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SEC OPERATIONS

**Oversight of Mutual Fund
Industry Presents
Management Challenges**

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Highlights of [GAO-04-584T](#), a testimony to the Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform, House of Representatives

SEC OPERATIONS

Oversight of Mutual Fund Industry Presents Management Challenges

Why GAO Did This Study

Having grown to over \$7.5 trillion in assets, mutual funds have become vital components of the financial security of more than 95 million American investors. However, in 2003, various allegations of misconduct and abusive practices involving mutual funds came to light. Therefore, ensuring that the Securities and Exchange Commission (SEC), which has primary oversight of the mutual fund industry, has the necessary resources and strategic focus to adequately oversee fund practices has never been more important. To assess how SEC is positioned to oversee mutual funds, GAO reviewed (1) how the abusive mutual fund practices were identified and SEC's subsequent responses, (2) SEC's plans for increasing its staffing in the divisions and offices responsible for overseeing mutual funds and its progress in developing a new strategic plan to guide staff deployment, and (3) the challenges SEC faces in overseeing the mutual fund industry.

What GAO Recommends

Although this testimony statement makes no recommendations, GAO discusses challenges that SEC will have to successfully overcome to improve its effectiveness and restore investor confidence in the securities markets.

www.gao.gov/cgi-bin/getrpt?GAO-04-584T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard Hillman at (202) 512-8678 or hillmanr@gao.gov.

What GAO Found

In late 2003, state law enforcement authorities were the first to bring to light various abusive practices in the mutual fund industry. SEC did not identify these practices because detecting fraud in routine examinations is difficult and it has been challenged to keep pace with the rapid growth of the mutual fund industry using its existing resources. However, since the abuses were identified SEC has acted vigorously to address these inappropriate practices, including taking various enforcement actions to punish wrongdoers and issuing numerous rule proposals designed to better prevent or detect abusive practices in the future.

After years during which its workload grew faster than its resources, SEC recently received budget increases that have allowed it to significantly increase its staffing. As shown in the table below, SEC also plans to significantly increase the numbers of staff that oversee mutual funds. However, SEC made these allocation decisions without the benefit of an updated and complete strategic plan, which it is preparing but has yet to finalize. As a result, GAO was unable to determine whether SEC has optimally allocated its limited resources to achieve the greatest benefits.

Although it has received additional resources in recent years, SEC faces a number of agencywide challenges impacting its mission and ability to oversee the mutual fund industry. These include improving its ability to better anticipate and detect problems in the industry and identifying and obtaining all the staff it needs to achieve its mission. SEC has experienced difficulty in effectively implementing various agencywide information technology initiatives, such as an electronic document imaging system and projects needed by units responsible for mutual funds. SEC also has various gaps in its authority that impede its ability to gather information, cooperate with other law enforcement authorities, and collect monies owed by violators.

Staff Positions for SEC Divisions and Offices with Responsibilities for Mutual Fund Regulation, Oversight, and Enforcement, at Fiscal Year End

SEC Unit	Actual 2002	Actual 2003	Estimated 2004	Requested 2005	Percent change, 2002-2005
<i>Investment Management Division</i>	173	167	190	200	16%
<i>Office of Compliance Inspections and Examinations^a</i>	397	439	545	579	46
<i>Enforcement Division^b</i>	980	1,016	1,248	1,278	30

Source: GAO analysis of SEC data.

Notes:

^a These include only staff conducting or supporting mutual fund and investment adviser examinations.

^b These include staff that conduct enforcement of all securities activities.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the Securities and Exchange Commission's (SEC) ongoing strategic planning efforts and the challenges that it is facing to proactively oversee our nation's mutual fund industry. In the last 20 years, mutual funds have grown from under \$400 billion to over \$7.5 trillion in assets and have become vital components of the financial security of the more than 95 million American investors estimated to own them. These funds have also grown to represent a significant portion of the nation's retirement wealth with 21 percent of the more than \$10 trillion in pension plan assets now invested in mutual funds. However, various allegations of misconduct and abusive practices involving mutual funds have recently come to light. As a result, ensuring that SEC has the necessary resources and strategic focus to adequately oversee our nation's mutual fund industry has never been more important.

Today, I will discuss our work examining how well SEC is positioned to effectively oversee the mutual fund industry. Specifically, I will discuss (1) how the abusive practices involving mutual funds came to light and SEC's subsequent responses, (2) SEC's plans for increasing its staffing in the divisions and offices responsible for overseeing mutual funds and its progress in developing a new strategic plan to guide staff deployment, and (3) challenges that may be affecting SEC's ability to effectively oversee the mutual fund industry. In preparing this testimony, we summarized perspectives gained from our recent series of reports and testimonies on practices in the mutual fund industry.¹ In addition, we also relied on information gathered from our previous and ongoing work involving SEC's resources and strategic planning efforts.² We also met with SEC officials to

¹See U.S. General Accounting Office, *Mutual Funds: Information on Trends in Fees and Their Related Disclosure*, [GAO-03-551T](#) (Washington, D.C.: Mar. 12, 2003); *Mutual Funds: Greater Transparency Needed in Disclosures to Investors*, [GAO-03-763](#) (Washington, D.C.: June 9, 2003); *Mutual Funds: Additional Disclosures Could Increase Transparency of Fees and Other Practices*, [GAO-03-909T](#) (Washington, D.C.: June 18, 2003); *Mutual Funds: Additional Disclosures Could Increase Transparency of Fees and Other Practices*, [GAO-04-317T](#) (Washington, D.C.: Jan. 27, 2004); and *Mutual Funds: Assessment of Regulatory Reforms to Improve the Management and Sale of Mutual Funds*, [GAO-04-533T](#) (Washington, D.C.: Mar. 10, 2004).

²See U.S. General Accounting Office, *Securities and Exchange Commission: Human Capital Challenges Require Management Attention*, [GAO-01-947](#) (Washington, D.C.: Sept. 17, 2001); *SEC Operations: Increased Workload Creates Challenges*, [GAO-02-302](#) (Washington, D.C.: Mar. 5, 2002); and *Securities and Exchange Commission: Preliminary Observations on SEC's Spending and Strategic Planning*, [GAO-03-969T](#) (Washington, D.C.: July 23, 2003).

discuss the status of their strategic planning efforts, including their plans to oversee the mutual fund industry. Finally, we reviewed SEC budget-related documents for fiscal years 2003 and 2004, and its 2005 budget request. We conducted our work from March to April 2004 in accordance with generally accepted government auditing standards.

In summary, in late 2003 state authorities were the first to bring a case after being alerted to various abusive practices in the mutual fund industry. Although SEC is the organization primarily responsible for oversight of the mutual fund industry, it did not identify these abusive practices because of the difficulty of detecting fraud, the lack of focus on the trading of fund shares in its examinations, and the challenges it faces in overseeing a growing industry using its existing resources. However, since the abuses came to light, SEC has taken various enforcement actions and issued numerous rule proposals designed to punish wrongdoers and better prevent or detect abusive practices in the future.

After years in which its workload grew faster than its resources, SEC recently received budget increases that have allowed it to significantly increase its staffing, including expanding the staff in the divisions and offices with mutual fund oversight responsibilities. However, SEC made these allocation decisions without the benefit of an updated and complete strategic plan. As a result, we are unable to determine whether SEC has optimally allocated its limited resources to achieve the greatest benefits.

In addition, SEC continues to face a number of challenges in improving and maintaining an effective mutual fund oversight structure, including improving its ability to better anticipate and detect problems in the industry and hiring all the staff it intends to bring on board in the coming years. In trying to improve its oversight effectiveness, SEC is also challenged to obtain and make effective use of information technology and faces various gaps in its authority that impede its ability to gather information, cooperate with other law enforcement authorities, and collect the monies owed by violators.

State Authorities Were First to Uncover Mutual Fund Trading Abuses but SEC Has Since Acted Swiftly to Address Problems

State authorities uncovered various abusive practices in the mutual fund industry in 2003, but since then SEC has taken swift action designed to punish wrongdoers and better prevent or detect abusive practices in the future. In September 2003, the Attorney General of the State of New York filed a case alleging abusive practices involving mutual funds. After receiving a tip, the Attorney General's staff investigated and filed fraud charges against a hedge fund manager for arranging with several mutual fund companies to improperly trade in fund shares and profit at the expense of other fund shareholders.³ The abuses in this case, and in others subsequently filed, included allegations of late trading and market timing. Late trading occurs when investors are able to illegally purchase or sell mutual fund shares after the 4:00 p.m. Eastern Time close of U.S. securities markets, when funds typically price their shares.⁴ Market timing occurs when certain fund investors place orders to take advantage of temporary disparities between the share value of a fund and the values of the underlying assets in the fund's portfolio. Although not illegal, most mutual funds discourage such trading because it increases their costs and lowers returns for their long-term investors.⁵ These inappropriate market timing cases generally involved either fund companies with stated policies against such trading that were facilitating market timing for selected

³A hedge fund is generally an entity that holds a pool of securities and perhaps other assets whose securities are sold to a limited number of high income or high net worth individuals or institutional investors through private placements. As a result, hedge fund offerings are not required to be registered under the Securities Act of 1933 and hedge funds are not registered as investment companies under the Investment Company Act of 1940.

⁴Under current rules, mutual funds accept orders to sell and redeem fund shares at a price based on the current net asset value, which most funds calculate once a day at 4:00 p.m. Eastern Time. Orders received after this time are required to be executed at the next day's asset value. Many investors, however, purchase mutual fund shares through other intermediaries such as broker-dealers, banks, and pension plan administrators. Because of the time required to combine and process these orders, SEC rules currently permit such intermediaries to forward the order information to funds after 4:00 p.m. An investor engaging in late trading is allowed to buy or sell shares at the current day's price after 4:00 p.m. With knowledge of developments in the financial markets that occurred after 4:00 p.m., such investors have an unfair opportunity for profits that is not provided to other fund shareholders.

⁵Reduction of the returns of a fund's long-term investors can occur, for example, when a U.S. mutual fund uses the last traded price for foreign securities (whose markets close hours before the U.S. markets) to value their portfolio. Opportunities for market timing can happen when events occur between the close of foreign securities markets and the close of U.S. securities markets that are likely to cause significant movements in the prices of those foreign securities when their home markets reopen. Investors with knowledge of such market-moving events and knowledge of a mutual fund's portfolio holdings can make swift profits, or limit losses, at the expense of long-term fund investors.

investors or broker-dealers or others that took deceptive actions to assist their customers to conduct market timing transactions.

Since this case was filed, the New York State Attorney General's Office has filed at least 10 additional cases involving mutual funds, broker-dealers, and other entities that were involved in late trading or market timing abuses. As of March 2004, state legal or regulatory authorities in at least three other states, including Massachusetts (3 cases), New Jersey (1 case), and Colorado (1 case) have taken actions against participants in the mutual fund industry for their involvement in late trading, market timing, or other abuses. Some of these cases also allegedly involved mutual fund executives or employees who were conducting market-timing activities in their own firms' funds.

SEC did not identify these abusive practices involving mutual funds for various reasons. According to SEC staff, many of the cases involved fraud and collusion among personnel and such activity is very hard to detect in a routine examination. Also, according to testimony by the head of the SEC office that conducts mutual fund examinations, SEC examiners did not reveal these practices because their examinations focused primarily on the operations of the mutual fund and trading of the fund's portfolio securities practices with an acknowledged potential for abuse. As a result, their examinations did not generally address the trading in the fund's own shares. SEC has also faced resource challenges for years that have affected its ability to conduct oversight in the mutual fund industry and other areas. For example, we reported on SEC's difficulties during the 1990s to keep pace with the growth in the industry and its inability to examine funds and investment advisers frequently.⁶ In recent testimony, the director of the SEC office that conducts examinations noted that, prior to 1998, SEC examinations of mutual fund firms had been as infrequent as once every 12-24 years.⁷ Scarce resources may have also affected SEC's

⁶See U.S. General Accounting Office *Investment Advisers: Current Level of Oversight Puts Investors at Risk*, GGD-90-83 (Washington, D.C.: June 26, 1990); *Bank Mutual Funds: Sales Practices and Regulatory Issues*, GGD-95-210 (Washington, D.C.: Sep. 27, 1995); and *Mutual Funds: SEC Adjusted Its Oversight in Response to Rapid Industry Growth*, GGD-97-67 (Washington, D.C.: May 28, 1997).

⁷See U.S. Securities and Exchange Commission, Lori A. Richards, Director, Office of Compliance Inspections and Examinations, *Testimony Before the U.S. Senate Committee on Banking, Housing and Urban Affairs Concerning Investor Protection Issues Regarding the Securities and Exchange Commission's Examinations of Mutual Funds* (Mar. 10, 2004).

decision to, unfortunately, not follow up on information it obtained regarding the recent wrongdoing in the mutual fund industry. In the summer of 2003, SEC staff had received a tip from a former fund employee who was aware of how his former employer was accommodating market timing by some investors, but SEC staff ultimately chose not to use further resources to pursue this case. The former fund employee then reported the matter to the Massachusetts Securities Division, which subsequently took action against the firm's executives. As a result of another tip, however, the SEC staff promptly recommended and brought an enforcement action against the fund complex and two portfolio managers based on market timing and excessive short-term trading by investment professionals employed by the fund complex.

However since these abuses have come to light, SEC and NASD, which oversees the broker-dealers that sell fund shares, have acted vigorously to address inappropriate practices in the mutual fund industry. For example, SEC has sent numerous requests for information to funds and broker-dealers about their trading practices. SEC's preliminary analysis of these data show that 25 percent of responding broker-dealers had accepted orders after the 4:00 p.m. close and 30 percent allowed market timing. Since September 2003, SEC also has taken 15 enforcement actions that involved late trading and inappropriate market timing, in many cases against some of the same participants also pursued by state authorities. As of March 2004, NASD has also brought multiple enforcement cases against broker-dealers, including a February 2004 case against one of its broker-dealer members that failed to prevent market timing occurring in one of its affiliated firm's mutual funds.

SEC and NASD also have issued at least 11 rule proposals to address abusive and other practices in the mutual fund industry. For example, to address late trading and market timing, SEC issued proposed rule changes that would require orders for mutual fund shares to be processed by intermediaries and received by funds or their agents by 4:00 p.m.⁸ SEC is also proposing a rule that would require that funds charge investors

⁸See Securities and Exchange Commission, Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares, Release No. IC-26288 (Dec. 11, 2003). Because many of the cases of late trading involved orders submitted through intermediaries, including banks and pension plans not regulated by SEC, this proposal requires that to obtain the current day's price, orders to purchase or redeem mutual fund shares be received by a fund, its transfer agent, or a registered clearing agency before the time the fund calculates the net asset value price of its shares, which for most funds occurs at 4:00 p.m. Eastern Time.

holding fund shares less than 5 days a 2-percent redemption fee, which would reduce the likely profitability of short-term trading strategies involving late trading or market timing.⁹ SEC also proposed that funds disclose information about their policies regarding market timing and their use of a pricing technique called fair-value pricing, which is designed to better ensure that fund shares are priced accurately and thus are less susceptible to market timing.¹⁰ SEC's Commissioners approved these rules on April 13, 2004.

In addition to issuing proposals to address late trading and market timing, SEC has also taken some actions that address longstanding concerns over other mutual fund practices, including the lack of transparency of some fees and costs and the potential for conflicts of interest in fund distribution and sales practices. Some of the actions SEC and NASD are proposing would require greater disclosure of fees that funds charge or the payments that broker-dealers receive from fund firms for marketing certain funds. We discussed these and the late trading and market timing proposals and our views on them in testimony for the Senate Committee on Banking, Housing and Urban Affairs on March 10, 2004.¹¹

Although SEC and the other regulators have acted swiftly to respond to the revelations of abusive mutual fund trading practices, other issues warrant SEC's continued attention. For example, SEC is seeking information on how fund advisers use investors' dollars to obtain research. This practice, called soft dollars, involves fund advisers receiving research or other services from broker-dealers in exchange for the commissions the advisers pay on trades conducted in fund portfolio securities. Although this practice can benefit the fund's investors, whose assets are used to pay

⁹See Securities and Exchange Commission, Proposed Rule: Mandatory Redemption Fees for Redeemable Fund Securities, Release No. IC-26375A (Mar. 5, 2004).

¹⁰See Securities and Exchange Commission, Proposed Rules: Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Release No. IC-26287 (Dec. 11, 2003). Specifically, this proposal would require mutual funds to disclose in their prospectuses the risks to shareholders of the frequent purchase and redemption of investment company shares, and fund policies and procedures pertaining to frequent purchases and redemptions. The proposal also would require funds to explain both the circumstances under which they would use fair-value pricing and the effects of using fair-value pricing. Fair-value pricing involves the use of models or other analytical techniques funds use to adjust the prices of a fund's portfolio securities in cases in which the last traded price for a security does not reflect its current market value.

¹¹See [GAO-04-533T](#).

these commissions, it can also create conflicts of interest or potential for abuse. Given the increased spotlight Congress and regulators are placing on the mutual fund industry, in our view, the time is right to address the conflicts created by soft-dollar arrangements. In addition, we have identified other actions that SEC should take that would improve disclosure of mutual fund fees, thus improving investor awareness of the fees they pay on their mutual fund investments. These actions would increase the transparency of fund fees and likely enhance competition among funds on the basis of the fees charged investors.

SEC Has Increased Resource Allocations Without the Benefit of An Updated Strategic Plan

After experiencing an extended period in which increases in SEC's workload grew faster than its staffing and other resources, SEC has received recent budget increases that have begun to allow it to increase its staffing, including positions in the divisions and offices with responsibilities for mutual fund regulation, oversight, and enforcement. However, SEC has taken these actions without the benefit of an updated strategic plan to guide staff deployment and the divisions and offices with responsibilities for mutual funds followed varying processes to determine their staffing needs. As a result, it is difficult to determine whether SEC has optimally allocated its limited resources to achieve the greatest benefits.

Additional Resources SEC Receives to Address Workload Imbalances Will Also Benefit Mutual Fund Oversight

After years of facing imbalances in its workload, SEC recently received additional resources that can help it more effectively oversee the securities markets, including the mutual fund industry. In March 2002, we reported that the growth rate of demands on SEC's staff, including the number of corporate and regulatory filings they must review, the complaints and allegations of wrongdoing they must investigate, and the numbers of mutual funds, investment advisers and other entities they must examine, had increased by about 60 percent from 1996 to 2000.¹² The rapid growth of the mutual fund industry during this time also posed challenges to SEC's staff. For example, the number of mutual funds in existence grew from about 4,500 at the end of 1993 to over 8,100 by the end of 2000. In addition, the issues that SEC staff had to address had also become more complex. However, SEC's staff resources during this period remained relatively flat. As a result, SEC's ability to fulfill its mission had become

¹²[GAO-02-302](#).

increasingly strained because of the imbalance between its workload and staffing resources.

Following the issuance of our March 2002 report, several high-profile corporate failures and accounting scandals came to light in 2002. In response to the resulting demands that public companies be held more accountable for information they report to investors, Congress passed the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley).¹³ The act, which addressed a number of concerns involving corporate governance, auditor independence, and regulation and oversight of the accounting profession, also provided additional resources to SEC. Subsequently, Congress appropriated \$716 million for SEC in 2003, an increase of 45 percent over its fiscal year 2002 budget. SEC was directed to use this increase both to add personnel and acquire new information technology to increase its effectiveness. The new personnel were expected to assist SEC in addressing its workload imbalance and to help it conduct the additional reviews of corporate filings mandated by the act. In recognition of the important role SEC plays in ensuring the integrity of U.S. securities markets, it has continued to receive additional budgetary resources since then with an appropriation for 2004 of \$811.5 million and a requested budget of \$913 million for 2005.

In addition to addressing other needs with these additional resources, SEC has also been able to respond to the mutual fund scandals by increasing the staff allocated to the three primary divisions and offices within the agency responsible for mutual fund regulation, oversight, and enforcement. Within SEC, the Division of Investment Management is responsible for creating rules and reviewing filings for mutual funds and investment advisers.¹⁴ Staff in SEC's Office of Compliance Inspections and Examinations (OCIE) conducts examinations and inspections of mutual funds companies and investment advisers.¹⁵ Finally, staff in SEC's Division of Enforcement investigate possible violations of securities laws, including

¹³Pub. L. No. 107-204.

¹⁴In addition to overseeing mutual funds and investment advisers, the Division of Investment Management also oversees entities required to register with SEC under the Public Utility Holding Company Act of 1935.

¹⁵In addition to investment management-related examinations, OCIE also oversees the activities of self-regulatory organizations and conducts their own reviews of broker-dealers, exchanges, and other entities active in the securities industry.

the Investment Company Act of 1940 and the Investment Advisers Act of 1940, and pursue legal actions against violators.¹⁶

To address the mutual fund scandals, SEC has plans to substantially increase the staffing in the units responsible for mutual fund oversight. As shown in table 1, between 2002 and 2005, SEC plans to increase the staffing for OCIE and the Division of Enforcement by 46 and 30 percent, respectively. SEC also plans to increase the staffing within the Division of Investment Management by 16 percent. SEC staff told us that many of the new personnel will be working on mutual fund issues.

Table 1: Staff Positions for SEC Divisions and Offices with Responsibilities for Mutual Fund Regulation, Oversight, and Enforcement, at Fiscal Year End

SEC Unit	Actual 2002	Actual 2003	Estimated 2004	Requested 2005	Percent change 2002-2005
<i>Investment Management Division^a</i>	173	167	190	200	16%
<i>OCIE^b</i>	397	439	545	579	46
<i>Enforcement Division^c</i>	980	1,016	1,248	1,278	30

Source: GAO analysis of SEC data.

Notes:

^aIncludes staff in the office that administers the Public Utility Holding Company Act of 1935.

^bThe amounts for OCIE present only those staff in SEC's headquarters and regional offices who support or conduct examinations of mutual funds and investment advisers.

^cThe amounts for the Division of Enforcement include all staff in SEC's headquarters and regional that support or conduct enforcement activities over mutual funds, investment advisers, broker-dealers, and all other entities that SEC regulates.

The units responsible for mutual fund oversight benefited from the additional staff they received. For example, OCIE staff said that with the added resources they received in 2003, they were able to begin conducting additional examinations that they hoped would allow them to increase the frequency of the reviews they conduct of the largest fund companies as well as those that pose the greatest compliance risks to as often as every 2 years. OCIE staff said that additional positions requested for 2005 would be used to expand its examination program in the SEC regional offices.

¹⁶SEC's Division of Enforcement also pursues cases against broker-dealers for abuses involving the sale of mutual fund shares under rules and regulations of the Securities Exchange Act of 1934.

SEC's Chairman also recently testified that he has asked the staff to prepare a rule proposal that would require managers to hedge funds to register with SEC and submit to examinations.¹⁷ OCIE staff said that some of the additional staff SEC requested for 2005 could likely be used to assist with those efforts.

SEC's Enforcement Division has also been able to devote more resources to mutual fund cases. After filing less than 10 cases involving mutual funds in 2003, Enforcement Division staff told us that they had already filed 18 cases involving funds as of March 2004 and currently had about 20 percent of their staff pursuing mutual fund-related matters.

Division of Investment Management officials told us that the 2003 budget increase allowed them to hire additional accountants to review investment company financial statements, as mandated by Sarbanes-Oxley. The officials said that additional resources obtained in 2004 and requested for 2005 will enable the division to increase its reviews of funds' financial statements from 1,134 in 2003, which represents about 10 percent of funds, to 4,800 in 2004, or about 40 percent of all funds.

SEC Allocated Resources Absent a Current Strategic Plan

Although SEC has directed increased resources to oversee mutual funds, these allocation decisions were made without the benefit of an updated strategic plan; thus, it is difficult to determine the extent to which these increases reflect the optimal use of SEC's limited resources. According to GAO guidance on effectively developing and implementing strategic plans, leading organizations recognize that their activities, core processes, and resources must be aligned to support their missions and help them achieve their goals.¹⁸ To achieve this, leading organizations articulate a well-defined mission in their overall strategic plan that forms the foundation for the key business systems and processes they use to ensure the successful outcome of their operations. By aligning activities to support mission-related goals, the organizations are also better able to link the levels of funding for their activities and anticipated results. As a complement to the

¹⁷See U.S. Securities and Exchange Commission, Chairman William H. Donaldson, *Testimony Before the U.S. Senate Committee on Banking, Housing and Urban Affairs Concerning Investor Protection Issues Regarding the Regulation of the Mutual Fund Industry* (Apr. 8, 2004).

¹⁸U.S. General Accounting Office, *Executive Guide: Effectively Implementing the Government Performance and Results Act*, [GAO/GGD-96-118](#) (Washington, D.C.: June 1, 1996).

strategic plan, organizations should also determine the specific staff competencies needed to fulfill their mission and develop a human capital plan that addresses how they will acquire, develop, and retain the employees they need.¹⁹

SEC is in the process of updating its strategic plan but as of April 13, 2004, had not completed this process. Under the Government Performance and Results Act, federal agencies are required to prepare strategic plans that address how they will fulfill their mission over the next 5 years. These strategic plans are required to be updated to reflect current circumstances every 3 years. Since SEC's last plan was prepared in 2000, significant changes in the securities markets and its budgetary resources have occurred. SEC was slated to complete its latest update by September 30, 2003. According to SEC staff, a draft summary of the agency's plan was present to the SEC Chairman in October 2003 but he directed staff to start fresh and not rely on the previous strategic plan. As of April 2004, SEC staff told us that the latest draft of the plan was awaiting approval by the Office of the Chairman and would need to be approved by the other SEC Commissioners.

In recent years, SEC has taken various steps to determine its resource allocations but has done so without an updated strategic plan to guide these decisions. As we reported in 2002, SEC traditionally had not reviewed its staffing and resources in terms of its overall strategic plan.²⁰ Instead, it generally developed its annual budget request, including requests for additional staff positions, by basing the request on its previous year's appropriation, rather than on the level of resources it actually may need to fulfill its mission.

Although lacking an updated strategic plan, SEC did use an internal study of its operations to guide resource decisions for 2003. The large budget increase resulting from Sarbanes-Oxley provided SEC with an additional 842 positions for fiscal year 2003. To allocate these positions across its various units, SEC drew upon an internal study that analyzed its operations, including workload, resource allocations, methods for assigning and managing work, and measures of performance, productivity,

¹⁹See U.S. General Accounting Office, *Human Capital: Key Principles for Effective Strategic Workforce Planning*, [GAO-04-39](#) (Washington, D.C.: Dec. 11, 2003) and *A Model of Strategic Human Capital Management*, [GAO-02-373SP](#) (Washington, D.C.: Mar. 15, 2002).

²⁰[GAO-02-302](#).

and quality of effort. Each SEC division and office also had to provide the SEC Chairman with details of what would be accomplished if additional resources were provided.

To allocate the positions included in the 2004 budget, the various units with responsibility for mutual fund oversight took varying steps to determine their staffing needs. Staff in the Enforcement and Investment Management divisions told us their managers were required to consider priorities and goals for the coming year and then estimate the number of staff needed to complete the activities associated with those goals. Staff in these divisions told us that determining those numbers was difficult because the amount of time required to complete the activities they perform, such as developing rules or investigating cases, can vary widely. In the case of the Enforcement Division, their resulting staffing allocation reflected an estimate of what they believed they could obtain rather than the amount of staff required to investigate all matters they might receive. Moreover, staff told us that it was not possible to determine how much fraud existed within the securities markets and therefore it was difficult to determine what level of resources realistically were needed to ensure enforcement of the federal securities laws. OCIE staff, in contrast, told us that they were better able to estimate workload measures, including the number and types of examinations to be completed and the amount of time required to complete them, in order to determine the number of staff they needed.

In the absence of a complete and updated strategic plan that identifies its key mission-related goals, we were unable to determine whether SEC's recent allocation decisions made the best possible use of its resources. In making these decisions, SEC has obviously increased staffing in key areas, including providing additional resources to develop rules, examine participants, and pursue enforcement actions against abusive practices in the mutual fund industry. However, without a complete and current strategic plan that outlines the agency's priorities, the agency lacks a key guide for ensuring that it is deploying its resources across these areas in the most efficient way to achieve the most effective outcomes.

Some Progress Made in Human Capital Management and Performance Measurement

Although SEC has yet to complete updated strategic and human capital plans, it has made some progress in addressing strategic human capital management and measuring its performance. For example, it has taken steps to improve its recruiting and hiring processes and has implemented an agencywide training program to increase its overall staff competency. Recognizing that retention of staff is important to achieving its mission,

SEC has negotiated an agreement with its new employee union that includes various “worklife” programs such as flextime, flexiplace, and tuition reimbursement as a means for increasing morale and job satisfaction.

SEC also has made progress in developing performance measures that are part of an overall strategic planning framework. To track the performance of its various units, SEC staff recently developed various measures of the activities undertaken within their units that they are calling the “performance dashboard.” Although still undergoing revision, these appear to contain key measures of performance for each program area within SEC. SEC staff acknowledged that many of the measures are still output-oriented, but they will likely be useful for improving SEC’s effectiveness. For example, Division of Investment Management staff told us that after seeing the “dashboard” reports, they made changes to their procedures that helped them reduce the number of applications for exemptions that were pending for 12 months or more by almost 30 percent. While the development of the dashboard report is promising, we are concerned that creating performance measures before the latest version of the agency’s strategic plan is complete may mean that SEC will have to replace some measures with others to be consistent with its newly defined strategic vision.

SEC Faces Agencywide Challenges That Also Affect Mutual Fund Oversight

Although it has received additional resources in recent years, SEC still faces a number of agencywide challenges impacting its mission and its ability to oversee the mutual fund industry. These challenges include improving its ability to head off major problems before they occur by better anticipating and detecting abuses in the securities industry. SEC also faces challenges in hiring and retaining all the staff it needs to achieve its mission as demands on staff continue to grow. Moreover, SEC has experienced difficulties in obtaining the information technology it needs to effectively oversee the mutual funds industry. Finally, SEC faces challenges in overcoming impediments to its ability to gather information, cooperate with other law enforcement authorities, and collect monies owed. Overall, SEC must effectively address these challenges to successfully restore and, in the long-run, maintain investor confidence in our securities markets.

Timely Anticipation and Identification of Problems Is a Challenge

One of the challenges SEC faces is being able to anticipate potential problems and identify the extent to which they exist. Historically, limited resources have forced the SEC to be largely reactive, focusing on the most critical events of the day. In this mode, the agency lacked the institutional structure and capability to systematically anticipate risks and align agencywide resources against those risks. In an environment such as this, it is perhaps not surprising that SEC was not able to identify the widespread misconduct and trading abuses in the mutual fund industry. Increasing SEC's effectiveness would require it to become more proactive by thinking strategically, identifying and prioritizing emerging issues, and marshalling resources from across the organization to answer its most pressing needs.

To improve its ability to better anticipate, identify, and manage emerging risks and market trends that stand to threaten SEC's ability to fulfill its mission, SEC is implementing a centralized risk assessment function within the agency. According to SEC's Chairman, this function will be housed in SEC's newly created Office of Risk Assessment and Strategic Planning, whose duties include:

- gathering and maintaining data on new trends and risks from external experts, domestic and foreign agencies, surveys, focus groups, and other market data;
- analyzing data to identify and assess new areas of concern across professions, companies, industries, and markets; and
- preparing assessments and forecasts on the agency's risk environment.

According to statements by SEC's Chairman, the yet-unstaffed office will work in coordination with staff assigned to conduct risk assessment activities from each division and a Risk Management Committee responsible for reviewing implications of identified risks and recommending an appropriate course of action. The new office is also intended to foster better communication and coordination between divisions and offices within the Commission.

SEC staff in the units with responsibility for mutual funds told us they have begun activities to identify emerging risks within their areas. For example, OCIE officials said that examiners have begun efforts to identify what they believe to be the key risks in their ongoing examinations. With this information, OCIE officials hope to develop a formalized process in which this information would flow up through the office and into the risk

assessment office. Similarly, according to Division of Enforcement officials, the division has reorganized staff in its Office of Chief Counsel by functional lines rather than by geographical location. The functional lines include investment adviser and mutual funds, broker-dealers and markets, and corporate accounting. The intent of this reorganization is to increase the staff's subject matter expertise and better detect emerging issues. Enforcement officials said they have already hired experts in the first two lines to further increase the division's expertise and assist in the agencywide risk analysis project, and have plans to hire a corporate accounting expert soon.

Filling New Positions and Existing Vacancies May Not Address All Needs

SEC continues to face agencywide challenges in hiring and retaining sufficient numbers of quality staff to achieve its mission. With the additional staff positions authorized in 2003 and vacancies and attrition in existing positions, SEC staff indicated that they were faced with hiring over 1,280 people in the last 1 ½ years. Although it has made considerable progress in filling these positions, SEC's Chairman stated in his recent testimony to a House Appropriations subcommittee that SEC still expects to have as many as 425 vacancies by May 2004, which is equal to an 11 percent agencywide vacancy rate.²¹ According to the Chairman's statement, about 150 of these vacancies are attorney positions, 120 are accountant positions, and 60 are examiner positions. In addition, by the end of 2005, SEC hopes to receive funding to hire an additional 106 staff, which SEC intends to use to, among other things, further enhance its oversight of mutual funds and to address its market structure reform initiatives.

As we reported to you in July 2003, the competitive service hiring requirements with which SEC was required to comply to hire staff involved the completion of various lengthy processes, such as ranking candidates by position, before filling a vacancy. According to SEC staff, the considerable time required to complete these processes hampered the agency's ability to meet its hiring goals. As a result, the agency asked for and received relief from these requirements under the Accountant, Compliance and Enforcement Staffing Act of 2003, enacted in July 2003

²¹See U.S. Securities and Exchange Commission Chairman William H. Donaldson, *Testimony Before the Subcommittee on Commerce, Justice, State, and the Judiciary, Committee on Appropriations, United States House of Representatives Concerning Fiscal 2005 Appropriations Request for the U. S. Securities and Exchange Commission* (Mar. 31, 2004).

and intended to enable SEC to expedite the hiring of accountants, economists, and examiners. SEC staff told us that bypassing competitive processes has helped them hire individuals for such positions more quickly. In recent testimony, SEC's Chairman noted that the number of vacant positions would have been much higher without this legislation.

In addition, acting under recently granted compensation authority, SEC also implemented a new compensation system, which established a pay structure more comparable to other federal financial regulators. SEC officials stated that the new hiring and compensation authority, along with current economic conditions, has improved the hiring and retention of staff. For example, according to SEC staff, since 2001 the agency's turnover rate dropped from approximately 8 percent in fiscal year 2001 to 1.2 percent in fiscal year 2002 and 1.5 percent in fiscal year 2003. Previously turnover had been as high as almost 14 percent.

The units responsible for mutual fund oversight generally have been making progress in meeting their goals for hiring additional staff, but demands on their staff continue to grow. SEC's Investment Management Division is attempting to reach a staffing level of 190 positions by the end of fiscal year 2004. According to division staff, at midyear they had about 175 staff on board. Of the remaining 15 vacancies, 5 are staff that are designated for public utility holding company oversight. Staff from the Enforcement program, which is attempting to reach 1,248 positions by the end of fiscal year 2004, had about 1,070 on board as of April 2004. However, staff from both these divisions told us that they have had difficulty in recruiting accountants due to competition from the private sector as well as the Public Company Accounting Oversight Board, which they said is able to pay much higher salaries.

Although OCIE has had some success in hiring additional examiners, the revelations of the widespread abuses in the industry has also resulted in an expansion of its workload. OCIE staff told us that in trying to reach their mutual fund-related staffing goals for the end of fiscal year 2004, only about 3 percent of their positions were vacant as of March 2004, primarily as a result of attrition. However, OCIE staff also told us that as a result of the mutual fund abuses, examiners will be conducting more comprehensive examinations and more targeted mini-sweeps, which are focused examinations that deal with just a single issue across a number of firms. For example, to aid in detecting any misconduct that might not otherwise be reflected in the books and records kept by a firm and shown to examiners, OCIE staff said that their routine examinations would now include a review of a sample of fund executives' internal e-mail

communications. Other new examination steps OCIE said they were implementing include reviewing personal trading records that show fund executives trading in their funds' shares and reviews of procedures to ensure that fund share orders are processed to receive the appropriate day's net asset value, including firms' procedures governing order receipt time and order time stamping.

Given these additional activities, OCIE staff said that the time required to complete an examination has increased dramatically and threatens their ability to meet the newly established goals for increased examination frequency. With the additional resources added to the examination program in 2003, SEC was able to increase examination frequency of the largest fund firms and of those posing the greatest compliance risk from once every 5 years to once every 2 years. As noted previously, SEC's examinations of some mutual fund companies had been as infrequent as once every 12-24 years during the 1990s. OCIE staff said that they are currently considering ways in which they could save time as well as maximize coverage of the industry, but they are not yet in a position to provide assurances that they have sufficient resources to both increase the frequency of examinations and conduct more in-depth reviews and mini-sweeps at their currently projected resource levels.

Staff in both OCIE and the Investment Management Division also told us that they will face additional demands on their time in the event that SEC requires hedge fund advisers to register with the agency, which SEC's Chairman has publicly stated he intends to propose. Potentially SEC staff might have to conduct additional regulatory filing reviews and examinations. The amount of additional effort required to oversee hedge fund advisers is not currently known, but Investment Management staff told us that they estimate that between 600 and 1,100 additional advisers would be required to register with SEC.

Obtaining and Effectively Using Information Technology Also a Challenge

Having traditionally lacked sufficient funding for information technology, SEC is in the process of implementing various agencywide initiatives, and the units responsible for mutual funds also have identified projects that could further improve their efficiency. Like the rest of the government, SEC's needs in the area of information technology continue to increase, but SEC recently received authorizations for additional funding to address its needs. As we reported in July 2003, SEC's fiscal year 2003 information technology budget increased more than 100 percent, from around \$44 million to \$100 million, which allowed SEC to begin funding a number of

agencywide, long-term technology projects. Many of these major initiatives are still in process. These projects include

- Implementing a document management and imaging initiative, intended to eventually eliminate paper documents and allow SEC staff to review and electronically file the large volumes of information that are part of litigation, examination, and enforcement activities. Staff told us that the planned system will provide an agencywide electronic capture, search, and retrieval mechanism for all investigative and examination materials.
- Converting SEC's Electronic Data Gathering Analysis and Retrieval (EDGAR) system into a searchable database that would help SEC conduct various types of industry and trend analyses. EDGAR is the database system that public companies use to file registration statements, periodic reports, and other forms electronically. Currently, EDGAR receives and archives data, but staff cannot immediately and easily analyze it. The goal is to create filings that will allow anyone to extract relevant data.
- Implementing a disaster recovery program that is being designed to store and move large amounts of data among regional or district offices without first going through Washington, D.C. The current project, when completed, will allow the agency to back up critical information and data on a daily basis at multiple locations.

In addition to these agencywide initiatives, staff in the units responsible for mutual fund oversight have identified a number of other technology projects that could help to improve the efficiency of their operations. For example, OCIE officials told us that they would like to provide audit guidance in an electronic format for examination staff, and create Web site links for staff to use in accessing information useful in an examination. They said that having these capabilities would likely reduce the time required to complete examinations.

OCIE officials also stated that they are considering a longer-term project involving the development of a mutual fund surveillance program. On March 5, 2004, the SEC Chairman announced the formation of an internal task force to draft the outlines of this new surveillance program. This group will examine the mutual fund reporting regime and consider changes to both the frequency of reporting to the Commission and the categories of information to be reported, as well as how new technologies can be used to enhance SEC's oversight responsibilities. OCIE's director stated that the goal of such a surveillance program would be to identify indications of problems, and then target the particular fund or adviser for

a follow-up inquiry. With such information, SEC staff would also likely be able to examine relevant data on an industrywide basis to determine if a systemic problem was emerging. Implementation of such an initiative will require a continued commitment to enhancing SEC's information technology capabilities.

Additionally, Investment Management officials said that they have started a project designed to allow investment companies to submit more of their required filings electronically. Their staff are evaluating available technology that will allow them to identify and analyze the data they receive more readily. Currently, most of the filings come in as pure text files and thus are not very well suited for quick quantitative analysis. Officials in the Division of Enforcement said that recent upgrades to their computers have been helpful. We also spoke with an official in SEC's Office of Investor Education and Assistance, which is responsible for analyzing investor complaints, responding to inquiries, and providing educational materials on numerous investing topics, including mutual funds. This official also told us about a number of technology projects that could improve staff operational efficiency. For example, according to the official, the office could benefit from data imaging and retrieval technology for inquiries and complaints that come in a paper format, as the technology would allow staff to access this information by topic or complainant. The official did note that one project, a database that catalogs complaints from the Internet, is currently being implemented.

In addition to the agency's ongoing document management and imaging initiative, SEC staff told us that additional efficiencies could be gained from an improved case tracking system and having greater ability to analyze data to look for trends taking place in the securities industry, particularly in the mutual fund area. Moreover, all of the SEC officials with whom we spoke agreed that the high costs associated with new technologies coupled with a limited information technology budget created a challenge for SEC in meeting its information technology needs.

Investigation and Collection Difficulties Also Hamper SEC's Regulatory Efficiency

SEC also faces challenges that affect its ability to investigate violations and to collect monetary fines and disgorgements that violators are ordered to pay, a process integral to effective oversight.²² Investigations of securities law violations can be labor intensive, complex, and sometimes require SEC staff to coordinate with staff from other law enforcement or regulatory authorities as has occurred in many of the mutual fund cases that SEC has brought recently. In addition, according to SEC staff, collecting the amounts that violators are ordered to pay can be time consuming and difficult.

SEC's staff has identified various issues that they believe hamper their efficiency in conducting enforcement and collections activities, including investigations involving mutual funds. At a February 2003 congressional hearing, the director of SEC's Enforcement Division testified that under existing criminal procedure law, SEC staff generally are not allowed access to grand jury information. In such cases SEC staff must conduct a separate, duplicative investigation to obtain the same information already in the hands of federal criminal authorities. In some cases, involving mutual funds, state law enforcement authorities convened grand juries.

SEC's ability to protect privileged information also remains in question, hampering its ability to collect such material. In a report mandated by the Sarbanes-Oxley Act, SEC staff noted that their investigative efforts are less efficient and effective at times because the parties under investigation have a disincentive to provide privileged or protected information to SEC. By disclosing such information to SEC, the parties risk that others, such as an adversary in private litigation, could argue that the disclosure waives the protection of that information. SEC staff would like to be able to ensure that these parties can maintain protection over such information after a disclosure to SEC.

The need for SEC staff to make lengthy and complicated efforts to collect fines or disgorgements also prevent them from investigating other matters. As a result, SEC staff indicated their efficiency would be improved if they had authority to contract with private attorneys to undertake litigation to enforce collection orders. The House is considering a bill introduced in

²²Fines are amounts violators are ordered to pay as punishment for violating the securities laws. Disgorgement is the process by which a violator is ordered to return money obtained as a result of a violation of these laws.

2003 that would give SEC authority to obtain these contracts, as well as other enhancements to the authority of SEC Enforcement staff.²³

This concludes my prepared statement. I would be happy to respond to questions.

Contacts and Acknowledgements

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²³These additional authorities are included as part of the Securities Fraud Deterrence and Investor Restitution Act of 2003, H.R. 2179.

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