rule should contribute to more efficient trading throughout our equity markets.

Turning to the proposed rule itself, I should stress that the trade-through rule, if adopted by the Commission, would take a substantially different and more comprehensive approach than the existing SRO and ITS trade-through rules. The trade-through rule would, for the first time, establish a uniform trade-through rule for all National Market System stocks. As a uniform rule, it would cover both exchange-listed stocks, which are governed by existing SRO trade-through rules and Nasdaq stocks, which have never been subject to a trade-through rule.

Furthermore, the rule would only protect automated quotations, in essence, those quotations against which an incoming order can execute immediately and without human intervention. It would not protect manual quotations. In so doing, the trade-through rule would correct a significant problem with the existing trade-through rules, which treat all quotes alike and effectively force fast markets to route orders to slow markets, where they can sometimes languish unfilled while a market moves away.

The reproposed trade-through rule also would incorporate a series of discrete exceptions—including those which accommodate sweep orders, address rapidly changing or "flickering" quotes, and allow for self-help when a market experiences a systems malfunction—that are designed to assure that the rule works in a relatively frictionless manner.

Finally, the trade-through rule would eliminate significant gaps in the coverage of the existing trade-through rules such as the exemptions for off-exchange block trades and 100-share quotes that have seriously undermined the extent to which the SRO rules protect limit orders and promote fair and orderly trading.

I should note that the reproposal asks for comment on two alternatives to the scope of the automated quotations in each market that would be protected. The first alternative, the Market BBO so-called "alternative," would protect the best-displayed bids and offers on each exchange, Nasdaq, and Nasdaq's Alternative Display Facility. The second alternative, the Voluntary Depth Alternative, would protect not only the best quotes but also orders below the best bid and above the best offer that a market voluntarily chooses to display in the consolidated quotation stream.

Commission staff is in the midst of evaluating the more than 1,500 comment letters received on the two trade-through rule alternatives as well as other aspects of the Regulation NMS reproposal. As I noted earlier, I have asked the staff to complete their analysis and prepare a recommendation for consideration in short order. While the issues raised by the trade-through rule and other components of Regulation NMS are extremely complex, and in some cases controversial, they have been further analyzed and debated over the course of many years, and I believe the time for action has arrived.

I can assure you that the Commission will carefully consider the comments received on Regulation NMS, including many from you and your colleagues, and that we are committed to achieving a result that furthers the important policy objectives that I have described without burdening the efficient operation of the markets.

On to credit agencies: I will now turn to the Commission's recent work with respect to credit rating agencies. By way of background, the Commission originally used the term "nationally recognized statistical rating organization" or "NRSRO" with respect to credit rating agencies in 1975, solely to differentiate between the different grades of debts held by broker-dealers as capital to meet Commission capital requirements.

Since that time, ratings by NRSRO's have become benchmarks in Federal and State legislation, domestic and foreign financial regulation, and privately negotiated financial contracts. The definition and interpretations of the definition would provide credit rating agencies with a better understanding of whether they qualify as an NRSRO.

The rule proposal builds on earlier Commission work with respect to the role of credit rating agencies. This work included public Commission hearings, a report required by the Sarbanes-Oxley Act, and a 2003 concept release. Panel participants at public hearings included NRSRO's, non-NRSRO credit rating agencies, broker-dealers, buy-side firms, issuers, the academic community, and the SEC Commissioners. Most participants favored the regulatory use of credit ratings by NRSRO's as a simple, efficient benchmark of credit quality and stated that standards for NRSRO's were necessary for this concept to have meaning.

In addition, the Commission conducted a study of credit rating agencies and submitted a report to the President and Congress under the Sarbanes-Oxley Act on January 24, 2003. The report considers the role of credit rating agencies and their importance to the securities markets, impediments faced by credit rating agencies in performing that role, measures to improve information flow to the market from credit rating agencies, barriers to entry in the credit rating business, and conflicts of interest faced by credit rating agencies. Finally, the Commission issued a concept release in 2003 to further study issues raised in the Sarbanes-Oxley report.

The concept release examined whether credit ratings should continue to be used for regulatory purposes under Federal securities laws and, if so, the process of determining whose credit ratings should be used and the level of oversight to apply to such credit rating agencies. One conclusion the Commission has drawn from its examination of the topic is that market participants would be well-served by a clearer set of standards for determining whether or not a credit rating agency is an NRSRO.

The Commission rule proposal of March 3, last week, responds to a number of issues raised by commentators in the concept release. The proposal retains the NRSRO concept and proposes a definition of an NRSRO. Moreover, the Commission would interpret the elements of the definition to provide greater clarity as to the meaning of that term. In addition, in light of the longstanding reliance by broker-dealers, issuers, investors, and others on the existing no-action process, if the Commission adopted a definition of an NRSRO, the Commission plans to continue to make its staff available to provide no-action letters as appropriate. No-action letters would be granted for a specific period of time, after which the no-action relief would need to be reconsidered.

The Commission notes that this proposal is intended only to address the meaning of the term NRSRO as it is used by the Commission. It does not attempt to address many of the broader issues raised in response to the 2003 concept release, such as whether the NRSRO designation unnecessarily raises barriers to entry to the credit rating business, except to make it clear that the credit rating agencies can confine their activities to limited sectors of the debt market and geographic areas.

The Commission believes that to conduct a rigorous program of NRSRO oversight more explicit regulatory authority from Congress is necessary. We believe that a well thought-out regulatory regime could provide significant benefits in such areas as recordkeeping and addressing the conflicts of interest in the industry. It would be important to ensure the public does not misconstrue any regulatory authority over credit rating agencies as a statement that the Government has vouched for the accuracy or quality of a credit rating.

Finally, the current NRSRO's have sought to craft a framework for voluntary oversight by the Commission. Discussions have been ongoing concerning the possible precise terms of such a framework. It is not clear at this time what form that framework might take. It is hoped that the framework will enhance oversight of NRSRO's from current levels by providing a means by which the Commission's staff can access, on an ongoing basis, whether an NRSRO continues to meet the NRSRO definition.

It is important to recognize that even if the industry does adopt such a framework, it would not give the Commission the same authority that actual legislative authority could. For example, if a credit rating agency failed to observe a provision of the voluntary framework, the Commission would not be able to bring an enforcement action. Moreover, the framework does not envision direct inspections by Commission staff, and the Commission would instead be in a position of relying on inspections conducted by third parties hired by the credit rating agencies.

Accordingly, if Congress believes more extensive Commission oversight is appropriate and possible with a voluntary framework, legislation may be needed if the industry does, in fact, adopt a voluntary framework. Congressional attention would be especially useful because the question of whether to impose a regulatory regime on the credit rating industry raises a number of important policy considerations that would need to be examined, including substantial First Amendment issues.

The Commission welcomes Congressional attention and, of course, would stand ready to work with Congress on crafting appropriate legislation if Congress determines that such legislation is necessary.

The mutual fund rulemaking: Let me turn now to this significant area of Commission focus and reform activity. Last year, in the wake of the mutual fund late trading and market timing scandals, the Commission undertook an aggressive mutual fund reform agenda. The reforms were designed first to improve the oversight of mutual funds by enhancing fund governance, ethical standards, compliance, and internal controls; second, to address late trading, market timing, and certain conflicts of interest; third, to improve disclosures to fund investors, especially fee-related disclosures.

It is my hope and expectation that, taken together, these reforms will minimize the possibility of the types of abuses we witnessed in the past 18 months from occurring again. When I last testified before this Committee on mutual fund reform in April 2004, we had taken final action on just two of our mutual fund initiatives, although many were in the proposal stage. Today, I am pleased to announce that we have adopted 10 of our initiatives and expect to complete the remaining two matters on our reform agenda in the coming months.

I would like to review for you the significant steps we have taken to strengthen and improve the mutual fund regulatory framework. With respect to enhancing mutual fund governance and internal oversight, a centerpiece of the Commission's reform agenda was the fund governance initiative. In July 2004, the Commission adopted reforms providing that funds relying on certain exemptive rules must have an independent chairman and 75 percent of the board members must be independent. In addition, the independent directors of these funds must engage in an annual self assessment and hold separate executive sessions outside the presence of management. The Commission also clarified that these independent directors must have the authority to hire staff to support their oversight efforts. I believe that these fund governance reforms will enhance the critical independent oversight of the transactions permitted by the exemptive rule.

As I said before, I believe that a management company executive who sits as chair of a fund's board is asked to do the impossible: To serve two masters. There are times when the executive's duties to the management company and its shareholders simply conflict with what is in the best interests of the fund investors. This is the case, for instance, when fund boards review many of the transactions permitted by our exemptive rules. I believe that an independent chairman and 75 percent of independent directors level the playing field on behalf of fund investors and blunt the control and dominance that many management companies have historically exerted in the fund board room.

Our fund governance reforms will also facilitate the effective implementation of other mutual fund initiatives the SEC has adopted and has put forward. These reforms, which are detailed in my written statement, include requirements for compliance policies and procedures, chief compliance officers, a code of ethics, a voluntary 2 percent redemption fee, a directed brokerage ban, and a late trading hard 4:00 proposal.

Let me focus for just a moment on the hard 4:00 proposal. To address the problems associated with late trading, which, as you know, involves purchasing or selling mutual funds after the time a fund prices its shares, typically 4:00, but receiving a price that is set before the fund prices its shares, the Commission proposed the so-called "hard 4:00 rule." This rule would require that fund orders be received by the fund, its delegated transfer agent, or a clearing agency by 4:00 in order to be processed that day.

We have received numerous comments raising concerns about this approach. In particular, we are concerned about the difficulties that a hard 4:00 rule might create for investors in certain retirement plans and particularly investors in different time zones. Consequently, our staff is focusing on alternatives to the proposal that could address the late trading problem, including technological alternatives.

The technological alternatives envisioned would include a tamper-proof time stamping system and an unalterable fund order sequencing system. These technological systems would be coupled with enhanced internal controls, third-party audit requirements, and certifications. Our staff has been gathering information from industry representatives to better understand the potential inherent in different technological systems that could be used to address this problem.

Given the technological implications of any final rule in this area, it is important that we get it right. Thus, I have instructed the staff to take the time necessary to fully understand the technological issues and the alternatives associated. Consequently, the Commission likely will not consider a final rule in this area until mid-2005.

Improving mutual fund disclosure, particularly disclosure about fund fees, conflicts, and sales incentives has been a stated priority for the Commission's mutual fund program throughout my tenure as Chairman, even before the mutual fund scandals came to light. As such, disclosure enhancement has been an integral part of our reform initiatives. I have highlighted these and other mutual fund-related initiatives in my written testimony.

But let me move on to another important area that you have mentioned, and that is the Sarbanes-Oxley implementation. Two years ago, when I came on board at the Commission, the country was still reeling from its disappointment with cooked books, indefensible lapses in audit and corporate governance responsibilities, and intentional manipulation of accounting rules. These lapses led to staggering financial losses and a crisis in investor confidence.

The resulting Sarbanes-Oxley Act of 2002 called for the most significant reforms affecting our capital markets, in my view, since the Securities Exchange Act of 1934. The Act established the foundation necessary to improve financial reporting and the behavior of companies and gatekeepers, and we have completed the rulemaking to implement these critically important reforms.

Key requirements have taken hold, including CEO and CFO certifications of the material completeness and accuracy of SEC periodic filings, enhanced disclosure of off-balance-sheet transactions, electronic reporting within two business days of insider transactions, increased disclosure of material current events affecting companies, strengthened rules regarding the independence of auditors and audit committees, establishment of the PCAOB, issuance of the first PCAOB inspection reports on the large accounting firms, issuance of important auditing standards by the PCAOB, and, for the first time, as required by Section 404 of the Act, public reporting on internal controls and their effectiveness by both management and its auditors.

I would like to focus for just a moment on Section 404 requirements for management and a company's auditor to report on the effectiveness of internal controls over financial reporting. This section of Sarbanes-Oxley may have the greatest long-term potential to improve financial reporting. It may also well be the most urgent financial reporting challenge facing a large share of corporate America and the audit profession in the year 2005.

I expect that we will begin to see a number of companies announce that they or their auditors have been unable to complete their assessments or audits of controls and additional companies announce that they have material weaknesses in their controls. For this initial pass, that result should not, by itself, necessarily be motivation for immediate or severe market reactions, in my view.

Section 404 is a disclosure provision, and investors will benefit from receiving full disclosure regarding any material weaknesses that are found: Full disclosure about the nature of any material weaknesses, their impact on financial reporting, and the control environment and management's plans to remediate them. This disclosure will allow investors and markets to make the appropriate judgments about what companies and auditors find.

Section 404 will work as intended if it brings this information into public view, and, in that event, the disclosure of material weaknesses and internal controls should be the beginning and not the end of the analysis for investors and markets. The goal should be continual improvement and controls over financial reporting and increased investor information and from that investor confidence. This should lead to better input for management decisions and higher quality information being provided to investors.

While these benefits are clear, it is also important that we evaluate the implementation of our rules and the auditing standard issued by the Public Company Oversight Board to ensure that these benefits are achieved in the most sensible way. We have been very sensible in the implementation of all aspects of the Sarbanes-Oxley Act and especially to this very significant aspect. This has included several measured extensions over this past year to accommodate the first wave of reporting.

In addition, in order to assess SEC and PCAOB rules for Section 404, now that we will have the first year of actual experience under the rules, the Commission will hold a roundtable discussion this April, and we are currently soliciting written feedback from the public regarding registrants' and accounting firms' implementation of these new reporting requirements. There will be open discussion via a website and then, of course, a very important set of roundtable discussions bringing together all of the players.

Through the roundtable and this feedback, we will be closely listening to and assessing the experiences with the management and auditor internal control requirements, including seeking to identify best practices for the preparation of these reports and evaluating whether there are ways to make the process more efficient and effective while fully preserving the benefits of the requirements. Throughout the process, the Commission and its staff will closely coordinate with the PCAOB and its staff, and we will seriously consider whether any additional guidance is necessary or appropriate.

We are also actively engaged in other activities to evaluate and assess the effects of the recent reforms, including the internal control reporting rules. For example, we have announced we are establishing a Securities and Exchange Commission Advisory Committee on Small Public Companies. The Advisory Committee will conduct its work with a view to protecting investors, considering whether the costs imposed by the current regulatory system for smaller public companies are proportionate to the benefits, and identifying methods, hopefully, of minimizing costs and maximizing benefits.

In addition, and at the request of the Commission staff, the task force of the Committee of the Sponsoring Organization, COSO, has been established and anticipates publishing additional guidance this summer in applying COSO's framework for smaller companies. Our actions have not been limited to smaller companies. We also are cognizant of the regulatory challenges our foreign registrants face. For all these reasons, we recently extended the compliance date for internal control reporting for an additional year for smaller companies and for foreign public companies. A review of the first year experiences of our larger registrants also should help smaller and foreign issuers in preparing for their first reports.

Mr. Chairman, Members of the Committee, I thank you for your indulgence. My testimony covers a broad spectrum of serious and very complex issues. There are a number of other substantive activities underway as well, but I have tried to limit my update to those things. I thank you all for your interest and attention. Together, we have made significant progress over the last several years in rebuilding public confidence.

This concludes my prepared testimony, and I would be glad to try and answer any questions you may have. Thanks very much.

Chairman SHELBY. Thank you, Mr. Chairman.

Mr. Chairman, about 2 years ago, this Committee held a hearing on analyst conflicts of interest in the Global Settlement. We examined how investment houses used research reports to bolster investment banking business. Some press reports suggested recently that these conflicts are still prevalent on Wall Street, particularly with respect to Fannie Mae, Freddie Mac, and their bankers.

Since the announcement of the Global Settlement, do you think that Wall Street has adequately addressed these conflicts, or have firms reverted to their old ways now that the regulatory spotlight has moved on to other practices? These are concerns that we have.

Chairman DONALDSON. Well, I think the price of making new rules is eternal oversight, if you will. It is like going on a diet. You get the weight off, but once you get the weight off——

Chairman SHELBY. You have to keep it off.

Chairman DONALDSON. —you have to pay attention to make sure it stays off.

Chairman SHELBY. We want to help you to keep it off.

[Laughter.]

Not you but the metaphor you are using.

Chairman DONALDSON. Well, we are very concerned with keeping our oversight crisp and focused and——

Chairman SHELBY. Keeping people honest and keep conflicts——

Chairman DONALDSON. I beg your pardon?

Chairman SHELBY. Keep people honest and keep people from engaging in so many conflicts, perhaps?

Chairman DONALDSON. Absolutely. I think that it is inevitable that there are certain conflicts that are intolerable in the investment business. There are certain conflicts that are inherent to the business. When you are standing in between a buyer and an issuer, both want the best deal, and you have to resolve that conflict. So we try to do the best we can in writing rules around those sorts of inevitable conflicts.

Chairman SHELBY. But you are going to continue to be diligent in that area, I suppose.

Chairman DONALDSON. We will, I can assure you.

Chairman SHELBY. Go back to Regulation NMS, the trade-through rule. It is my understanding that the proponents of the trade-through rule contend that the rule ensures that investors receive the best price when they trade their shares. Opponents of the trade-through rule contend, as I understand it, that although the rule may have served a useful function, it no longer makes sense in today's markets. Technological innovations have created new systems and programs that allow market participants to make instantaneous trading decisions with minimal human intervention in executing trades.

What is the real problem you are trying to address here, in view of what I just said?

Chairman DONALDSON. Basically, we are trying to reconcile two different, and hopefully not mutually exclusive, objectives. One objective is the protection of the so-called "best bid or offer," and this is, in my view, a rock upon which our markets have been so successful through the years. That means if someone is willing, an individual investor in particular, to put a bid or an offer out there, they must be assured that somebody will not trade around them—that, in effect, they are offering, as the trade said, they are offering a free option to the marketplace. And they must be rewarded for that by making sure that their order will be honored.

We are trying to reconcile that objective, and, by the way, the best markets are those that have the most displayed limit orders out there, so that incentive to put that order out there as opposed to keeping it in your pocket is very important.

Chairman SHELBY. Information.

However, as you know, there are new electronic ways of trading faster than this on some of the floor exchanges, and certain buyers believe that the speed of execution and the integrity of their order is more important to them than necessarily honoring that best bid or offer. So the purpose of the trade-through rule—and again, I must emphasize that the new trade-through rule that we are talking about addresses two things: One, it will only be applied to an instantaneous quotation, for example, to an electronic quotation where the transaction can take place immediately, and two, it will basically, in applying to that transaction, it will address the general inefficiency of the trade-through rule as it has been applied in the older system currently existing in the markets, which was devised 20 or 30 years ago, which is like a horse and buggy kind of thing to identify trade-throughs.

It is a modern, efficient way of assuring that we have both speed and best bid and offer priority.

Chairman SHELBY. Mr. Chairman, if the trade-through rule is necessary to protect buy and sell orders and promote investor confidence, why do such huge organizations like TIAA–CREF, a well-known institutional investor, oppose the trade-through rule? Is there a lack of consensus on this proposal among the investing public?

Chairman DONALDSON. As in any of these undertakings that we do, there are always people on all sides of this. There are many different interests, if you will, represented out there. The whole national market system proposal that we are putting forward will affect in one way or another a number of those interests. There are an equal number of large investors like the ones that you cited, more, as a matter of fact, that believe in our trade-through rule and have so stated.

But I think that the real issue here, as I say, is that this is a compromise. This is a compromise between those that would say just speed and trade anywhere you want, and that is of interest to certain funds, who would love to not have to honor the best bid and offer and would love to trade somewhere without people——

Chairman SHELBY. You say it is a compromise. Is it a compromise to protect people other than the public? Does it protect some people in the status quo as opposed to new ways of doing business?

Chairman DONALDSON. No, what I was going to say, is that it is a compromise trying to get the best of both worlds, and I think that the most important aspect of this is that in addition to enforcing the trade-through rule for an electronic transaction, there will be no protection in the so-called "slow markets." So, if you have a market as envisioned by the New York Stock Exchange and some of the other markets who will have an electronic market and side-by-side a floor-based or a so-called slow market, those who choose to operate in the slow market will not be protected by the trade-through rule.

Chairman SHELBY. Do they have a similar situation in, say, Frankfurt, or is it totally electronic?

Chairman DONALDSON. In Frankfurt?

Chairman SHELBY. Yes, in Frankfurt, for example, or in London.

Chairman DONALDSON. We have to deal with the markets as they exist in this country, and I do not think the Frankfurt Stock Exchange in any way is similar to the New York Stock Exchange for a whole lot of reasons.

Chairman SHELBY. Do they have a trade-through rule, I guess I am asking you, on the Frankfurt exchange?

Chairman DONALDSON. Yes; well, the German and the English block trades go off the exchange.

Chairman SHELBY. Okay.

Chairman DONALDSON. They will not under our new rule here in the United States. The blocks will be forced to conform to the national market system rules.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Chairman Donaldson, I read this report of your speech earlier in the week before a securities lawyers' conference here in Washington in which you made the point, according to this article: "'Lawyers and auditors are crucial gatekeepers for the integrity of the markets. Lapses over the past few years by outside advisors directly contributed to financial frauds that devastated thousands of investors. I hope you will not expend significant time, money, and energy devising structures designed at evading requirements and trying to achieve an accounting or disclosure result that artfully dodges the rule's purpose,' Donaldson said," and you also, as I understand it, talked about the conduct of auditors at accounting firms of all size and that Agency officials will continue to scrutinize auditors' relationships with their clients for possible violation of independence rules.

As I understand it, the SEC has lodged enforcement actions against lawyers and also against auditors, particularly where they feel the relationship has gotten too close with their clients for them to render impartial reviews of financial reports. How serious do you regard this problem as being, and what do you foresee the Commission doing as we move ahead?

Chairman DONALDSON. In the ordinary course of our enforcement actions, we are confronted with professional malfeasance, and we have law requirements that allow us to bring actions against lawyers and accountants and to deny them the privilege to appear before the Commission and, in certain cases, more restrictive actions. What I was talking about in that speech was not the gross aiding and abetting actions that become illegal. What I was talking about was a state of mind.

We can write all the rules we want, but what really counts is the state of mind of not only management but also, I believe, the advisors to management, and that would include auditors; it would include accountants; it would include lawyers; it would include anyone who might be considered to be a gatekeeper. And what I was urging was that they pay attention to their role, not only to show just exactly how you can walk up to and conform with a law and not to just figure out ways of legally getting around that law but also to be a counselor on what the intent of the law was.

Now, that is a long answer. I believe that you know, during the 1990's, when a lot of these problems arose, I think there was a problem. I hope that, because of our actions and by speaking as I have, people are beginning to think twice about defining their role only as an executor of clever ways of doing things.

Senator SARBANES. Now, in the carrying out of Section 404 of the Sarbanes-Oxley Act, you have given some additional time for the filing of the 404 reports to smaller companies and to foreign companies; is that correct?

Chairman DONALDSON. Yes.

Senator SARBANES. And that would be until some time next year; is that right?

Chairman DONALDSON. Yes; we approved implementation of Section 404 in June 2003. Last week, we extended the compliance date for nonaccelerated filers, that is, companies with less than $75 million market cap and for foreign private issuers, and this extension benefits roughly 65 percent of our registrants, and it is important to note it affects only about 5 percent of the total U.S. market cap.

The requirements were effective for the first time for companies with more than a $75 million market cap for the fiscal year ended December 2004. We have granted a 45-day extension for companies with less than $700 million market cap. So what we have tried to do is to adjust, if you will, for smaller companies and for foreign issuers, this is a big process, a process versus the number of people available to do it in small companies.

Senator SARBANES. So as I understand it, if you are above a $700 million cap, these are U.S. companies now, you are required to file, well, now, I mean, those reports will be coming out, and we will be able to take a read on whether there are material deficiencies.

Chairman DONALDSON. That is right.

Senator SARBANES. If you are between $75 million and $700 million market cap, they have another 45 days to come in with their reports, and if you are under $75 million, you can go to next year rather than this year.

Chairman DONALDSON. That is right, 2006.

Senator SARBANES. And the foreign companies, I gather, is without relationship to the market cap.

Chairman DONALDSON. That is right.

Senator SARBANES. I gather part of that was pushed by the fact that they were all currently being required to conform with international accounting standards as a part of the process in their own respective countries and that also is, for some of them at least, a difficult process, and this was to recognize that and give them additional time; is that correct?

Chairman DONALDSON. That is correct.

Senator SARBANES. The ultimate objective, though, would be that any public company listed on a U.S. exchange would be meeting the same requirements. They may be delayed in when they get there, but eventually, they will have to get there just like the companies that have already moved ahead in order to make this analysis and make the appropriate certifications.

Chairman DONALDSON. Absolutely; the issue here has been, as you know, Europe and the European Union have moved to international accounting standards as of January 1, so they have to go all of a sudden from, let us say, Italian GAAP and German GAAP, they have to go to international accounting standards; and then they have to go another step to reconcile international accounting standards with U.S. GAAP at the same time that they are dealing with the stock option expensing item.

So we decided that we would give the European issuers some time to go through this difficult process, and it is very difficult for them, but, ultimately, it is just a matter of a year extension. It is not a matter of letting them out of our requirements.

Senator SARBANES. And unless we hold everyone to it, we are going to be faced with the anomalous situation of having companies listed who are meeting different standards and requirements, and of course, that is not the purpose. Eventually, given appropriate time to work through some of these practical problems, and I recognize there are some practical problems, but eventually, all companies listed on American exchanges would be meeting the same standards; is that correct?

Chairman DONALDSON. Yes, that is correct.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman Donaldson, my question is in regard to the FASB December 16 approval of the rule requiring the expensing of stock options.

Chairman DONALDSON. Yes.

Senator ALLARD. I understand the SEC's response at this point is you are going through what you call interpretive guidance to assist companies with implementation. And, you know, for some of us, there is concern out there, because the stock options have been a way of increasing productivity and, if you are a new company, getting people into your company with some talent based on what they may feel is the future of that particular company.

And so, I am curious as to how you are viewing the interpretive guidance procedure, and what are you thinking about as far as the interpretive guidance procedure, and in what way and how would that help a new company that is getting started?

Chairman DONALDSON. As you know, the FASB standard requires that options expensing begin in the third quarter of 2005.

Senator ALLARD. Right.

Chairman DONALDSON. As an accounting matter, this makes sense, because clearly, I mean, the expensing of them makes sense, because the options do have a cost, and the trick here has been the formula to decide exactly how much should be expensed. That is where there are various models that have been approved by FASB, and our staff now is in the process of formulating guidance on this subject in response to a number of questions that have been raised. The staff plans to issue this guidance this month in terms of questions that we have had about the different models.

Of course, the models are all contingent and dependent upon the numbers you put into them, the assumed rates and so forth. This gets to be a very complex subject. There are lots of entrepreneurs out there who are putting forth ways of doing this, if you will; economists, mathematicians, and so forth who are getting pretty sophisticated, and we intend to offer guidance in terms of the interpretation of these different models, and we will do that, as I say, this month.

Senator ALLARD. The guidance that you are offering, is this guidance that is being reflected back to FASB or guidance that is being reflected to companies or both?

Chairman DONALDSON. I would say both. We are in constant touch with FASB, and our Chief Accountant and the PCAOB talk all the time, and certainly, the guidance that we are giving would be coordinated with FASB.

Senator ALLARD. And those are to come out when, now? You say within the next month?

Chairman DONALDSON. Yes, this month.

Senator ALLARD. Okay; toward the end of this month, you are thinking?

Chairman DONALDSON. Sometime this month.

Senator ALLARD. Sometime this month.

Chairman DONALDSON. Yes.

Senator ALLARD. Now, the guidance, then, it is going to be in the form of various approaches that you may take if you are a business in complying with that FASB requirement on stock options where you expense them?

Chairman DONALDSON. There are, as I say, different models that are acceptable, and there are—once you understand the models and understand their application to your business, you will be able to select a model, but you also will have to disclose the model that you have accepted and the inputs that you put into it, so that somebody from the outside will understand what went into your determination.

Senator ALLARD. You are talking about a formula that might, for example, fit into a computer, and then, you just put in those variables that would apply to your company once you decide which model you would like to go with, and then, would that try to facilitate—I am trying to understand how this could be that quickly put out by the companies so they could comply.

Chairman DONALDSON. As I say, these models, you know, have been a subject of great investigation and debate by FASB. There are a number of Ph.D. scholars, mathematicians, and so forth, and economists who have been advising on these very sophisticated models. However, there are some very sophisticated consulting groups around that will help companies do that if they do not have the wherewithal or the talent in their company to do it. And we hope to be in a position, as I say, to give guidance as people deal with this.

Senator ALLARD. Mr. Chairman, my time has expired. Thank you.

Chairman SHELBY. Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman, and I want to thank you for holding this hearing, and I want to thank Chairman Donaldson for always being available to us as well as for the job he is doing.

I think these are very difficult times to be a regulator for many reasons, but you have a changing world. You have technologies that come in and move very quickly, and the trick is not to overreact but at the same time to update, and the trick is also to make sure that the basic framework that our markets and our whole economy has existed under for a long time, which has been overwhelmingly successful, keeps the basic balance between efficiency, fairness, and openness, and I think you have done a good job there.

Particularly, I think you have done a good job on something of great concern to me, which is market structure. I think the original staff proposal made by the SEC on Regulation NMS, makes a great deal of sense. On the one hand, you have to update things; there is no question, and speed does matter. But there is an overall guiding principle we have here, which is that the markets be fair, be deep, be liquid, and serve the small investor as well as the big guys. The day our markets are not regarded as being on the level is the day they begin to decline.

There are many individual interests who say do it my way, because I understand that, they make more money doing it that way, or it serves their interests. They would rather not have their trades be known. But I think if you study history, if you go for the short-term interests of one little group or another, you end up having real trouble in the markets that ends up hurting everybody.

I would urge you, Mr. Chairman, the SEC, and everyone else to resist the short-term impulse to say, hey, I want to do it a different way, because I benefit, because we have a much broader, deeper principle, which is the functioning of the markets, the caring for the small investor as well as the large investor, et cetera.

So, I was pleased to read what you said in your statement. I just want to—and I think we are updating our markets. There is no question speed matters, but speed is not the—we should not go for speed uber alles, even though some want it. And I think, again, you have reflected that balance in this NMS solution. I would argue to you if you make exceptions, you will undo the whole rule. An exception swallows the rule that you would make, because once everyone is not tied to the same rules, the outliers can prevail and undo the whole system. And so, I would strongly urge you not to seek exception and not to allow exception. Let everybody play by the same rules. At the same time, I do think, you know, if you go too far, you will end up with fragmented markets, go to a CLOB. That will end up fragmenting the markets. If you do not go far enough, somebody will come in who is more efficient and dominate.

Again, I want to compliment you on where you are headed. I would say, you know, I think I know the Chairman asked about somebody who was opposed, I think TIAA–CREF. I would just like to note that there are lots of companies like TIAA–CREF who are for this rule such as the Investment Company Institute, which represents the mutual fund industry, T. Rowe Price, Vanguard, Barclay's, as well as the people who favor the small investor: Consumer Federation of America and groups like that have been supportive of your proposal.

Let me ask you this: Testimony given by some said that there was not a trade-through problem in, say, Nasdaq stocks. And then, your Office of Economic Analysis, which detailed in the Reg NMS reproposal, said that characterization was not true, that there was that kind of problem there. And now, the people who originally proposed this are trying to discredit the staff report. Have they made any valid objections? Do you still stand by that staff report?

Chairman DONALDSON. Yes, we still stand by that judgment. We have taken those comments that have come in to us. We have reanalyzed some of the statistics that we put forth in the original national market system data, and the data does not show that trading in Nasdaq stocks is more efficient than trading in New York Stock Exchange stocks; rather, both these markets have some pluses and minuses, strengths and weaknesses, but an effective trade-through rule is needed in both markets to promote best execution of retail orders.

I do not want to get too far into the statistics here, but the fact of the matter is that the trade-throughs, depending on how you measure them, the effect of trading through best bids and offers in the Nasdaq market and broad cross-section of stocks is bigger than it is at the New York Stock Exchange, and this causes all the problems that I talked about in terms of not honoring the best bid and offer and not, in effect, paying people for being willing to give this option, if you will, of putting a bid or an offer out there.

Senator SCHUMER. Right; just a second question on a different subject. Is my time up, Mr. Chairman? I know we have a vote.

Chairman SHELBY. Yes, but go ahead.

Senator SCHUMER. Okay; soft dollars. You have been consistent in assuring the market that in your opinion, independent research will be treated under the same rules as proprietary research, that the definition of what constitutes research, of course, needs to be more precisely defined so you do not write off things as research like trips to the Bahamas where they might make a phone call and call someone and ask their judgment.

[Laughter.]

Senator SARBANES. Do they call someone in the Bahamas or someone somewhere else?

Senator SCHUMER. No, they go to the Bahamas to call someone in New York and call it research.

[Laughter.]

But the basic core of research is very much needed, and that is why I joined with my colleague, Senator Sununu, in sending you a letter yesterday asking you for an update and time lines as to when we could expect the rulings here. I agree with, again, your basic thrust that we do need to preserve independent research, and we cannot just eliminate it. When will a new rule be proposed, and can you expand on what the SEC is considering as the definition of research?

Chairman DONALDSON. Yes; in early 2004, I established a task force within the SEC to look at the issue of soft dollars. I think we should change that name.

Senator SCHUMER. It is like privatization. It is going to stick no matter what somebody tries to do.

Chairman DONALDSON. It has a pejorative image to it, but nonetheless, soft dollars.

Chairman SHELBY. What would you call it other than soft dollars?

Chairman DONALDSON. The task force has been meeting continuously. It has come up with a number of recommendations, but of all of these recommendations, I have asked the staff to focus on three areas. One is clarifying the scope of brokerage and research services that are eligible for soft dollar payment. What exactly is in this modern day, when the original intent here was to have soft dollars pay for research, now, research comes in electronic forms. It comes with equipment to deliver the electronic forms, et cetera, et cetera; what is allowable under 120(a)(d)?

Number two is requiring that broker and investment advisor records of soft dollar activity are clarified, so that inside the mutual fund, if you will, the new independent directors and independent chairman can see an analysis of just exactly the composition of those soft dollars and how much is going for what.

Senator SCHUMER. Right.

Chairman DONALDSON. And then, a third component is relating this, advisors relating this to their clients. Mutual fund managers, mutual funds themselves, are relating this information in a clear form so people see exactly how those soft dollars are being used.

I might just say that I believe that with the Global Settlement and the rise now of independent research, you know, I believe that anything we would do to inhibit independent research from being done and to limit research only to being done by major investment firms would be a mistake.

Senator SCHUMER. I agree.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

I outlined three items that I would talk about. I think we have discussed the deregistration thing sufficiently in your responses to Senator Sarbanes, so let me move on to the other two in the time that we have remaining before we have to go vote.

Naked short selling: You put out a new rule in January to deal with naked short selling, and as nearly as I can tell from my constituents who feel victimized by this, it is not working. There is a story that appeared on Friday in the *Financial Wire* on naked short selling that summarizes it perfectly. A Michigan man, if I can quote from it, I will give you a copy of it, a Michigan man, Robert C. Simpson, who claims to have acquired 100 percent of the issued and outstanding stock of Global Links Corporation is likely to become the poster boy for those opposed to illegal naked short sales.

It goes on and talks about this. This, for those who may not know is where a brokerage house sells shares it does not own and has not borrowed. Short selling is a perfectly legitimate activity in the market, but it requires that the person who sells the share he does not own, borrows those shares so that he can buy them back when it becomes necessary. All right; Simpson filed an SEC Commission Schedule 13(d) on February 3 showing his purchase of and voting power for 1,158,209 shares of the corporation, yet the day after he purportedly stuck every last corporate certificate for Global Links in his sock drawer, the company traded 37,044,500 shares. And the next day, it traded 22,471,600 shares. And Thursday of last week, it traded 199,616 shared.

Quoting the article, it says: "Simpson is said to have gone back to his sock drawer and despite the fact that a sock or two, as is always the case, were missing, all 1,158,209 Global Links certificates were still there." There were no shares available to be borrowed, and yet, in 2 days, there were over 50 million shares traded. And I have constituents who say trading since the rule was adopted in our stock has exceeded the available float by four or five times on a daily basis.

Now, your staff is going to come in, we are going to have a briefing on this in depth, and I will not go into it in greater depth here, but this article, just last Friday in a national publication, indicates that people are still selling short shares they do not have and are clearly never going to acquire if the one fellow has acquired every share. And I am told that the way that it works is that one brokerage house sells short, has 13 days under your rule under which to acquire the shares, and in that 13-day period hands the whole transaction off to another brokerage house, and they just keep moving it around, and nobody ever has to settle, and they use the 13-day period to avoid the rule, and you end up with this kind of circumstance.

Thirty-three million shares traded in a single day when there are only 1 million shares outstanding, and one investor has filed a statement with you saying that he has all of them; that is clearly something that needs work.

Chairman DONALDSON. Senator Bennett, thank you for that observation. As you, yourself, note, short selling is not illegal.

Senator BENNETT. I approve of short selling. It is the naked short selling we are going after.

Chairman DONALDSON. And when you get into naked short selling, the Regulation SHO, which was adopted in 2004, has three primary rules that address the problem with extended settlement failures: The location requirement, the close-out requirement, and the borrowing requirement.

Senator BENNETT. Excuse me; I do not want to go into that, we have got a vote and my time is running out, and you are going to give me a briefing on that. So let me move to the other area very quickly.

Chairman DONALDSON. And we would like to give you a briefing on our oversight in this area.

Senator BENNETT. My main message here is that the evidence is that the Reg SHO is not working. So that is what we need to get into in detail.

I am one who endorses the idea that stock options should be expensed. I agree that they have a cost. But I have been tremendously disappointed—that is an understatement—about the way FASB has handled this. Basically, they have punted on the most difficult and important question, which is valuation. They have said okay, you can use Black Scholes, or you can use binomial, or you can make up something else if you get to these experts that you referred to in your response to Senator Schumer, and that is fine.

What kind of accounting standard is that, when FASB says you have to expense them, but we do not particularly care what valuation you put on them? And what you are going to see, indeed, are seeing now, if you and the SEC are not the gatekeeper to bring some sanity to this debate are three, in my view, bad results which are not mutually exclusive. You can have all three of them: Number one, which we are already seeing, no more options. There are companies that are saying we just cannot deal with this, and so, the safe thing for us to do is to opt out of offering stock options. Dell cuts options for employees by 60 percent, "To curb option grants, companies are using a variety of strategies. Others are simply reducing option grants without offering a replacement. That is the case at Dell, which awarded employees 51 million options in 2004, down from 126 million 2 years earlier." That is a February of this year statement from *Business Week* online.

In *The New York Times*, February 19, 2005: "Time Warner said yesterday it would no longer grant stock options to most employees, citing new accounting rules." Aetna, from the *Boston Globe,* January 2005: "While the new ruling will not prevent companies from granting options, doing so will reduce their reported earnings. Many fear management increasingly will limit options to top executives. Last month, in fact, Hartford insurance giant Aetna, Inc., once known for its generous stock options, said it would no longer offer them to rank and file employees under the new accounting standards."

Pfizer, February 28, 2005: "Pfizer said in the U.S. Securities and Exchange Commission filing that in response to new accounting rules requiring employee stock options to be expensed, it plans in

2005 to reduce the number of options granted, except for the most senior Pfizer management" and so on.

The prediction was made that people would stop giving options to anybody but the top executives, and that is coming true. If they could get a valuation system that made sense, I think that would not be the way, but if I were running a company again, I do not want to run the risk, which leads to the second reality that I am afraid is coming is going to be lawsuits.

If you can, under FASB, pick Black Scholes, binomial, or a third one that is developed by your own experts, you are automatically setting yourself up for a lawsuit from somebody like Bill Orack, who is going to say you picked the wrong one, and therefore, we are going to sue you. So you have no safe harbor here. As long as there are these alternatives that says that FASB says you can choose, you are fair game for every predatory trial lawyer out there who wants to come after you, particularly if you are a big company like the ones I have mentioned, and I think they have sat down, and they have said look, we could come up with a valuation that might make some sense, but we do not want to have to defend it in court, and the easiest, smartest, and simplest thing for us to do is to cut out the options.

And then, the third thing that is going to happen that we see examples of is that the analysts are not going to pay any attention to these earnings reports. They are going to look at the earnings reports and say these valuations are meaningless; we want to compare performance of company X of 2005 to performance of company X in 2004. The earnings report in 2004 did not include any expensing for options, so in our analysis in 2005, we will not examine expensing for options. There were always footnotes available to us before; we will treat them as footnotes available again.

So you have the situation where the analysts are paying no attention to the accounting, and yet, the accounting requirements are stifling the granting of options and setting up a situation for lawsuits. You, sir, are the last gatekeeper against this kind of insanity. We have not been able to get FASB to deal with the question of intelligent valuation of stock options. I am pleading with you and your accountants to find some way through this thicket that will allow a company to issue options with a safe harbor, knowing that they are not going to get sued, and will allow the analysts to examine the accounting in a way that makes some sense, because we are setting ourselves up for the worst of all possible worlds.

Chairman DONALDSON. Senator, I know we are running out of time, but let me just try and give a couple of quick responses to that.

Senator BENNETT. Please.

Chairman DONALDSON. Number one and perhaps most important is I would like to, if you have the time, have our experts brief you on this.

Senator BENNETT. For this, I have all the time you need.

Chairman DONALDSON. Well, we would like to do that.

Number two is that the problem that was being addressed here was the excessive use of options, largely because no expense was attributed to them. That was the issue.

Senator BENNETT. Yes.

Chairman DONALDSON. So clearly, we have moved in the right direction in terms of saying that this is an expense, and it must be counted.

Senator BENNETT. With that, I fully agree.

Chairman DONALDSON. What is the expense?

Senator BENNETT. That is the problem.

Chairman DONALDSON. We have gone through—I should say FASB has gone through—as you indicated—a series of very intense attempts to get at a single model, and in fact, they have come up with a couple of models. I am told, and this is why I want you to talk to our experts, that those models come up with amazingly similar results when applied, generally speaking. That is point number two.

Point number three, and this is the most important one, and as a former analyst, I can say this, that if I were still an analyst, I would be reading the footnotes that indicate what model is being used and what the inputs in that model are being used, and I do not want to make a judgment on enforcement now, but I would say that, if somebody follows a model that has been approved, discloses the model, discloses how they have used it, and what the inputs have been, the chances of, certainly, litigation coming from us is zero.

Senator BENNETT. I am not worried about litigation coming from you. I am worried about Bill Orack.

Chairman SHELBY. Senator Sununu, you have the last word as long as you can hold the vote on the floor.

STATEMENT OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. When Bill Orack starts suing people for using double declining balance depreciations that have straight line depreciation or some of the digits depreciation, I will start worrying a lot more about the legal implications of expensing stock options.

I want to ask a few questions about the trade-through rule. In your opening statement, you talked about, and I do not know if it was the most important value, one of the values of the proposed trade-through provisions being that they will create an incentive to display more limit orders.

Chairman DONALDSON. I am sorry?

Senator SUNUNU. Create an incentive to display more limit orders. Is that the most important value?

Chairman DONALDSON. It is an important value.

Senator SUNUNU. Certainly one of the principal goals.

And I would agree with that, the general premise that more information displayed, offered up in these markets is of value. But it would seem to me that if that were, if the proposal to extend trade-through to other markets would really help encourage the display of limit orders, then, you would expect more limit orders to be displayed currently on the New York Stock Exchange than are currently displayed at Nasdaq, and my understanding is that that is not the case, that there are more limit orders on Nasdaq than the NYSE. Does that not seem to defeat the argument?

Chairman DONALDSON. No, I do not think so, because basically, the ITS trade-through rule as it exists at the New York Stock Exchange has not been effective in preventing trade-throughs. The existing rule——

Senator SUNUNU. So you are saying it has not been effective, the existing one has not been effective, and you believe that this one would be more effective.

Chairman DONALDSON. Absolutely, because this is totally different. The existing rule is seriously flawed because of block trade exceptions and because it only provides a satisfaction remedy rather than actually preventing trade-throughs.

Now, the new trade-through rule, if the Commission were to agree to put it in, applies only to an electronic market, an instantaneous market, and it relies upon not a 25-year-old ITS system, but it relies upon the most modern system in the way the orders get there and the way they are executed at the exchange.

Senator SUNUNU. Good, clear answer, but it raises a concern with me that you are admitting that you have not been able to design an effective trade-through rule in the past. You think this is a better one. I am always inclined to give you the benefit of the doubt. Why not apply this on a trial basis on the New York Stock Exchange in order to find out whether your hopes, dreams, and aspirations for improving the display of limit orders come to fruition?

Chairman DONALDSON. I will tell you, to use a poor analogy, the ITS system, which was devised by the stock exchange and particularly the New York Stock Exchange, is a horse and buggy system. I mean, it is like saying your horse and buggy could not go 100 miles an hour. This is a very different concept and a very different system, and insofar as, you know, the option of applying it temporarily and so forth, that is something we have looked at.

The other side of it would be why not put the system in, and, if it does not work, you can see why it does not work and modify it? You are not going to know in a small sample. You are definitely not going to know unless you apply it to all NMS stocks.

So, you know, but again, I think the concept of trying something out works in certain instances. We will see if it does here. I do not want to prejudge what the Commission will decide on this, but I will just leave it there.

Senator SUNUNU. Are you saying you may consider applying it to only the New York Stock Exchange?

Chairman DONALDSON. We are, again, you have to be talking to me now and not the Commission. We have to define whether you are talking to our staff; you are talking to me; you are talking to——

Senator SUNUNU. I am sure that they appreciate the fact that you never force them to sit up here. You take all the heat. You are very good about that.

Chairman DONALDSON. But, you know, I want to be very clear that the Commission has not voted on this. I also want to be very clear that the staff has spent years getting to this, seminars, et cetera. And I believe that the staff feels very strongly that this should be applied to both markets, that there is no difference between the stocks that are traded, and that to not apply it to both markets opens up the door to regulatory arbitrage. If you have different systems, then you have different incentives for traders and so forth. So, I think the staff feels very strongly that way. I am trying to keep an open mind about this in terms of my own personal view, as I believe the rest of the Commissioners are.

Chairman SHELBY. Senator Sununu, I know you want to keep going, but they are holding our vote. Our time has expired on the floor, and we have four straight votes.

Go ahead.

Senator SUNUNU. Thank you.

[Laughter.]

The Chairman did not pass you that note, did he?

Chairman SHELBY. No, I have a few questions for the Chairman, too. I might have to go on the record or have to be brief.

Senator SUNUNU. No, I will finish up so you can ask one or two. My guess is we have about 5 or 10 more minutes here before they really get serious about closing the vote.

Chairman SHELBY. I hope you are right.

[Laughter.]

Senator SUNUNU. Let me put it this way: They are not going to vote without you. They may vote without me, but they are not going to vote without you.

Chairman SHELBY. Okay.

Senator SUNUNU. I think the cost estimate for the top of book proposal was $167 million. The depth of book proposal, it would seem to me, is going to be a lot more expensive than that. Can we expect the Commission to put forward a more detailed estimate of the cost of these new regulations so that we can make a judgment as to whether or not the projected value is really worth it?

Chairman DONALDSON. Yes, I think you can expect us to juxtapose projected costs against projected savings for investors and that that will be part of the process of presenting this to the Commission and, in turn, presenting it to the public.

Senator SUNUNU. Thank you. I just want to reiterate that given that the number of trade-throughs on New York is the same as the number or percentage of trade-throughs at Nasdaq, given the fact that that points to a point you made, the existing trade-through rule has not been effective, given the fact that there is a lot of difference of opinion about what kind of an approach is best suited here, I just have real concerns about, one, rewriting the trade-through rule and then, two, once that is done, expanding its application when I do not know that there were really a lot of comments and input to the Commission advocating for expanding the application of the trade-through rule.

I would like to think that these changes will have the positive effect that you describe, because I agree, more information, more limit orders displayed on automated exchanges is a good thing, but I would like to think that we can find a way to apply this kind of a concept, prove its value, which is less expensive and less risky before we dramatically try to expand it.

Thank you, Mr. Chairman.

Chairman SHELBY. Mr. Chairman, I would like to pose a question for you, and you can get back to me if you choose: The credit rating agencies, the NRSRO's, how can we work with you to complement your effort? Specifically, do you need additional legislative authority, and if so, would you get back with us and talk to us? We want to make sure you have the authority, unquestioned, to deal with the credit rating agencies. Some people say you might need legislation. If you do, we want to give it to you.

Will you get back with me on that, or do you want to just answer that now?

Chairman DONALDSON. Sure, no, I would like to get back to you. I would just say very quickly that we are continuing to pursue the voluntary route to see how far we can go; not optimistic on that, answering some of the——

Chairman SHELBY. Why do we not do a parallel, then? You pursue the voluntary, and let us think about what authority you need because this Committee wants to make sure you have the authority to do your job.

Chairman DONALDSON. Thank you. We would be delighted to do that.

Chairman SHELBY. Thank you, Mr. Chairman.

The hearing is adjourned.

[Whereupon, at 11:54 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF SENATOR MICHAEL B. ENZI

Chairman Donaldson, welcome back to the Senate Banking Committee. As this is your first hearing with us in the new Congress, I am sure your testimony and the following discussion will touch on many issues before the Commission. I look forward to your input on these matters today and in the months ahead.

There are a couple of issues in particular that come to mind. As you know, there is a problem right now on our military bases at home and abroad. Unscrupulous salespersons are selling our military servicemen and women unsuitable financial products and charging outrageous fees for them. This practice must be stopped. I am glad that the SEC is taking this situation seriously and that the sales and marketing regulations regarding these products is being duly enforced.

I also look forward to the conclusion of any ongoing investigations into these matters that you may be conducting. It is important that this situation not be allowed to continue any longer. I hope that you and the other Members of the Committee share my sense of urgency in this matter.

I was also pleased to see that the SEC has worked to address the implementation effects of the Sarbanes-Oxley Act. As an original cosponsor of this Act, I believe that the accounting reforms that it contains are crucial to the well-being of our Nation's markets and the confidence of its investors. However, it is clear that some companies, especially smaller ones, are having a difficult time becoming compliant by the original deadline. It was encouraging to see the SEC extend that deadline last December. As the SEC continues to implement these important accounting reforms, I would hope that they will make full use of their recently established Advisory Committee on Smaller Public Companies to gain important perspective from our Nation's small companies.

These are just two of many important issues that you will address today and in subsequent hearings before this Committee. I am eager to continue working with you and the Members of this Committee on all of them. Chairman Donaldson, I look forward to your testimony.

PREPARED STATEMENT OF WILLIAM H. DONALDSON

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

MARCH 9, 2005

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for inviting me to testify today on the state of the securities industry. I am glad to have the opportunity to answer any questions you may have concerning the securities industry generally. I understand, though, that you are particularly interested in the Commission's recent initiatives regarding market structure, credit rating agencies, mutual funds, and the implementation of the Sarbanes-Oxley requirements, and I plan to address these in detail in my opening remarks. As you know, the Commission has been devoting considerable resources to initiatives in each of these areas over the past few years. I welcome your continuing interest in these issues of such fundamental importance to the fairness and efficiency of the U.S. securities markets.

Regulation NMS

I will begin with a status report on Regulation NMS, a broad set of proposals designed to modernize and strengthen the regulatory structure of the U.S. equity markets. At present, the Commission is in the final stages of a particularly extensive and open rulemaking process that included publication of the original Regulation NMS proposal in February of last year, public hearings in April, a supplemental request for comment in May, and a reproposal in December. In fact, Regulation NMS is the product of more than 5 years of study and hard work by the Commission that included multiple public hearings and roundtables, an advisory committee, three concept releases, the issuance of temporary exemptions intended in part to generate useful data on policy alternatives, and a constant dialogue with industry participants and investors. The comment period on the reproposal of Regulation NMS expired on January 26, and the staff is in the midst of evaluating the comments and preparing a final package of rules for Commission consideration. I would expect the Commission to take action on Regulation NMS within the next several weeks.

In developing Regulation NMS, the Commission has been guided by the fundamental principles for the National market system that were established by Congress in 1975. In particular, the national market system is premised on promoting fair competition among markets, while at the same time assuring that all of those markets are linked together, through facilities and rules, in a system that promotes interaction between the orders of buyers and the orders of sellers in a particular security. As a result, the national market system incorporates two distinct types of competition—competition among markets and competition among orders. Over the years, the Commission's often difficult task has been to maintain the right balance between these two types of competition as technology and trading practices evolve.

The Commission has expended considerable effort to strike the appropriate balance in developing the proposals in each of the four substantive areas addressed by Regulation NMS—trade-throughs, market access, sub-penny quoting, and market data. Of these, the proposed trade-through rule has by far generated the most attention, and I would like to focus my remarks on that aspect of Regulation NMS. I would note, however, that the Commission has not yet taken final action on any part of Regulation NMS, and my fellow Commissioners and I are in the process of weighing and considering a number of different policy considerations, which each of us must do in deciding how ultimately to vote on the Regulation NMS proposals when they are put before the Commission.

Let me begin by emphasizing three important policy goals I believe would be furthered by the trade-through rule. First, the rule would provide an effective backstop, on an order-by-order basis, to a broker's duty of obtaining best execution for market orders. Retail investors typically expect their market orders to be executed at a price no worse than the relevant quotation at time of order execution, yet it can be difficult for investors to monitor whether their orders in fact are executed at the best price. The trade-through rule, in combination with a broker's duty of best execution, is designed to benefit retail investors by generally prohibiting the practice of executing orders at inferior prices.

Second, the trade-through rule is designed to promote fair and orderly markets and investor confidence by providing greater assurance that limit orders displaying the best prices are not bypassed by trades at inferior prices. Retail investors, in particular, may feel unfairly treated when they are the "most willing" buyer or seller and yet their best-priced limit orders are traded through. By protecting the best-priced orders, the rule is designed to promote a fair playing field for both small and large investors in the U.S. equity markets.

Finally, the trade-through rule is designed to encourage the use of limit orders and thereby contribute to greater market depth and liquidity. Displayed limit orders are the building blocks of public price discovery and efficient markets. Although there are many types of liquidity, displayed limit orders represent, by far, the most transparent and readily accessible source of liquidity. They also provide an essential benchmark that guides the use of other types of liquidity, such as undisplayed trading interest, matching systems, and dealer capital commitments. As a result, the enhanced displayed liquidity and public price discovery elicited by the trade-through rule should contribute to more efficient trading throughout the equity markets.

Turning to the proposed rule itself, I should stress that the trade-through rule, if adopted by the Commission, would take a substantially different and more comprehensive approach than the existing SRO and ITS trade-through rules. The trade-through rule would, for the first time, establish a uniform trade-through rule for *all* national market system (NMS) stocks. As a uniform rule, it would cover both exchange-listed stocks, which are governed by existing SRO trade-through rules, and Nasdaq stocks, which have never been subject to a trade-through rule. Furthermore, the rule would only protect *automated* quotations—in essence, those quotations against which an incoming order can execute immediately and without human intervention. It would not protect manual quotations. In so doing, the trade-through rule would correct a significant problem with the existing trade-though rules, which treat all quotes alike and effectively force fast markets to route orders to slow markets, where they can sometimes languish unfilled while the market moves away. The reproposed trade-through rule also would incorporate a series of discrete exceptions—including those that accommodate sweep orders, address rapidly changing or "flickering" quotes, and allow for "self-help" when a market experiences a systems malfunction—that are designed to assure the rule works in a relatively frictionless manner. Finally, the trade-through rule would eliminate significant gaps in the coverage of the existing trade-through rules—such as the exemptions for off-exchange block trades and 100-share quotes—that have seriously undermined the extent to which the SRO rules protect limit orders and promote fair and orderly trading.

I should note that the reproposal asked for comment on two alternatives to the scope of the automated quotations in each market that would be protected. The first alternative—the "Market BBO" alternative—would protect the best displayed bids and offers on each exchange, Nasdaq, and the NASD's Alternative Display Facility. The second alternative—the "Voluntary Depth" alternative—would protect not only the best quotes, but also orders below the best bid and above the best offer that a market *voluntarily* chooses to display in the consolidated quotation stream.

That said, I should point out that some Commissioners and commenters have questioned the need for a trade-through rule on the listed markets, where they believe that the current trade-through rule is ineffective. These same Commissioners and some commenters question whether the trade-through rule should be extended to Nasdaq, which they believe operates well without one. In their view, improved access to, and connectivity among, the competing markets, coupled with vigorous enforcement of best execution obligations, will best achieve fair, efficient, and liquid markets, and make a trade-through rule unnecessary. I have asked the staff to give serious consideration to all viewpoints as they develop final recommendations for Commission consideration.

Commission staff is in the midst of evaluating the more than 1,500 comment letters received on the two trade-through rule alternatives, as well as other aspects of the Regulation NMS reproposal. As I noted earlier, I have asked the staff to complete their analysis and prepare a recommendation for Commission consideration in short order. While the issues raised by the trade-through rule and other components of Regulation NMS are extremely complex and, in some cases, controversial, they have been thoroughly analyzed and debated over the course of many years, and I believe the time for action has arrived. I can assure you that the Commission will carefully consider the comments received on Regulation NMS—including many from you and your colleagues—and that we are committed to achieving a result that furthers the important policy objectives I have described without burdening the efficient operation of the markets.

Credit Rating Agencies

I will now turn to the Commission's recent work with respect to credit rating agencies. By way of background, the Commission originally used the term "Nationally Recognized Statistical Rating Organization" or "NRSRO" with respect to credit rating agencies in 1975 solely to differentiate between grades of debt securities held by broker-dealers as capital to meet Commission capital requirements. Since that time, ratings by NRSRO's have become benchmarks in Federal and State legislation, domestic and foreign financial regulations and privately negotiated financial contracts.

In the last few weeks, (1) the Commission staff has issued a no-action letter to A.M. Best, a privately owned and operated credit rating agency; (2) the Commission has proposed a rule that would define the term "NRSRO" with the goal of providing greater transparency to the process for identifying NRSRO's; and (3) the current NRSRO's are discussing with Commission staff a voluntary framework of standards to address important issues such as potential conflicts of interest. I will now discuss each step in detail.

A.M. Best

Last Thursday, on March 3, the Commission staff issued a no-action letter to A.M. Best providing assurance that the staff will not recommend enforcement action if ratings from A.M. Best are used by broker-dealers for purposes of the net capital rule. In effect, the no-action letter adds A.M. Best to the group of credit rating agencies considered "NRSRO's." Prior to A.M. Best, eight credit rating agencies had received NRSRO no-action letters from the Commission staff. However, consolidation during the 1990's, reduced the number of pre-A.M. Best NRSRO's to four firms: Dominion Bond Rating Service; Fitch; Moody's; and Standard & Poor's.

Proposed Rule Defining NRSRO

On March 3, the Commission voted to issue a rule proposal that would define the term "NRSRO" for purposes of Commission rules. The goal of the proposal is to provide greater clarity and transparency to the process of determining whether a credit rating agency's ratings should be relied on as NRSRO ratings for purposes of Commission rules. The definition and interpretations of the definition would provide credit rating agencies with a better understanding of whether they qualify as an NRSRO.

The rule proposal builds on earlier Commission work with respect to the role of credit rating agencies. This work included public Commission hearings, a report required by the Sarbanes-Oxley Act, and a 2003 concept release. Panel participants at the public hearings included NRSRO's, non-NRSRO credit rating agencies, broker-dealers, buy-side firms, issuers, the academic community, and SEC Commissioners. Most participants favored the regulatory use of credit ratings issued by NRSRO's as a simple, efficient benchmark of credit quality, and stated that standards for NRSRO's were necessary for this concept to have meaning.

In addition, the Commission conducted a study of credit rating agencies and submitted a report to the President and Congress under the Sarbanes-Oxley Act of 2002 on January 24, 2003. The report considers the role of credit rating agencies and their importance to the securities markets, impediments faced by credit rating agencies in performing that role, measures to improve information flow to the market from credit rating agencies, barriers to entry into the credit rating business, and conflicts of interest faced by credit rating agencies.

Finally, the Commission issued a concept release in June 2003 to further study issues raised in the Sarbanes-Oxley report. The concept release examined whether credit ratings should continue to be used for regulatory purposes under the Federal securities laws, and, if so, the process of determining whose credit ratings should be used, and the level of oversight to apply to such credit rating agencies. One conclusion that the Commission has drawn from its examination of the topic is that market participants would be well served by a clearer set of standards for determining whether or not a credit rating agency is an NRSRO.

The Commission's rule proposal of March 3 responds to a number of issues raised by commenters to the concept release. The proposal retains the NRSRO concept and proposes a definition of "NRSRO." Moreover, the Commission would interpret the elements of the definition to provide greater clarity as to the meaning of the term. In addition, in light of the longstanding reliance by broker-dealers, issuers, investors, and others on the existing no-action process, if the Commission adopted a definition of NRSRO, the Commission plans to continue to make its staff available to provide no-action letters, as appropriate. No-action letters would be granted for a specified period of time, after which the no-action relief would need to be reconsidered.

The Commission notes that this proposal is intended only to address the meaning of the term "NRSRO" as it is used by the Commission; it does not attempt to address many of the broader issues raised in response to the 2003 Concept Release, such as whether the NRSRO designation raises barriers to entry to the credit rating business, except for making clear that credit rating agencies that confine their activities to limited sectors of the debt market or to limited (or largely non-United States) geographic areas can qualify as NRSRO's. The Commission believes that to conduct a rigorous program of NRSRO oversight, more explicit regulatory authority from Congress is necessary. We believe that a well-thought-out regulatory regime could provide significant benefits in such areas as record-keeping and addressing conflicts of interest in the industry. It will be important to ensure that the public does not misconstrue any regulatory authority over credit rating agencies as a statement that the Government has vouched for the accuracy or quality of a credit rating.

The Voluntary Framework

Finally, the current NRSRO's have sought to craft a framework for voluntary oversight by the Commission. Discussions are ongoing concerning the precise terms of a framework. It is not clear at this time what form that framework might take. It is hoped that the framework will enhance oversight of NRSRO's from current levels by providing a means by which the Commission staff can assess on an ongoing basis whether an NRSRO continues to meet the "NRSRO" definition.

It is important to recognize that even if the industry does adopt such a framework, it would not give the Commission the same authority that actual legislative authority could. For example, if a credit rating agency failed to observe a provision of the voluntary framework, the Commission would not be able to bring an enforcement action. Moreover, the framework does not envision direct inspections by Commission staff, and the Commission would instead be in a position of relying on inspections conducted by third parties hired by the credit rating agencies. Accordingly, if Congress believes more extensive Commission oversight is appropriate than possible with a voluntary framework, legislation may be needed even if the industry does in fact adopt a voluntary framework.

Congressional attention would be especially useful because the question of whether to impose a regulatory regime on the credit rating industry raises a number of important policy considerations that would need to be examined, including First Amendment issues. The Commission welcomes Congressional attention and, of course, would stand ready to work with Congress on crafting appropriate legislation if Congress determines that such legislation is necessary.

Mutual Fund Rulemaking

I turn now to another area of significant Commission focus and reform activity—mutual funds. Last year, in the wake of the mutual fund late trading and market timing scandals, the Commission undertook an aggressive mutual fund reform agenda. The reforms were designed to (1) improve the oversight of mutual funds by enhancing fund governance, ethical standards, and compliance and internal controls; (2) address late trading, market timing, and certain conflicts of interest; and (3) improve disclosures to fund investors, especially fee-related disclosures. It is my hope and expectation that, taken together, these reforms will minimize the possibility of the types of abuses we witnessed in the past 18 months from occurring again.

When I last testified before this Committee on mutual fund reform on April 8, 2004, we had taken final action on just two of our mutual fund reform initiatives, although many were in the proposal stage. Today, I am pleased to announce that we have adopted 10 of our initiatives and expect to complete the few remaining matters on our reform agenda in the coming months. I would like to review for you the significant steps we have taken to strengthen and improve the mutual fund regulatory framework.

Enhancing Internal Oversight

Fund Governance Reforms: With respect to enhancing mutual fund governance and internal oversight, a centerpiece of the Commission's reform agenda was the fund governance initiative. In July 2004, the Commission adopted reforms providing that funds relying on certain exemptive rules must have an independent chairman, and 75 percent of board members must be independent.[1] In addition, the independent directors to these funds must engage in an annual self-assessment and hold separate "executive sessions" outside the presence of fund management. The Commission also clarified that these independent directors must have the authority to hire staff to support their oversight efforts. These fund governance reforms will enhance the critical independent oversight of the transactions permitted by the exemptive rules. Funds must comply with these requirements by January 16, 2006.

As I have said before, I believe that a management company executive who sits as chair of a fund's board is asked to do the impossible—serve two masters. There are times when the executive's duties to the management company and its shareholders simply conflict with what is in the best interest of fund investors. This is the case, for instance, when fund boards review many of the transactions permitted by our exemptive rules. I believe that an independent chairman and a 75 percent majority of independent directors level the playing field on behalf of fund investors and blunt the control and dominance that many management companies historically have exerted in fund boardrooms. Our fund governance reforms will also facilitate the effective implementation of other mutual fund initiatives the SEC has adopted and will put forward.

Compliance Policies and Procedures and Chief Compliance Officer Requirement: One of the most important of these initiatives, adopted in December 2003, requires that funds and their advisers have comprehensive compliance policies and procedures and appoint a chief compliance officer. In the case of a fund, the chief compliance officer is answerable to the fund's board and can be terminated only with the board's consent. The chief compliance officer must report to the fund's board regarding compliance matters on at least an annual basis. Funds and advisers were required to comply with these new requirements beginning October 5, 2004. We believe that making these changes to the mutual fund compliance infrastructure, and the increased focus on compliance that comes from the new chief compliance officer requirement will help to minimize the kinds of compliance weaknesses that led to the mutual fund scandals.

Code of Ethics Requirement: In July 2004, the Commission adopted a new rule that requires registered investment advisers, including advisers to funds, to adopt a code of ethics that establishes the standards of ethical conduct for each firm's employees. The code of ethics rule represents an effort by the Commission to reinforce the fundamental importance of integrity in the investment management industry. Investment advisers were required to comply with the new code of ethics requirement as of February 1, 2005.

Addressing Late Trading, Abusive Market Timing and Directed Brokerage for Distribution

Late Trading/Hard 4:00 Proposal: To address the problems associated with late trading (which involves purchasing or selling mutual fund shares after the time a fund prices its shares—typically 4:00—but receiving the price that is set before the fund prices its shares), the Commission proposed the so-called "hard 4:00" rule. This rule would require that fund orders be received by the fund, its designated transfer agent or a clearing agency by 4 p.m. in order to be processed that day.

[1] Commissioners Glassman and Atkins dissented, raising several concerns regarding the need for and effectiveness of this rulemaking.

We have received numerous comments raising concerns about this approach. In particular, we are concerned about the difficulties that a hard 4:00 rule might create for investors in certain retirement plans and investors in different time zones. Consequently, our staff is focusing on alternatives to the proposal that could address the late trading problem, including various technological alternatives. The technological alternatives could include a tamper-proof time-stamping system and an unalterable fund order sequencing system. These technological systems could be coupled with enhanced internal controls, third party audit requirements and certifications.

Our staff has been gathering information from industry representatives to better understand potential technological systems that could be used to address the late trading problem. Given the technological implications of any final rule in this area, it is important that we get it right. Thus, I have instructed the staff to take the time necessary to fully understand the technology issues associated with any final rule. Consequently, the Commission likely will not consider a final rule in this area until mid-2005.

Market Timing/Redemption Fee Rule: Last week, the Commission adopted a "voluntary" redemption fee rule, which permits (but does not require) funds to impose a redemption fee of up to 2 percent. The rule requires that fund boards consider whether they should impose a redemption fee to protect fund shareholders from market timing and other possible abuses. The voluntary rule represents a change from the "mandatory" approach proposed by the Commission. Many commenters opposed a mandatory redemption fee rule because of concerns that investors would inadvertently trigger the fee's application and because a 2 percent redemption fee may not be appropriate in all cases.

When the Commission adopted the new rule, we also requested comment on whether to require that any redemption fee imposed by a fund conform to certain uniform standards. This standardization may facilitate imposition and collection of redemption fees throughout the fund industry. I am hopeful that we will quickly reach a decision on this part of the rule, after we hear back from commenters.

The new rule also mandates that funds be able to access information from intermediaries operating omnibus accounts, so that funds can identify shareholders in those accounts who may be violating a fund's market timing policies. Under these arrangements, the intermediaries and funds would share responsibility for enforcing fund market timing policies. I should also note that fair value pricing remains critical to eliminating arbitrage opportunities for market timing.

Directed Brokerage Ban: In September 2004, the Commission adopted amendments to Rule 12b–1 under the Investment Company Act to prohibit mutual funds from directing commissions from their portfolio brokerage transactions to broker-dealers to compensate them for distributing fund shares. The Commission's concern was that this practice can compromise best execution of portfolio trades, increase portfolio turnover, conceal actual distribution costs, and inappropriately influence broker-dealer recommendations to investors. In adopting the ban, the Commission determined that directing brokerage for distribution represented the type of conflict that was too significant to address by disclosure alone. The directed brokerage ban went into effect December 13, 2004.

Improving Disclosures to Fund Investors

Improved mutual fund disclosure—particularly disclosure about fund fees, conflicts and sales incentives—has been a stated priority for the Commission's mutual fund program throughout my tenure as Chairman, even before the mutual fund scandals came to light. As such, disclosure enhancements have been an integral part of our reform initiatives. As part of our mutual fund reform agenda, we have adopted the following disclosure reforms, all of which have become effective.

Shareholder Reports: In February 2004, the Commission adopted significant revisions to mutual fund shareholder reports. These revisions include dollar-based expense disclosure, quarterly disclosure of portfolio holdings, and a streamlined presentation of portfolio holdings in shareholder reports. These requirements became effective in August 2004.

Disclosure Regarding Market Timing, Fair Valuation, and Selective Disclosure of Portfolio Holdings: In April 2004, the Commission adopted amendments requiring funds to disclose (1) market timing policies and procedures, (2) practices regarding "fair valuation" of their portfolio securities and (3) policies and procedures regarding the disclosure of their portfolio holdings. Each of these disclosures specifically addresses abuses that came to light in the mutual fund scandals. These requirements became effective in May 2004.

Breakpoint Discounts: In June 2004, the Commission adopted rules requiring mutual funds to provide enhanced disclosure regarding breakpoint discounts on front-end sales loads, in order to assist investors in understanding the breakpoint opportunities available to them. This initiative addresses the failure on the part of many broker-dealers to provide sales load discounts to mutual fund investors who were entitled to them. The requirement became effective in July 2004.

Board Approval of Investment Advisory Contracts: Also in June 2004, the Commission adopted rules requiring that shareholder reports include a discussion of the reasons for a fund board's approval of its investment advisory contract. The disclosure is intended to focus directors' and investors' attention on the importance of the contract review process and the level of management fees. This requirement became effective in August 2004.

Disclosure Regarding Portfolio Manager Conflicts and Compensation: In August 2004, the Commission required that funds provide additional information regarding portfolio manager conflicts and compensation, including information about other investment vehicles managed by a fund's portfolio manager, a portfolio manager's investment in the funds he or she manages and the structure of the portfolio manager's compensation. These requirements became effective in October 2004.

Point of Sale/Fund Confirmations: In addition to these adopted reforms, last week, on March 1, the Commission requested additional comment on a proposal requiring brokers to provide investors with enhanced information regarding costs and broker conflicts associated with their mutual fund transactions. The proposal would require disclosure at two key times—first at the point of sale, and second at the completion of a transaction in the confirmation statement. We tested our proposal with investor focus groups, and based on the very helpful feedback we received from these focus groups, we issued our request for additional comment. We also are sensitive to the concerns expressed by brokerage industry commenters about the costs associated with our original proposal. Our staff therefore is examining more cost-effective methods of providing investors with the disclosures they need. I am hopeful that the Commission can move quickly on this initiative after we have an opportunity to review the comments that respond to our recent request for input.

Upcoming Mutual Fund Initiatives

Having outlined the Commission's progress on our mutual fund reform agenda, I would like to highlight some additional mutual fund related initiatives that are on the horizon.

Portfolio Transaction Costs Disclosure: In December 2003, the Commission issued a concept release requesting comment on measures to improve disclosure of mutual fund transaction costs. In many cases, investors do not understand how the costs associated with the purchase and sale of a mutual fund's portfolio securities affect their bottom-line investment in the fund. These transaction costs can include the payment of commissions and spreads as well as costs associated with soft dollars and other brokerage arrangements. Transaction costs also can encompass costs that are difficult to quantify, such as opportunity costs and market impact costs. Using feedback that we received in response to our concept release, our staff is preparing a proposal to improve disclosure of mutual fund transaction costs.

Soft Dollars: I believe it is necessary to examine the nature of the conflicts of interest that can arise from soft dollars, which involve an investment adviser's use of brokerage commissions to purchase research and other products and services. Consequently, I have formed a Commission task force that is reviewing the use of soft dollars, the impact of soft dollars on our Nation's securities markets and whether soft dollars further the interests of investors. In addition, the task force is reviewing whether we can improve disclosure to better inform investors about the use of soft dollars and whether there are enhanced disclosures that can be made to fund boards to enable them to better evaluate funds' use of soft dollars. The Task Force also is examining the definition of "research" as used in Section 28(e) of the Securities Exchange Act of 1934. Soft dollar arrangements present many of the same concerns irrespective of whether research is provided on a proprietary basis, or by an independent research provider, and I expect that any recommendations from the staff would accord similar treatment to both types of arrangement.

Rule 12b–1: When the Commission proposed to ban directed brokerage for distribution under Rule 12b–1, it also requested comment on the broader question of whether Rule 12b–1 (which allows mutual fund assets to be used to promote the sale of fund shares) should be revised more broadly or even eliminated. The Commission received numerous comments on this issue. The Commission adopted Rule 12b–1 over 20 years ago, and the mutual fund industry has evolved significantly since then. The idea of using Rule 12b–1 fees as a substitute for a sales load—which in many cases they have come to be—is different than the use of 12b–1 fees for advertising and marketing purposes, which was envisioned when the Rule was adopted. In light of these changes in the industry and in the use of 12b–1 fees, the future of Rule 12b–1 is a topic that should receive a thorough and reasoned review.

Mutual Fund Disclosure Reform: As I outlined above, the Commission has adopted a number of new mutual fund reform initiatives designed to improve the disclosures made to fund investors. Each of these disclosure reforms was merited. However, I believe it is time to step back and take a top-to-bottom assessment of our mutual fund disclosures. I have asked the staff to carry out a comprehensive review of the mutual fund disclosure regime and how we can maximize its effectiveness on behalf of fund investors. The staff also will examine how we can make better use of technology, including the Internet, in our disclosure regime. Throughout this review process, we will solicit input from mutual fund investors.

Sarbanes-Oxley Implementation

Two years ago, when I came on board at the Commission, the country was still reeling from its disappointment with cooked books, indefensible lapses in audit and corporate governance responsibilities, and intentional manipulation of accounting rules. These lapses led to staggering financial losses and a crisis in investor confidence. The resulting Sarbanes-Oxley Act called for the most significant reforms affecting our capital markets since the Securities Exchange Act of 1934. The Act established the foundation necessary to improve financial reporting and the behavior of companies and gatekeepers, and we have completed the rulemaking to implement these critically important reforms. Key requirements have taken hold including:

- CEO and CFO certifications of the material completeness and accuracy of SEC periodic filings;
- Enhanced disclosure of off-balance sheet transactions;
- Electronic reporting within two business days of insider transactions;
- Increased disclosure of material current events affecting companies;
- Strengthened rules regarding the independence of auditors and audit committees;
- Establishment of the PCAOB;
- Issuance of the first PCAOB inspection reports on the large accounting firms;
- Issuance of important auditing standards by the PCAOB; and
- For the first time, as required by Section 404 of the Act, public reporting on internal controls and their effectiveness—by both management and auditors.

I would like to focus for a moment on the Section 404 requirement for management and a company's auditor to report on the effectiveness of internal controls over financial reporting. This Section of Sarbanes-Oxley may have the greatest long-term potential to improve financial reporting. It may also well be the most urgent financial reporting challenge facing a large share of corporate America and the audit profession in 2005. I expect that we will begin to see a number of companies announce that they or their auditors have been unable to complete their assessments or audits of controls, and additional companies announce that they have material weaknesses in their controls.

For this initial pass, that result should not, by itself, necessarily be motivation for immediate or severe market reactions. Section 404 is a disclosure provision, and investors will benefit from receiving full disclosure regarding any material weaknesses that are found—full disclosure about the nature of any material weakness, their impact on financial reporting and the control environment and management's plans for remediating them. This disclosure will allow investors and markets to make the appropriate judgments about what companies and auditors find. Section 404 will work as intended if it brings this information into public view, and in that event the disclosure of material weaknesses in internal controls should be the beginning and not the end of the analysis for investors and markets. The goal should be continual improvement in controls over financial reporting and increased investor information and confidence. This should lead to better input for management decisions and higher quality information being provided to investors.

While these benefits are clear, it is also important that we evaluate the implementation of our rules and the auditing standard issued by the Public Company Accounting Oversight Board (PCAOB) to ensure that these benefits are achieved in the most sensible way. We have been very sensitive to the implementation of all aspects of the Sarbanes-Oxley Act, and especially to this very significant aspect. This has included several measured extensions over this past year to accommodate the first wave of reporting.

In addition, in order to assess SEC and PCAOB rules for Section 404 now that we will have the first year of actual experience under the rules, the Commission will hold a roundtable discussion this April and is currently soliciting written feedback from the public regarding registrants' and accounting firms' implementation of these new reporting requirements. Through the roundtable and this feedback, we will be closely listening to and assessing the experiences with the management and auditor internal control requirements, including seeking to identify best practices for the preparation of these reports and evaluating whether there are ways to make the process more efficient and effective, while fully preserving the benefits of the requirements. Throughout this process the Commission and its staff will closely coordinate with the PCAOB and its staff, and we will seriously consider whether any additional guidance is necessary or appropriate. We are actively engaged in other activities to evaluate and assess the effects of the recent reforms, including the internal control reporting rules. For example, we have announced we are establishing the Securities and Exchange Commission Advisory Committee on Smaller Public Companies. The advisory committee will conduct its work with a view to protecting investors, considering whether the costs imposed by the current regulatory system for smaller public companies are proportionate to the benefits, and identifying methods of minimizing costs and maximizing benefits. In addition, and at the request of Commission staff, a task force of the Committee of Sponsoring Organizations (COSO) has been established and anticipates publishing additional guidance this summer in applying COSO's framework to smaller companies. Our actions have not been limited to smaller companies. We also are cognizant of the regulatory challenges our foreign registrants face. For all of these reasons, we recently extended the compliance date for internal control reporting for an additional year for smaller and foreign public companies. Review of the first year experiences of our larger registrants also should help smaller and foreign issuers in preparing their first reports.

Conclusion

This testimony covers a broad spectrum of serious and very complex issues the Commission is currently dealing with. There are a number of other substantive activities underway at the Commission as well, but I have tried to limit my update to the things I understand are foremost on your minds. I thank the Members of this Committee for your interest and attention to the important issues affecting the securities markets today, and for the support you have shown the Commission and its staff. Together, we have made significant progress over the last several years in rebuilding public confidence in our markets. This concludes my prepared testimony. I would be glad to try and answer any questions you may have.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM WILLIAM H. DONALDSON

Q.1. I have been contacted by representatives of the National Treasury Employees Union Chapter 293 representing 2,800 employees at the U.S. Securities and Exchange Commission expressing concerns about the parity of benefits paid to SEC employees. As you are aware, Section 8 of the Investor and Capital Markets Fee Relief Act, Public Law 107–123, provides that "In setting and adjusting the total amount of compensation and benefits for employees, the Commission shall consult with, and seek to maintain comparability with, the agencies referred to under Section 1206 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (12 U.S.C. 1833b)."

In relevant part, the union chapter has written the following:

> [W]hy [does] the SEC refuse . . . to give employees a Supplemental 401(k) with 5 percent employer match—a comparable FIRREA benefit?

Pay Parity Lite—SEC Chairman Pitt testified in April 2002 that his $76 million pay parity request "is lower than the amount that we believe would be required to match what several of the banking agencies currently provide. A fully implemented system identical to the FDIC model, for example, could easily cost more than $100 million." See paragraphs 6 & 8, April 17, 2002 testimony by Chairman Pitt before Subcommittee on Commerce, Justice, State, and the Judiciary, Committee on Appropriations, U.S. House of Representatives.

The Supplemental 401(k) benefit is the major difference between the SEC and FDIC:

- FDIC: Supplemental 401(k), 5 percent match
- OCC: Supplemental 401(k), 3 percent match
- FHFB: Supplemental 401(k), 3 percent match
- OTS: Supplemental 401(k), 2 percent match
- SEC: No Supplemental 401(k) plan

Management has advanced 2 arguments against the Supplemental 401(k):

- too expensive and
- conflict of interest by SEC retaining a "regulated entity" 401(k) Administrator.

Regarding the "too expensive" argument, management refuses to provide any cost information to justify their position—blithely ignoring both: (1) the statutory requirement[1] of comparable pay and benefits with FIRREA agencies and (2) Federal Service Impasses Panel Order[2] requiring SEC to provide NTEU with relevant pay and benefit information. Further, we note that the SEC returned $125 million of its budget over the past 2 years.

Regarding the "conflict of interest" argument, we told SEC management about Pentegra Group, who is not subject to SEC jurisdiction and administers the OTS Supplemental 401(k). Moreover, the

[1] 5 U.S.C. Sec. 4802. Similarly, SEC is ignoring the same statute by failing to report annually to Congress how it is maintaining pay parity with the FIRREA's.

[2] See *In the Matter of SEC* v. *NTEU,* Case No. 02 FSIP 122 (2002) which reads, in part: "The parties agree to establish a Labor/Management Committee for the purpose of sharing information that is reasonably available and necessary for a full and proper discussion, understanding, and negotiations of benefits and compensation." Page 10 Item VII. Benefits and Compensation.

conflict of interest issue has not stopped the SEC from purchasing goods and services from hundreds of SEC registrants (that is, Microsoft, Dell, and Dreyfus to name a few). Management's failure to support their arguments or consider union solutions speaks volumes.

Recently, SEC managers proposed a substitute in lieu of the Supplemental 401(k) program that would require Congressional legislation amending the Federal Employee Retirement System statute to specifically allow SEC to increase its contribution to Thrift Savings Plan accounts from the government-wide 5 percent cap to 7 percent. In response to this proposal, the union requested:

- copies of their draft legislation;
- list of Congressional sponsors;
- a list of the Congressional Committees approached by the SEC regarding the proposed legislation;
- whether OMB had considered and approved SEC initiative;
- whether SEC was aware of the FERS statute being amended to allow other agencies to do what the SEC proposed;
- timeline for completing the legislation and implementing the Supplemental 401(k).

Management was either unable or unwilling to provide any information to the above information request. Given the embryonic and problematic state of management's proposal, the union questioned why the Pentegra Administered Supplemental 401(k) program option is not being pursued . . . .

In sum, . . . why [is it that the] SEC refuses to provide SEC employees with a Supplemental 401(k) and 5 percent Employer Match, considered to be the "crown jewel" of comparable FIRREA benefits.

I would appreciate your reviewing these concerns and providing an appropriate response in light of the Act.

A.1. The Commission is fulfilling the Congress' mandate that it provide its employees with overall pay and benefits comparable to those provided by the "FIRREA agencies." Looking to the full panoply of benefits that agencies provide, rather than a single benefit like a 401(k) plan, data from 2004 shows the Commission provided benefits that average 28 percent of an employee's salary, above an average of 26.5 percent of salaries provided by other financial regulators. The pay and benefits that the Commission provides have greatly enhanced staff retention, a primary goal of pay parity. For fiscal year 2004, the last year for which complete data is available, the SEC's turnover rate was approximately 6 percent, which is comparable with the turnover rates for fiscal years 2002 and 2003 and well below the Agency's prepay parity rates of the late-1990's. Within the constraints of the Commission's budgets, the Commission is committed to continuing to enhance its overall employee benefits to maintain comparability and sustain its success in employee retention.

As part of maintaining overall comparability, the Commission is interested in being able to adjust the retirement benefits for its employees. Conflict-of-interest concerns, however, make it far more difficult for the Commission to fashion a Supplemental 401(k) than it was for the FIRREA agencies. Unlike the FIRREA agencies, the

Commission has regulatory authority over any firm that would serve as an investment adviser. Such conflict-of-interest concerns are not present, that is, in the Commission's dealings with other vendors, such as Dell, Microsoft, or Dreyfus (over whose day-to-day business practices the Commission does not have such regulatory authority).

The Commission is exploring the feasibility of increasing matching contributions to employees' TSP accounts. This approach would avoid the 401(k) conflict-of-interest issues discussed above and result in far lower administrative costs—costs that would provide no direct benefit to SEC employees—than a stand-alone 401(k). However, since 5 U.S.C. 8432(c)(2) currently caps agency TSP contributions at 5 percent, it appears that additional legislative authority would be needed before we would be able to implement this approach. The Commission staff is available to show your staff how 5 U.S.C. 4802 could be amended to override that cap, which the Commission would suggest setting to an increased level of 7 percent.

Separately, 5 U.S.C. Section 4802(d)(1)(B)(ii) states that the Commission shall include, "the *effects* of implementing the plan . . . in the annual program performance report submitted" to Congress. The primary effect of pay parity that the SEC currently measures is the Agency's turnover rate, as discussed above. The SEC has provided this information to Congress in the Performance Budget chapter of its fiscal year 2006 Congressional Budget request. In addition, this information also has been included in the Agency's fiscal year 2004 performance and accountability report.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR ALLARD FROM WILLIAM H. DONALDSON

Q.1. I am aware that at the December 15 meeting of the SEC, staff responding to a question by Commissioner Campos indicated that a solution might be at hand to move Nasdaq's exchange application forward.

Could you comment on these developments and perhaps give us an update on this process?

A.1. In December, Nasdaq filed a proposal that would change its Nasdaq Market Center Execution Service, formally known as SuperMontage, to require that all trades executed in the Nasdaq Market Center Execution Service be executed in price/time priority. This proposal has been published and is on our website *(http://www.sec.gov).* While neither I nor the Commission have come to any conclusions about this filing, I believe this proposal is a significant step in Nasdaq's exchange application process.

As currently proposed, the Nasdaq Exchange would not have price priority rules, in contrast to the requirements of all other U.S. exchanges. Price priority rules promote order interaction, which facilitates the price discovery process. The lack of price priority rules in Nasdaq's exchange application raised profound market structure issues that could have had implications for all of our registered exchanges and ultimately investors. The proposal filed in December is intended to address this concern

The staff is also working with Nasdaq and the NASD to resolve how over-the-counter trades will be reported once they are no longer printed on Nasdaq's Market Center Execution Service. I anticipate that the NASD will be filing a proposal shortly, which the Commission will publish. Once the issue of price priority rules is resolved, I expect that the Commission would be in a position to act on Nasdaq's exchange application.

Q.2. The New York Stock Exchange would say that the hybrid market proposal is their response to customer demands for greater speed and certainty as well as providing more choices to execute their orders. Would you agree that the NYSE proposal demonstrates the benefits of competition between markets?

I was hoping you could tell me the status of the SEC's consideration of the NYSE's hybrid market filing?

A.2. The New York Stock Exchange (NYSE) has proposed to significantly alter its existing auction market structure by expanding automatic executions on its market. This proposal reflects the impact of both competition and regulation on the markets.

Among other things, the NYSE proposes to automatically execute in its Direct+ system all marketable limit orders, market orders, and ITS commitments, regardless of size. The details of enhanced auto-ex capabilities and other changes contemplated by the NYSE's Hybrid proposal can be found at *http://www.sec.gov/rules/sro/nyse/3450667.pdf.*

The NYSE Hybrid proposal was most recently published for comment in November 2004. The Commission has received a total of25 comments to the proposal. On May 25, the NYSE submitted an amendment to its Hybrid proposal. The Commission is currently reviewing this recent submission and will soon publish the amended Hybrid proposal for another round of public comment before taking any final action.

Q.3. Nasdaq and the NYSE currently have some structural differences.

With the trade-through rule being changed from its current function to having a fast/slow component, I am hoping to get your insights on whether the Commission has considered initially retaining a reformed trade-through rule for NYSE stocks. Perhaps then, that would allow for an extended amount of time to study and analyze the results with the NYSE, complimented by hybrid fast/slow system, as they have proposed.

Would it be feasible for the Commission to allow Nasdaq to continue to rely on best execution, and come back to trade-through in a few years and decide if either market or both markets need a trade-through rule?

A.3. As you know, the Commission voted to adopt Regulation NMS on April 6, 2005. Prior to adopting Regulation NMS, the Commission considered the need to extend the Order Protection Rule to Nasdaq stocks. The Commission received comment both supporting and opposing applying the Rule to Nasdaq stocks.

Many commenters strongly supported the adoption of a uniform rule for all NMS stocks to promote best execution of market orders, to protect the best displayed prices, and to encourage the public display of limit orders. They stressed that limit orders are the cornerstone of efficient, liquid markets and should be afforded as much protection as possible. They noted, for example, that limit orders typically establish the "market" for a stock. In the absence of limit orders setting the current market price, there would be no benchmark for the submission and execution of marketable orders. Focusing solely on best execution of marketable orders (and the interests of orders that *take* displayed liquidity), therefore, would miss a critical part of the equation for promoting the most efficient markets (for example, the best execution of orders that *supply* displayed liquidity and thereby provide the most transparent form of price discovery). Commenters supporting the need for an intermarket trade-through rule also believed it would increase investor confidence by helping to eliminate the impression of unfairness when an investor's order executes at a price that is worse than the best displayed quotation, or when a trade occurs at a price that is inferior to the investor's displayed order.

Other commenters, in contrast, opposed any intermarket trade-through rule. Some commenters who were opposed to any trade-through rule expressed the view that there is a lack of empirical evidence justifying the need for intermarket protection against trade-throughs in that market. They noted, for example, that trading in Nasdaq stocks has never been subject to a trade-through rule, while trading in exchange-listed stocks, particularly NYSE stocks, has been subject to the ITS trade-through provisions. Given the difference in regulatory requirements between Nasdaq and NYSE stocks, many commenters relied on two factual contentions to show that a trade-through rule is not needed: (1) fewer trade-throughs occur in Nasdaq stocks than NYSE stocks; and (2) trading in Nasdaq stocks currently is more efficient than trading in NYSE stocks. Based on these factual contentions, opposing commenters concluded that a trade-through rule is not necessary to promote efficiency or to protect the best displayed prices.

The Commission carefully evaluated the views of these commenters on both the original proposal and the reproposal. In addition, Commission staff prepared several studies of trading in Nasdaq and NYSE stocks to help assess and respond to commenters' claims, which are available on the Commission's website. In general, the Commission found that current trade-through rates are not lower for Nasdaq stocks than NYSE stocks, despite the fact that nearly all quotations for Nasdaq stocks are automated, rather than divided between manual and automated as they are for exchange-listed stocks. Moreover, the majority of the trade-throughs that currently occur in NYSE stocks fall within gaps in the coverage of the existing ITS trade-through rules that will be closed by the Order Protection Rule. Consequently, the Order Protection Rule, by establishing effective intermarket protection against trade-throughs, will materially reduce the trade-through rates in both the market for Nasdaq stocks and the market for exchange-listed stocks.

In addition, the commenters' claim that the Order Protection Rule is not needed because trading in Nasdaq stocks, which currently does not have any trade-through rule, is more efficient than trading in NYSE stocks, which has the ITS trade-through provisions, also is not supported by the relevant data. The data reveals that the markets for Nasdaq and NYSE stocks each have their particular strengths and weaknesses. In assessing the need for the

Order Protection Rule, the Commission has focused primarily on whether effective intermarket protection against trade-throughs will materially contribute to a fairer and more efficient market for investors in Nasdaq stocks, given their particular trading characteristics, and in exchange-listed stocks, given their particular trading characteristics. Thus, the critical issue is whether each of the markets would be improved by adoption of the Order Protection Rule, not whether one or the other currently is, on some absolute level, superior to the other. The Commission believes that effective intermarket protection against trade-throughs will produce substantial benefits for investors in both markets and, therefore, adopted the Order Protection Rule for both Nasdaq and exchange-listed stocks.

Some commenters argued that competitive forces alone would achieve the fairest and most efficient markets. In particular, they asserted that reliance on efficient access to markets and brokers' duty of best execution would be sufficient without the need for an intermarket rule against trade-throughs. This argument, however, fails to take into account two structural problems—principal/agent conflicts of interest and "free-riding" on displayed prices.

Agency conflicts may occur when brokers have incentives to act otherwise than in the best interest of their customers. For example, brokers may have strong financial and other interests in routing orders to a particular market, which may or may not be displaying the best price for a stock. Moreover, the Commission has not interpreted a broker's duty of best execution for retail orders as requiring that a separate best execution analysis be made on an order-by-order basis. Nevertheless, retail investors generally expect that their small orders will be executed at the best displayed prices. They may have difficulty monitoring whether their individual orders miss the best displayed prices at the time they are executed and evaluating the quality of service provided by their brokers. Given the large number of trades that fail to obtain the best displayed prices (for example, approximately 1 in 40 trades for both Nasdaq and NYSE stocks), the Commission is concerned that many of the investors that ultimately received the inferior price in these trades may not be aware that their orders did not, in fact, obtain the best price. The Order Protection Rule will backstop a broker's duty of best execution on an order-by-order basis by prohibiting the practice of executing orders at inferior prices, absent an applicable exception.

Just as importantly, even when market participants act in their own economic self-interest, or brokers act in the best interests of their customers, they may deliberately choose, for various reasons, to bypass (for example, not protect) limit orders with the best displayed prices. For example, an institution may be willing to accept a dealer's execution of a particular block order at a price outside the NBBO, thereby transferring the risk of any further price impact to the dealer. Market participants that execute orders at inferior prices without protecting displayed limit orders are effectively "free-riding" on the price discovery provided by those limit orders. Displayed limit orders benefit all market participants by establishing the best prices, but, when bypassed, do not themselves receive a benefit, in the form of an execution, for providing this public good. This economic externality, in turn, creates a disincentive for investors to display limit orders and ultimately could negatively affect price discovery and market depth and liquidity.

As demonstrated by the current rate of trade-throughs of the best quotations in Nasdaq and NYSE stocks, these structural problems often can lead to executions at prices that are inferior to displayed quotations, meaning that limit orders are being bypassed. The frequent bypassing of limit orders can cause fewer limit orders to be placed. The Commission therefore believes that the Order Protection Rule is needed to encourage greater use of limit orders. The more limit orders available at better prices and greater size, the more liquidity is available to fill incoming marketable orders. Moreover, greater displayed liquidity will at least lower the search costs associated with trying to find liquidity. Increased liquidity, in turn, could lead market participants to interact more often with displayed orders, which would lead to greater use of limit orders, and thus begin the cycle again. We expect that the end result will be a national market system that more fully meets the needs of a broad spectrum of investors.

Q.4.a. This question pertains to the trade-through rate at Nasdaq versus the trade-through rate at NYSE—I remember it came up last July when you and various market participants testified before this Committee. I have been told that Nasdaq and NYSE have similar trade-through rates of about 2 percent. What is the Commission's justification for imposing the trade-through rule to Nasdaq when there remains little to no evidence that the rule yields measurable results?

A.4.a. One principal factual contention of commenters on the original proposal who were opposed to a trade-through rule is premised on the claim that there are fewer trade-throughs in Nasdaq stocks, which are not covered by any trade-through rule, than in NYSE stocks, which are covered by the ITS trade-through provisions. To respond to these commenters, the Commissions staff reviewed public quotation and trade data to estimate the incidence of trade-throughs for Nasdaq and NYSE stocks. In general, the Commission has found that current trade-through rates are not lower for Nasdaq stocks than NYSE stocks, despite the fact that nearly all quotations for Nasdaq stocks are automated, rather than divided between manual and automated as they are for exchange-listed stocks. Moreover, the majority of the trade-throughs that currently occur in NYSE stocks fall within gaps in the coverage of the existing ITS trade-through rules that will be closed by the Order Protection Rule. Consequently, the Commission believes that the Order Protection Rule, by establishing effective intermarket protection against trade-throughs, will materially reduce the trade-through rates in both the market for Nasdaq stocks and the market for exchange-listed stocks.

Some commenters questioned whether the trade-through rates found by the staff study were significant enough to warrant adoption of the trade-through reproposal. The Commission does not agree that the trade-through rates found in the staff study are insignificant, nor does it believe that the total number of trade-throughs is the sole consideration in evaluating the need for the

Order Protection Rule. A valid assessment of their significance and the need for intermarket protection against trade-throughs must be made in light of the Exchange Act objectives for the NMS that would be furthered by the Order Protection Rule, including: (1) to promote best execution of customer market orders; (2) to promote fair and orderly treatment of customer limit orders; and (3) by strengthening protection of limit orders, to promote greater depth and liquidity for NMS stocks and thereby minimize investor transaction costs. The staff study examined trade-through rates from a variety of different perspectives, including percentage of trades, percentage of total share volume, percentage of share volume of trades of less than 10,000 shares, and percentage of total share volume of traded-through quotations. In evaluating the need for the Order Protection Rule, the different measures vary in their relevance depending on the particular objective under consideration.

For example, the percentage of total trades that receive inferior prices is a particularly important measure when assessing the need to promote best execution of customer market orders. The staff study found that 1 of every 40 trades (2.5 percent) for both Nasdaq and NYSE stocks have an execution price that is inferior to the best displayed price, or approximately 98,000 trades per day in Nasdaq stocks alone. Investors (and particularly retail investors) often may have difficulty monitoring whether their orders receive the best available prices, given the rapid movement of quotations in many NMS stocks. Furthering the interests of these investors in obtaining best execution on an order-by-order basis is a vitally important objective that warrants adoption of the Order Protection Rule.

The percentage of total trades that receive inferior prices also is quite relevant when assessing the need to promote fair and orderly treatment of limit orders for NMS stocks. Many of the limit orders that are bypassed are small orders that often will have been submitted by retail investors. One of the strengths of the U.S. equity markets and the NMS is that the trading interests of all types and sizes of investors are integrated, to the greatest extent possible, into a unified market system. Such integration ultimately works to benefit both retail and institutional investors. Retail investors will participate directly in the U.S. equity markets, however, only to the extent they perceive that their orders will be treated fairly and efficiently. The perception of unfairness created when a retail investor has displayed an order representing the best price for an NMS, yet sees that price bypassed by 1 in 40 trades, is a matter of a great concern to the Commission. The Order Protection Rule is needed to maintain the confidence of all types of investors that their orders will be treated fairly and efficiently in the NMS.

The third principal objective for the Order Protection Rule is to promote greater depth and liquidity for NMS stocks and thereby minimize investor transaction costs. Depth and liquidity will be increased only to the extent that limit order users are given greater incentives than currently exist to display a larger percentage of their trading interest. The potential upside in terms of greater incentives for display is most appropriately measured in terms of the share volume of trades that currently do not interact with displayed orders. It is this volume of trading interest that will begin interacting with displayed orders after implementation of the Order Protection Rule.

The share volume of trade-throughs, rather than the number of trade-throughs, is most useful for assessing the effect of the Order Protection Rule on depth and liquidity because very small trades represent such a large percentage of trades in today's markets, but a small percentage of share volume. For example, the staff study found that, for Nasdaq stocks, 100-share trades represented 32.7 percent of the number of trade-throughs, but only 0.8 percent of the share volume of trade-throughs. Thus, the number of trade-throughs is useful for assessing the number of investors, particularly retail investors, affected by trade-throughs, while the share volume of trade-throughs is useful for assessing the extent to which depth and liquidity are affected by trade-throughs. For example, 41.1 percent of the share volume of trade-throughs in Nasdaq stocks is attributable to trades of greater than 1,000 shares that bypass quotations of greater than 1,000 shares. Addressing the failure of this substantial volume of trading interest to interact with significant displayed quotations is a primary objective of the Order Protection Rule.

In contrast, the share volume of quotations that currently are traded-through grossly underestimates the potential for increased incentives to display because it reflects only the current size of displayed quotations in the *absence* of strong price protection. As a result, the relatively low share volume of traded-through quotations is a symptom of the problem that the Order Protection Rule is designed to address—a shortage of quoted depth—rather than an indication of the benefits that the Order Protection Rule will achieve. For example, when many Nasdaq stocks can trade millions of shares per day, but have average displayed size of less than 2,000 shares at the NBBO, it will be nearly impossible for trade-throughs of displayed size to account for a large percentage of total share volume—there simply is not enough displayed depth. Small displayed depth is evidence of a market problem, not market quality.

Every trade-through transaction in today's markets potentially sends a message to limit order users that their displayed quotations can be and are ignored by other market participants. The cumulative effect of such messages over time as trade-throughs routinely occur each trading day should not be underestimated. When the total share volume of trade-through transactions that do not interact with displayed quotations reaches 9 percent or more for many of the most actively traded Nasdaq stocks, this message is unlikely to be missed by those who watched their quotations being traded through. Certainly, the routine practice of trading through displayed size is most unlikely to prompt market participants to display even greater size.

Thus, the Commission believes that the percentage of share volume in a stock that trades through displayed and accessible quotations is a useful measure for assessing the potential increase in incentives for display of limit orders after implementation of the Order Protection Rule. In particular, the dual measurements of percentage of share volume of traded-through quotations (an overall 1.9 percent for Nasdaq stocks) and the percentage of share volume of trades that bypass displayed quotations (an overall 7.9

percent for Nasdaq stocks) likely represent the lower and upper bounds for a potential improvement in depth and liquidity after implementation of the Order Protection Rule.

Q.4.b. Have you and the other Commissioners or SEC staff discussed the cost implications on the securities industry for imposing a trade-through rule on the trading of Nasdaq-listed securities?

A.4.b. The Commission discussed the estimated costs of the Order Protection Rule in both the Proposing and Reproposing Releases. In the Reproposing Release, the Commission noted the concerns of some commenters over the anticipated cost of implementing the original trade-through proposal. These commenters argued that the Order Protection rule would be too expensive and that the costs associated with implementing it would outweigh the perceived benefits of the Rule. Some commenters were concerned about the cost of specific requirements in the proposed rule, particularly the procedural requirements associated with the proposed opt out exception (for example, obtaining informed consent from customers and disclosing the NBBO to customers).

Some of the commenters based their concerns about implementation costs on the estimated costs included in the Proposing Release for purposes of the Paperwork Reduction Act of 1995 (PRA). In the Reproposing Release, the Commission revised its estimate of the PRA costs associated with the proposed rule to reflect the streamlined requirements of the Rule as reproposed, and to reflect a further refinement of the estimated number of trading centers subject to the rule. In particular, the Order Protection Rule as reproposed did not (and as adopted does not) contain an opt out exception, as was originally proposed. Therefore, the concerns expressed by commenters relating to the costs of implementing an opt out exception are not applicable, and were not included in the Reproposing Release and the final rule as approved by the Commission. In the Reproposing Release, the Commission also refined its estimate of the number of broker-dealers that would be required to establish, maintain, and enforce written policies and procedures to prevent trade-throughs.

Taken together, these changes substantially reduced the estimated costs associated with the implementation of and ongoing compliance with the rule. Specifically, the estimated PRA costs associated with the reproposed Order Protection Rule, as discussed in the Reproposing Release, were $17.8 million in start-up costs and $3.5 million in annual costs. In addition, the estimated implementation costs discussed in the Reproposing Release for necessary systems modifications were $126 million in start-up costs and $18.4 million in annual costs. Accordingly, the total estimated costs discussed in the Reproposing Release were $143.8 million in start-up costs and $21.9 million in annual costs.

Although a number of commenters generally expressed the view that there would be significant costs associated with implementing and complying with the reproposed Order Protection Rule, they did not discuss the specific estimated cost figures included in the Reproposing Release or include their own estimates. Many commenters expressed concerns with the costs associated with implementing the Voluntary Depth Alternative, believing that the costs of implementing the Voluntary Depth Alternative would be substantially greater than the Market BBO Alternative. As you know, the Commission voted to adopt the Market BBO Alternative and not the Voluntary Depth Alternative.

The Commission does not believe that the changes made to the Order Protection Rule as adopted, including the inclusion of a stopped order exception, will materially impact the estimated costs included in the Reproposing Release. The Commission continues to estimate implementation costs for the Order Protection Rule as adopted of approximately $143.8 million and annual costs of approximately $21.9 million.

In assessing the implementation costs of the Order Protection Rule, it is important to recognize that much, if not all, of the connectivity among trading centers necessary to implement intermarket price protection has already been put in place. Trading centers for exchange-listed securities already are connected through the ITS. The Commission understands that, at least as an interim solution, ITS facilities and rules can be modified relatively easily and at low cost to provide the current ITS participants a means of complying with the provisions of the rule. With respect to Nasdaq stocks, connectivity among many trading centers already is established through private linkages. Routing out to other trading centers when necessary to obtain the best prices for Nasdaq stocks is an integral part of the business plan of many trading centers, even when not affirmatively required by best execution responsibilities or by Commission rule. Moreover, a variety of private vendors currently offer connectivity to NMS trading centers for both exchange-listed and Nasdaq stocks.

Commenters also expressed concern that applying the trade-through proposal to the Nasdaq market would harm market efficiency and execution quality. The Commission, however, stated in the Reproposing Release, and continues to believe, that a rule that serves to limit the incidence of trade-throughs will improve market efficiency and benefit execution quality.

RESPONSE TO A WRITTEN QUESTION OF SENATOR STABENOW FROM WILLIAM H. DONALDSON

Q.1. I appreciate your comments regarding the trade-through proposal. I have a few thoughts regarding this issue because many interested parties have visited my office with concerns.

In recent years, the United States has moved from trading in fractions to trading in decimals. While decimalization has been a boon to investors by reducing spreads, it has drastically reduced the amount of liquidity they can see at the national best bid and offer. Where investors used to be able to see liquidity over a span of 12 cents, today the national best bid and offer shows them liquidity at only a penny.

As a policy matter, it is hard to argue that decimalization should leave investors with less transparency and liquidity.

However, wouldn't it make sense to consider updating the rules governing the display of market data to compensate for the reduction in transparency caused by decimalization?

In other words, is not it possible that restoring this lost transparency would facilitate finding the "best price" and achieve some of the goals of the trade-through proposal, but do so in a way that is less intrusive and more reliant on market forces?

(For example by extending the limit order display rule to require exchanges, market makers, and other market centers to publish customer orders within 5 cents of their best published quotations.)

A.1. The Commission received a few comment letters suggesting that, rather than reducing the consolidated display requirement, the Commission should expand the requirement to include additional information on depth-of-book quotations, because the NBBO alone has become less informative since decimalization. The Commission does not believe, however, that streamlining the quotations included in the consolidated display requirement will detract from the quality of information made available to investors. The adopted consolidated display rule will continue to require the disclosure of basic quotation information (for example, prices, sizes, and market center identifications of the NBBO). Particularly for retail investors, the NBBO continues to retain a great deal of value in assessing the current market for small trades and the quality of execution of such trades. For example, statistics on order execution quality for small market orders (the order type typically used by retail investors) reveal that their average execution price is very close to, if not better than, the NBBO. The adopted consolidated display requirement will allow market forces, rather than regulatory requirements, to determine what, if any, additional quotations outside the NBBO are displayed to investors. Investors who need the BBO's of each SRO, as well as more comprehensive depth-of-book information, will be able to obtain such data from markets or third party vendors. Commenters that discussed this aspect of the proposal generally agreed that the proposal would benefit investors and vendors by giving them greater freedom to make their own decisions regarding the data they need.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR ENZI FROM WILLIAM H. DONALDSON

Q.1. A brokerage firm has a program in place to rebate 50 percent of the 12b-1 fees that it receives for mutual funds to its customers who invest in those funds. This can represent a real cost savings for investors. But some mutual funds are refusing to participate, in part because they believe that rebating of 12b-1 fees to investors may not be permitted under (the existing interpretation of) Federal securities laws.

I understand that the SEC staff has taken a look at this issue. Will you provide guidance to the marketplace as to whether or not it is permissible to rebate 12b-1 fees to investors? Where will this task stand on the SEC's list of priorities?

A.1. Some funds may be concerned that a broker-dealer's rebate of 12b–1 fees to fund investors would violate Rule 12b–1 under the Investment Company Act and/or Section 22(d) of that Act. As discussed below, however, Rule 12b-1 does not prohibit broker-dealers from rebating 12b–1 fees to their customers, and such rebates may be paid by broker-dealers in a manner consistent with Section 22(d).

Rule 12b-1: Rule 12b-1 is an exemptive rule that permits a fund to pay for distribution expenses using fund assets under certain conditions. Among other things, a fund must make such payments pursuant to a written plan of distribution (12b-1 plan), and the fund's board of directors must determine, when implementing and continuing the plan, that there is a reasonable likelihood that the plan will benefit the fund and its shareholders.

The staff recently provided interpretive guidance concerning fund directors' duties under Rule 12b-1 in connection with rebates of 12b-1 fees by broker-dealers. The staff stated that a fund's board of directors should consider any rebates of 12b-1 fees by broker-dealers to their customers when determining whether to implement or continue the fund's 12b-1 plan.[1] Some apparently have misinterpreted this staff guidance to mean that a fund's board could never determine that there is a reasonable likelihood that a 12b–1 plan would benefit the fund and its shareholders if a broker-dealer rebated 12b-1 fees to its customers. I understand that the staff intends to provide additional guidance in the near future to clarify that Rule 12b-1 does not prohibit fund shareholders from receiving rebates of 12b-1 fees from broker-dealers.

Section 22(d): Section 22(d) prohibits a fund, its principal underwriter, and dealers from selling fund shares at a price other than the current offering price set forth in the fund's prospectus. Thus, for example, the staff has taken the position that a dealer is generally prohibited from providing a benefit to its customers that would directly offset a portion of the offering price of fund shares.[2] In general, however, the staff believes that Section 22(d) does not prohibit dealers from paying or making available certain benefits to their customers so long as the benefits are not directly related to the purchase of fund shares.[3]

Whether a broker-dealer's rebate of 12b–1 fees to its customers would directly offset the offering price of fund shares in violation of Section 22(d) would depend on the particular facts and circumstances. In general, however, rebates of 12b-1 fees by a broker-dealer that are not directly related to the purchase of fund shares would not violate Section 22(d). I have been informed that the staff intends to provide additional guidance in the near future to clarify this point.

Q.2. Chairman Donaldson, I read a recent press release that stated that the Commission has added 19 members to the Advisory Committee on Smaller Public Companies. What is the next step that will be taken by the Advisory Committee?

We filled the 19 openings on the Advisory Committee on March 7, 2005. The Advisory Committee held its first meeting, its organizational meeting, on April 12. At that meeting, the committee decided to issue a release seeking public comment on its proposed agenda. The release was issued on April 26 and published in the

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[1] *See* Edward Mahaffy (pub. avail. Mar. 6, 2003). See also Southeastern Growth Fund, Inc. (pub. avail. May 22, 1986).

[2] *See* Murphy Favre, Inc., SEC No-Action Letter, May 22, 1987 (stating that a broker-dealer's proposal to provide coupons for discount travel to investors in connection with their purchase of fund shares generally would violate Section 22(d)); The Alger Fund, SEC No-Action Letter, May 4, 1990 (stating that a broker-dealer's proposal to provide free airline mileage credits to persons exchanging shares of one fund for shares of other funds would violate Section 22(d)).

[3] *See,* that is, Portico Funds, Inc., SEC No-Action Letter, April 11, 1996 (stating that a bank's proposal to provide certain benefits to its customers who, among other things, held specified minimum balances in fund shares purchased through their brokerage account at a bank affiliate would not violate Section 22(d)).

Federal Register on April 29. The public comment period ended on May 31. After consideration of the public comments, the committee will finalize its agenda.

The committee is not waiting until the public comment period is over, however, to begin its work. The Co-Chairs have established four subcommittees, where they expect most of the fact finding to occur. The subcommittees are:

- Internal Control Over Financial Reporting
- Corporate Governance and Disclosure
- Accounting Standards
- Capital Formation

The subcommittees have begun their work and will be providing periodic reports to the Co-Chairs and the full Advisory Committee. The next meeting of the full committee is scheduled for mid-June in New York City, with follow up meetings scheduled for August in Chicago and September in San Francisco. The Co-Chairs expect to take public testimony at those meetings. The fact-finding phase of the committee's efforts is scheduled to be completed at the end of September.

The committee's Master Schedule and proposed agenda, as well as other information on the committee, are available on its web page, which can be found on the Commission's website at *http://www.sec.gov/info/smallbus/acspc.shtml.*

Q.3. How do you see the role of the Advisory Committee on Smaller Public Companies evolving as you implement the provisions of Sarbanes-Oxley? Will the Commission be involved in other rulemaking processes?

A.3. I expect that the role of the Advisory Committee will evolve somewhat as the Commission continues to implement Sarbanes-Oxley, including the internal control provisions of Section 404. The Commission may resolve some of the near-term, smaller public company implementation issues before the end of the committee's 13-month term in April 2006. Similarly, the committee may make some interim recommendations before the end of its term. I suspect, however, that most of the committee's recommendations will involve longer-term issues involving the structure of the SEC's program for regulating smaller public companies, and that the committee will issue those recommendations in April 2006. We intend to give serious consideration to all the Advisory Committee's recommendations, whether they involve rulemaking or other administrative action.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM WILLIAM H. DONALDSON

Q.1. Though I applaud the Commission's decision yesterday to delay the implementation of Regulation B, the delay does not change the fact the regulation is fundamentally flawed. As you know, the Commission recently received a letter from 14 Members of this Committee, you have also received a bipartisan letter from our House colleagues and a joint letter from the Federal Reserve, FDIC and OCC all voicing opposition to this regulation. Will the Commission revise the regulation, rather than simply delay it?

A.1. The Commission proposed Regulation B for public comment in June 2004. We received over 100 comments, including many thoughtful comments from banks and the banking regulators. To ensure that we have adequate time to fully consider the commenters' concerns, the Commission granted banks and savings associations an exemption from broker registration, which otherwise would be required by the Gramm-Leach-Bliley Act, through September 30, 2005.

This delay should give us time to craft a set of rules that will implement the bank broker provisions of the GLBA, and achieve functional regulation, in a way that works for the industry. Our primary goal is to clarify the reach of the statutory exceptions. However, we are also mindful that banks engage in other securities activities that are outside of those exceptions but that nonetheless may raise limited investor protection concerns. We plan to address those activities, not by bending the statute to the breaking point, but by providing targeted exemptions designed to ensure that the investor protection concerns remain limited. We believe we are making good progress in finalizing bank broker rules that will strike the right balance.

As we move forward, we will continue to work with the banking regulators and with the industry. We believe we can fulfill our investor-protection mandate while responding to the industry's need for flexibility and the bank regulators' objective of ensuring the safety and soundness of the national banking system. On a related note, I recently met with the heads of the banking agencies to learn more about their specific concerns and expect to receive additional information from them.

Q.2. In your testimony you told us you are still working on the final rule after-hours trading. What kind of message is sent to investors when you come out with rules on independent chairs, months ago, even though many argue if that is a problem or not, and we still do not have a final rule on one of the real abuses in the mutual fund industry?

A.2. The independent chairman provision, in the Commission's view, was necessary to address the conflicts of interest involved in the recent enforcement actions.

The Commission proposed to address late trading abuses in December 2003, a few months after the mutual fund scandals first were made public. The Commission's proposal (the Hard 4 close) would permit same-day pricing only for orders to purchase or redeem fund shares that are received by the fund, a single designated transfer agent for the fund, or a registered clearing agency by the fund's pricing time (which for most funds is 4 p.m. Eastern Time).

Currently, fund intermediaries (including broker-dealers, banks, and retirement plan administrators) must accept orders to purchase or redeem a fund's shares on behalf of the fund, but may submit those orders to the fund after 4 p.m. Funds rely on intermediaries to separate orders received before 4 p.m., which should receive same day pricing, from orders received after 4 p.m., which should receive next-day pricing. Unfortunately, we have found that on numerous occasions, intermediaries permitted late trading by bundling post-4 p.m. orders with pre-4 p.m. orders for same-day pricing.

The Hard 4 close proposal was designed to reduce the potential for late trading by limiting the entities that could accept an order for same-day pricing. Many commenters objected to the proposal, however, because it would require a large number of intermediaries to change the way they do business, thus imposing substantial costs on them. Other commenters expressed serious reservations about the impact of the rule on fund shareholders in Western time zones, and on shareholders who invest through pension plans. Since the end of the comment period, Commission staff has been evaluating comments the Commission has received on the proposal, including proposed alternative approaches to the Hard 4 close. Our staff continues to research and evaluate other approaches to the problem.

Q.3. Can you give me an update on the Nasdaq exchange application. Does it bother you that it has taken so long to approve/disapprove their application?

A.3. Please see the response to Senator Allard's question 1 for an update on the status of Nasdaq's exchange's application.

Q.4. Do you believe that delaying implementation of Section 404 of Sarbanes-Oxley for foreign companies for a year puts American companies, who must incur those costs now, at a competitive disadvantage?

A.4. No. The Commission provided for this delay because many companies outside the United States, particularly in Europe, are facing the significant burden, not faced by U.S. companies, of converting their accounting systems in 2005 to conform to International Financial Reporting Standards, or "IFRS. " In some cases, these companies and their auditors are well on their way to completing the processes necessary to report on their internal controls. In many other cases, however, it would be a significant strain on both company and accounting firm resources to undertake the conversion to IFRS and the initiation of internal control reports at the same time.

Allowing foreign issuers the time to work through the IFRS conversion process before implementing internal control reporting requirements should provide for more effective implementation of both the conversion to IFRS and the internal control reporting requirements, and ultimately benefit investors.

Q.5. Are you concerned that the options that FASB gives corporations for expensing models will confuse investors?

A.5. Investors should benefit from the new standard because, for the first time, issuers will expense the cost of all employee stock options. While different models may be used to calculate that expense, the model selected must comply with the general criteria set forth in the standard. Overall, the new standard should improve the comparability of financial statements.

Both the new FASB accounting standard and the Commission staff guidance published in Staff Accounting Bulletin No. 107 (SAB 107), however, emphasize the need for companies to explain to investors the methods and models used for expensing the cost of employee stock options. In SAB 107, the Commission staff also notes that companies should explain any significant differences between the financial statements before and after implementation of the new accounting standard, including differences that result from refinements in a company's estimates or assumptions that are used in its model. These disclosures will be an important part of the information provided to investors.

Q.6. Are you concerned about the number of 3–2 votes the Commission has taken during your tenure?

A.6. Much has been made about the very few votes in which the Commission has not reached consensus. I would like to set the record straight.

In over 98 percent of all instances in which we have had a Commission vote during my tenure, we have had consensus. We always seek to reach consensus, but sometimes reasonable people can differ, particularly on very complex or difficult matters. But let me explain how I reach a decision on these issues.

I do not view any market issues as "Republican" or "Democratic" issues. I approach each issue based on my over 30 years experience with the securities industry—as the founder of a major Wall Street brokerage firm, the Chairman of a stock exchange, and a CEO of a listed company. Those experiences give me a perspective that guides me in my determinations. I advocate what I believe is best for our marketplace, without regard for political labels. Obviously, there are many issues in which consensus can be reached through compromise. But on major issues, some of which have languished for years at the Commission, I am driven by my understanding of the need for markets to have certainty and closure. Fortunately, the areas where we disagree are few and far between, but above all we must each cast a vote in compliance with our mandate—to protect investors and ensure that our markets are fair and orderly.

Q.7. Are you concerned that the U.S. capital markets are not as attractive to foreign issuers as they once were, and most of the new hires in the financial services sector last year were accountants, auditors, lawyers, and compliance officials?

A.7. The SEC's responsibility to create results in U.S. markets that are attractive to U.S. and other investors necessitates a regulatory system that is designed to promote investor protection. I believe that both issuers and investors will be attracted to high quality markets, and that keeping the U.S. markets at the highest quality is imperative, both from a policy perspective as well as from our statutory mandate. Accordingly, the regulatory efforts of the past 3 years will have the long-term effect of assuring the continued viability and strength of the U.S. markets.

The enactment of the Sarbanes-Oxley Act has required both U.S. and foreign issuers to refocus on the need to have strong accounting and financial reporting systems. This increased attention to financial reporting may be a reason for any increase in the hiring of accountants, auditors, lawyers, and compliance officials. As noted in response to question 4, many foreign private issuers also are in the process of converting from the use of home-country accounting standards to International Financial Reporting Standards. While this process has not been easy for many companies, in the long-run it should lead to significant improvements in the quality and integrity of the financial information that fuels our securities markets.

Q.8. Nasdaq and NYSE have similar trade through rates of about 2 percent. What is the justification for imposing a rule, when we see that it does not necessarily have any measurable results. What are the cost implications for the securities industry for imposing a trade-through rule on the trading of Nasdaq-listed securities?

A.8. The Commission believes that the Order Protection Rule, by establishing effective intermarket protection against trade-throughs, will significantly reduce the trade-through rates in both the market for Nasdaq stocks and the market for exchange-listed stocks. Please see my answer to Senator Allard's question 4 for the complete response to this question.

Q.9. What significant current and recent enforcement actions have been taken against NYSE specialists by the SEC? Press reports indicate other problems, without naming the firms; can you explain the functional problems likely to be revealed?

A.9. In March 2004, the Commission settled administrative enforcement proceedings against the five largest NYSE specialist firms. The terms of the settlements required the five firms to, among other things, disgorge profits and pay fines of approximately $240 million, collectively.

In July 2004, the Commission settled administrative proceedings against the remaining two NYSE specialist firms. The terms of the settlements required these two firms to, among other things, disgorge profits and pay fines of approximately $5 million.

On April 12, 2005, the Commission instituted an administrative proceeding, which is still pending, against 20 former NYSE specialist individuals in connection with the same conduct: David A. Finnerty, Donald R. Foley II, Scott G. Hunt, and Thomas J. Murphy—formerly of Fleet Specialist, Inc.; Kevin M. Fee and Frank A. Delaney IV of Bear Wagner Specialists LLC; Freddy DeBoer—formerly of LaBranche & Co. LLC; Todd J. Christie, James V. Parolisi, Robert W. Luckow, Patrick Murphy, and Robert A. Johnson, Jr.—formerly of Spear Leeds & Kellogg Specialists LLC; and Patrick J. McGagh, Jr., Joseph Bongiorno, Michael J. Hayward, Richard P. Volpe, Michael F. Stern, Warren E. Turk, Gerard T. Hayes, and Robert A. Scavone, Jr.—formerly of Van der Moolen Specialists USA, LLC. Simultaneously, the U.S. Attorney's Office for the Southern District of New York filed criminal charges against 15 of these specialists in connection with the same conduct.

In the pending action against the former NYSE specialists, the Division of Enforcement alleges that between 1999 and mid-2003 these specialists pervasively engaged in fraudulent and other improper trading by executing orders for their firms' proprietary accounts ahead of executable public customer or "agency" orders that were placed through the NYSE's electronic trading system known as the DOT system. The complaint states that, through these transactions, these specialists violated their basic obligation to match executable public customer buy and sell orders, and not to fill customer orders through trades from their firms' proprietary accounts when those customer orders could be matched with other customer orders. The Division also alleges that, through this improper trading, these specialists caused customer losses in the millions of dollars during the years in question. The Division alleges that through this course of fraudulent trading, the specialists willfully violated Section 17(a) of the Securities Act of 1933, Sections 10(b) and 11(b) of the Securities Exchange Act of 1934, and Rules 10b-5 and 11b-1 thereunder, and various NYSE rules. The proceedings will determine what relief, if any, is in the public interest including disgorgement, prejudgment interest, civil penalties, and other remedial relief.

Also on April 12, 2005, the Commission settled an administrative proceeding against the NYSE in connection with its failure to adequately regulate its specialists' trading. Under the terms of the settlement, the NYSE is required to, among other things, set aside $20 million to fund a third-party regulatory auditor to conduct four regulatory audits of the Exchange through 2011.

As the Commission's April 12 press releases noted, the staffs investigation of individuals is on-going. The staff is continuing to investigate to determine whether it is appropriate to recommend the institution of additional administrative proceedings against other individual specialists in connection with the same conduct.

In addition, the staff is continuing to investigate the conduct of the NYSE regulatory staff to determine whether it is appropriate to recommend the institution of administrative proceedings against any NYSE employees in connection with the NYSE's failure to adequately regulate specialist trading.

Q.10. In studying the comments submitted to the SEC on Reg. NMS, many in the industry, except for the NYSE and some specialist firms, had serious concerns about the economic work by the SEC to justify a trade-through rule on Nasdaq. In fact, Commissioner Glassman, an economist, decried the SEC economic work in the December 15 open meeting to discuss the revised trade-through proposal. Do you share these concerns?

A.10. These economic studies tell me that while both primary equity markets have great strengths, they both have weaknesses that could be improved with enhanced incentives for order display. The studies also support the comments we received—that the problem of trade-throughs is a real one, particularly for small investors who cannot easily monitor the behavior of their agents.

Many of the criticisms of the staff studies generally related to possible reasons why the staff studies might have overestimated trade-through rates, particularly for Nasdaq stocks. In response to these comments, Commission staff analyzed and supplemented its trade-through study, and found that these studies continue to support the need for enhanced protection of limit orders as a means to promote greater depth and liquidity in NMS stocks.

Q.11. All regulations should clearly define the problems that they are attempting to solve. In the case of extending a trade-through rule to Nasdaq, what problem is the SEC is trying to solve? I have heard it said that a trade-through rule would encourage the posting of limit orders, but according to statistics from retail brokers (whose customers consist of many individual investors), individual investors prefer to post limit orders in Nasdaq instead of the

NYSE. Since Nasdaq does not have a trade-through rule and the NYSE has a trade-through rule, it does not appear that the theory of encouraging limit orders can be upheld.

A.11. By strengthening price protection in the NMS for quotations that can be accessed fairly and efficiently, the Order Protection Rule is designed to promote market efficiency and further the interests of both investors who submit displayed limit orders and investors who submit marketable orders. Price protection encourages the display of limit orders by increasing the likelihood that they will receive an execution in a timely manner and helping preserve investors' expectations that their orders will be executed when they represent the best displayed quotation. Limit orders typically establish the best prices for an NMS stock. Greater use of limit orders will increase price discovery and market depth and liquidity, thereby improving the quality of execution for the large orders of institutional investors.

Some commenters asserted that the large number of limit orders in Nasdaq stocks indicates that sufficient incentives exist for the placement of limit orders in such stocks. Strengthened intermarket trade-through protection, however, is designed to improve the quality of limit orders in a stock, particularly their displayed size, and thereby promote greater depth and liquidity. This goal is not achieved, for example, by a large number of limit orders with small sizes and high cancellation rates.

Strong intermarket price protection also offers greater assurance, on an order-by-order basis, to investors who submit market orders that their orders, in fact, will be executed at the best readily available prices, which can be difficult for investors, particularly retail investors, to monitor. Investors generally can know the best quoted prices at the time they place an order by referring to the consolidated quotation stream for a stock. In the interval between order submission and order execution, however, quoted prices can change. If the order execution price provided by a market differs from the best quoted price at order submission, it can be particularly difficult for retail investors to assess whether the difference was attributable to changing quoted prices or to an inferior execution by the market. The Order Protection Rule will help assure, on an order-by-order basis, that markets effect trades at the best available prices. Finally, market orders need only be routed to markets displaying quotations that are truly accessible.

In addition, commenters' claim that the Order Protection Rule is not needed because trading in Nasdaq stocks, which currently does not have any trade-through rule, is more efficient than trading in NYSE stocks, which has the ITS trade-through provisions, also is not supported by the relevant data. This conclusion is particularly evident when market efficiency is examined from the perspective of the transaction costs of long-term investors, as opposed to short-term traders. The data reveals that the markets for Nasdaq and NYSE stocks each have their particular strengths and weaknesses. In assessing the need for the Order Protection Rule, the Commission has focused primarily on whether effective intermarket protection against trade-throughs will materially contribute to a fairer and more efficient market for investors in Nasdaq stocks, given their particular trading characteristics, and in exchange-listed stocks, given their particular trading characteristics. Thus, the critical issue is whether each of the markets would be improved by adoption of the Order Protection Rule, not whether one or the other currently is, on some absolute level, superior to the other. It is also worth noting that many of the trade-throughs in listed stocks involve trades not subject to the existing ITS trade-through rule. These trade-throughs involve 100 share quotes and blocks executed off an exchange, which are excluded from the ITS rule.

For these reasons, the Commission believes effective intermarket protection against trade-throughs will produce substantial benefits for investors in both markets and, therefore, voted to adopt the Order Protection Rule for both Nasdaq and exchange-listed stocks.

Q.12. Extending the trade-through rule to Nasdaq would create significant changes to that market. I have heard much controversy over this proposed rule. It appears that the Commission is divided on the trade-through rule and many market participants are very much opposed to it. Would it not be best to find a way that could have more consensus, both among the industry and the Commissioners, before moving forward with such a dramatic rule change? After all, such changes could have a significant impact on the capital markets.

A.12. Regulation NMS raises complex, difficult issues that go to the heart of our national market system. The problems raised by these issues have beset the marketplace for years, to the detriment of investors. The adoption of Regulation NMS is the culmination of a deliberative and open process undertaken by the Commission that included more than 5 years of study, multiple public hearings and roundtables, an advisory committee, three concept releases, a constant dialogue with industry participants and investors, a proposing release, supplemental release, and reproposing release. In addition, in response to its various solicitations of comment, the Commission received over 2,400 comment letters. The insights of these commentators on the proposal, as well as those of panelists at the public hearings, were carefully considered by the Commission and have informed Regulation NMS as adopted. I believe that this comprehensive, transparent, and iterative process was in the best tradition of Commission rulemaking.

It is important to recognize that the views of the various participants in the market structure debate can, and do, differ on the policy issues raised by Regulation NMS. This difference is reflected in the many comments letters received by the Commission, both supporting the imposition of a trade-through rule for all NMS stocks and opposing such a rule. This lack of consensus among the industry and investors is not, however, surprising. We cannot expect all market participants to agree on issues as complex and fundamental as those raised by Regulation NMS. Given the lack of consensus among the many commenters, it also is not surprising that the Commissioners themselves hold different policy views on these complex and important issues.

Although I recognize the importance of achieving consensus, I do not believe that allowing the status quo to continue any longer would have been in the best interests of investors and the national market system. With respect to the fundamental issues raised by

Regulation NMS, we cannot expect that any action taken by the Commission to resolve the issues will ever satisfy all market participants. The Commission must instead focus on taking the right steps for investors and the national market system, and I strongly believe that is what we have done by adopting Regulation NMS.

Q.13. Several of the comment letters filed with the Commission cast doubt on the reliability of the study done by the Commission's staff into actual "trade-throughs" on the New York Stock Exchange and Nasdaq. In particular, they questioned whether the electronic communications networks' "reserve" functions had skewed the results? Would a failure to account for this reserve function lead to false positives? Is there a sound factual basis for extending the proposed trade-through rule to Nasdaq at this point or would it be better to defer consideration of that possibility?

A.13. Several commenters asserted that the study by Commission staff overestimated trade-through rates because it failed to consider the existence of reserve size and sweep orders in the Nasdaq market, which could have caused "false positive" trade-throughs. In theory, order routers could intend to sweep the market of all superior quotations before trading at an inferior price, but if they did not effectively sweep both displayed size and reserve size, the superior quotations would not change and the staff study would report a false indication of a trade-through when the trade in another market occurred at an inferior price. In practice, however, those who truly intend to sweep the best prices are quite capable of routing orders to execute against both displayed and estimated reserve size, thereby precluding the possibility of a false positive trade-through. Indeed, although commenters asserted that the staff study failed to consider the existence of reserve size for Nasdaq stocks, the validity of their own argument is premised on the failure of sophisticated market participants to consider the existence of reserve size when routing sweep orders.

It currently is impossible to determine from publicly available trade and quotation data whether the initiator of a trade-through in one market has simultaneously attempted to sweep better-priced quotations in other markets. The data can reveal, however, the extent to which false-positive indications of a trade-through were even a possibility by examining trading volume at the traded-through market. If the accumulated volume of trades in that market did not equal or exceed the displayed size of a traded-through quotation, it shows that a sweep order, even one attempting to execute only against displayed size, could not have been routed to the market that was traded-through. Commission staff therefore has supplemented its trade-through study to check this possibility and to help the Commission assess and respond to commenters' criticisms. It found that this possibility rarely occurs—a finding that fully supports an inference that market participants are capable of effectively sweeping the best prices, both displayed and reserve, when they intend to do so. Thus, it is very unlikely that the existence of reserve size and sweep orders caused a significant number of false positive trade-throughs in Nasdaq stocks.

Q.14. Will the Commission will move forward with its Regulation NMS before the contours of the NYSE's hybrid market proposal have been fully determined and vetted? Would it be preferable for the Commission to take that up before getting to final approval of its Regulation NMS?

A.14. As you know, on April 6, the Commission voted to adopt Regulation NMS. Over the past several months, Commission staff have been working with the NYSE on the NYSE's proposal to become a "hybrid" electronic-floor based market. On May 25, the NYSE submitted an additional amendment to its Hybrid proposal. The Commission plans to publish the NYSE's recent amendment for another round of comments before taking any final action.

Q.15. Would the proposed trade-through rule, in either alternative form, provide sufficient flexibility for the large State pension funds, and the large mutual funds, to get best execution of their block orders? What I am concerned about is whether those large blocks, if they exceed the total amount of displayed liquidity, would be disadvantaged in some way, to the detriment of the many thousands of small pensioners and mutual fund investors—school teachers, police officers, fire fighters, for example—whose investment stake often is less than the minimum stake a brokerage firm would require to open an account.

A.15. Although the adopted Order Protection Rule does not provide a general exception for block orders, it addresses the legitimate interest of large investors, such as State pension funds and the large mutual funds, in obtaining an immediate execution in large size (and thereby minimizing price impact) by including an exception for "intermarket sweeps" that allows broker-dealers to access multiple price levels simultaneously at different trading centers to continue to facilitate the execution of block orders. Specifically, the exception allows the entire size of a large order to be executed immediately at any price, as long as the broker-dealer routes orders seeking to execute against the full displayed size of better-priced protected quotations. The size of the order therefore need not be parceled out over time in smaller orders that might tip the market about pending orders. By both allowing immediate execution of the large order and protecting better-priced quotations, the adopted Order Protection Rule is designed to appropriately balance the interests for investors on both sides of the market.

The exception is fully consistent with the principle of protecting the best displayed prices because it is premised on the condition that the trading center or broker-dealer responsible for routing the order will have attempted to access all better-priced protected quotations up to their displayed size. Consequently, there is no reason why the trading center that receives an intermarket sweep order while displaying an inferior-priced quotation should be required to delay an execution of the order.

In addition, the adopted Order Protection Rule includes exceptions for executing volume-weighted average price (VWAP) orders and stopped orders. The exception for VWAP orders, as well as other types of orders that are not priced with reference to the quoted price of a stock at the time of execution and for which the material terms were not reasonably available at the time the commitment to execute the order was made, will serve the interests of marketable orders and is consistent with the principle of protecting the best displayed quotations. The use of stopped orders represents a common and valuable form of capital commitment by dealers that inures to the benefit of investors. The adopted exception will apply to the execution of so-called "underwater" stops, in order to prevent abuse of the exception. Specifically, the exception applies to the execution by a trading center of a stopped order when the price of the execution of the order was, for a stopped buy order, lower than the national best bid in the stock at the time of execution or, for a stopped sell order, higher than the national best offer in the stock at the time of execution. To qualify for the exception, the stopped order must be for the account of a customer and the customer must have agreed to the stop price on an order-by-order basis.

Q.16. Like Senator Bennett, I am very concerned about naked short selling. I know you have offered to brief Senator Bennett on this problem but could you tell the Committee for the record what steps you are taking to combat naked short selling?

A.16. The term "naked short selling," which is not specifically defined in either the Federal securities laws or Self-Regulatory Organization (SRO) rules, generally describes selling short without borrowing the necessary securities to make delivery, thus potentially resulting in a "fail to deliver" securities to the buyer. When dealing with claims about naked short selling, it is important to know which activity is the focus of discussion.

- *Selling stock short without having located stock that can be available for delivery at settlement.* This activity would violate Rule 203(b)(1) of Regulation SHO, except for short sales by market makers engaged in bona fide market making. Market makers are not required to locate stock before selling short, because they need to be able to provide liquidity and price efficiency.
- *Selling stock short and failing to deliver shares at the time of settlement. This activity is not per se illegal.* Broker-dealers in general must impose a contractual obligation on short sellers to deliver stock at the time of settlement, and a failure to deliver may result in a contractual breach. However, generally it does not result in a rule violation, with the possible exception of a fraudulent course of conduct of selling short with no ability or intention to deliver the stock (although we are not aware of recent cases brought on this basis).
- *Selling stock short and failing to deliver shares at the time of settlement with the purpose of driving down the security's price.* This manipulative activity, in general, would violate various securities laws, including Rule 10b-5 under the Securities Exchange Act of 1934 (although not Regulation SHO).

To the extent there is evidence of illegal naked short selling, the staff pursues cases vigorously.[1] However, to recommend enforcement action, the staff needs some evidence that stocks are being targeted illegally. Not all short sales are illegal, or evidence of illegal activities. Not all open fails to deliver are fraudulent, or evidence of fraud.

[1] *See Rhino Advisors, Inc. and Thomas Badian,* SEC Litigation Release No. 18003 (Feb. 27,2003); *see also Pinnacle Business Management, Inc., Vincent A. La Castro, and Jeffrey G. Turino,* SEC Litigation Release No. 17507 (May 8, 2003).

There appears to be confusion on the part of some investors about the operation of Regulation SHO and what the Commission is doing to address alleged abusive naked short selling. Commission staff is seeking to address investor confusion in a number of ways. For example, in addition to the staff's availability to respond to investor inquiries on a daily basis, the staff has published on the Commission's Internet website "Key Points for Investors about Regulation SHO," which addresses the questions and complaints of individual investors *(http://www.sec.gov/spotlightlshortsales.htm).* The staff has also published on the website "Frequently Asked Questions Concerning Regulation SHO." These materials address a number of the commonly asked questions and concerns regarding Regulation SHO.

Preliminary data indicate that Regulation SHO is having the intended impact on failures to deliver. From the time Regulation SHO went into effect in January 2005 through the end of April 2005, the average daily aggregate fails to deliver has declined by 29.9 percent, the average daily number of threshold securities has declined by 29 percent, and the average daily fails of threshold securities has declined by 40.0 percent. Regulation SHO appears to be effectively reducing fails to deliver without causing disruption to the markets. On an average day, approximately 1 percent of all trades by dollar value fail to settle. Put another way, 99 percent of all trades by dollar value settle on time without incident.

The staff is continuing to monitor the operation of Regulation SHO and is continually communicating with the legal and compliance groups of the SRO's to monitor and enforce compliance. The staff of the Commission's Office of Compliance, Inspections and Examinations, together with the SRO's, has commenced a targeted examination program of market participants to assess compliance with Regulation SHO.

In addition, the staff is active in pursuing information about abuses or noncompliance with its rules and regulations. The Commission has investigated, and will continue to investigate, complaints and allegations of short sale rule violations. The staff will not hesitate to recommend Commission action where sufficient evidence exists of a failure to comply with the provisions of Regulation SHO or other short selling violations.

RESPONSE TO A WRITTEN QUESTION OF SENATOR CARPER FROM WILLIAM H. DONALDSON

Q.1. Chairman Donaldson, I understand one brokerage firm has a program in place to rebate 50 percent of the 12b-1 fees that it receives for mutual funds to its customers who invest in those funds. This can represent a real cost savings for investors. But some mutual funds are refusing to participate, in part because they believe that rebating of 12b-1 fees to investors may not be permitted under (the existing interpretation of) Federal securities laws.

I understand that the SEC staff has taken a look at this issue. My question for you is—will you make it a priority to provide guidance to the marketplace as to whether or not it is permissible to rebate 12b-1 fees to investors?

A.1. Please see my answer to Senator Enzi's question 1 for the complete response to this question.