GAO
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Highlights

Highlights of GAO-05-415, a report to congressional requesters

Why GAO Did This Study

As the frontline regulator of mutual funds, the Securities and Exchange Commission (SEC) plays a key role in protecting the nearly half of all U.S. households owning mutual funds, valued around $8 trillion in 2005. Mutual fund abuses raised questions about the integrity of the industry and quality of oversight provided by SEC and self-regulatory organizations (SRO) that regulate broker-dealers selling funds. This report assesses (1) changes SEC has made to, or is planning for, its mutual fund exam program; (2) key aspects of SEC's quality control framework for routine fund exams; and (3) the adequacy of SEC's oversight of NASD and the New York Stock Exchange in protecting shareholders from mutual fund sales abuses.

What GAO Recommends

This report makes four recommendations to SEC designed to help ensure that it is using its resources effectively to oversee mutual funds and broker-dealers selling mutual funds, to improve aspects of its quality control framework for routine fund exams, and to enhance its oversight of SRO exams of broker-dealers selling mutual funds. In its written comments, SEC provided additional information on the benefits of its revised exam strategy for overseeing funds and advisers and on the benefits of its broker-dealer oversight exams.

www.gao.gov/cgi-bin/getrpt?GAO-05-415.

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.

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MUTUAL FUND INDUSTRY

SEC's Revised Examination Approach Offers Potential Benefits, but Significant Oversight Challenges Remain

What GAO Found

SEC is initiating several changes intended to strengthen its mutual fund exam program but faces challenges overseeing the fund industry. In the wake of the fund abuses, SEC has revised its past approach of primarily conducting routine exams of all funds on a regular schedule. It concluded these exams were not the best tool for identifying emerging problems, since funds were not selected for examination based on risk. To quickly identify problems, SEC is shifting resources away from routine exams to targeted exams that focus on specific risks. It will conduct routine exams on a regular schedule but only of funds deemed high risk. SEC also is forming teams to monitor some of the largest groups of advisers and funds. Although SEC is seeking to focus its resources on higher risk funds and activities, the resource tradeoffs it made in revising its oversight approach raise significant challenges. The tradeoffs may limit SEC's capacity not only to examine funds considered lower risk within a 10-year period but also to accurately identify which funds pose higher risk and effectively target them for routine examination. Potentially taxing its resources further, SEC recently adopted a rule to require advisers to hedge funds (investment vehicles generally not widely available to the public) to register with it. This rule is expected to increase SEC's exam workload, but the precise extent is not yet known.

SEC has integrated some quality controls into its routine exams, but certain aspects of its framework could be improved. It relies on experienced staff to oversee all exam stages but does not expressly require supervisors to review work papers or document their review. GAO found deficiencies in key SEC exam work papers, raising questions about the quality of supervisory review. SEC also does not require examiners to prepare written exam plans, though they use considerable judgment in customizing each exam. Written plans could serve as a guide for conducting exams and reviewing whether exams were completed as planned. As done by other regulators, SEC also could review a sample of work papers to test compliance with its standards.

A primary tool that SEC uses to assess the adequacy of SRO oversight of broker-dealers offering mutual funds provides limited information for achieving its objective and imposes duplicative costs on firms. To assess SRO oversight, SEC reviews SRO exam programs and conducts oversight exams of broker-dealers, including their mutual fund sales practices. SEC's oversight exams take place 6 to 12 months after SROs conduct their exams and serve to assess the quality of SRO exams. However, GAO reported in 1991 that SEC's oversight exams provided limited information in helping SROs to improve their exam quality, because SEC and the SROs used different exam guidelines and their exams often covered different periods. GAO found that these problems remain, raising questions about the considerable resources SEC devotes to oversight exams. GAO also found that SEC has not developed an automated system to track the full scope of work done during its oversight exams. Thus, SEC cannot readily determine the extent to which these exams assess mutual fund sales practices.