United States Government Accountability Office

GAO

Report to the Committee on the Judiciary, House of Representatives

April 2005

# MUTUAL FUND TRADING ABUSES

# Lessons Can Be Learned from SEC Not Having Detected Violations at an Earlier Stage

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Accountability ★ Integrity ★ Reliability

GAO-05-313

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# Highlights

Highlights of GAO-05-313, a report to the Committee on the Judiciary, House of Representatives

April 2005

# MUTUAL FUND TRADING ABUSES

## Lessons Can Be Learned from SEC Not Having Detected Violations at an Earlier Stage

### Why GAO Did This Study

Recent violations uncovered in the mutual fund industry raised questions about the ethical practices of the industry and the quality of its oversight. A widespread abuse involved mutual fund companies' investment advisers (firms that provide management and other services to funds) entering into undisclosed arrangements with favored customers to permit market timing (frequent trading to profit from short-term pricing discrepancies) in contravention of stated trading limits. These arrangements harmed long-term mutual fund shareholders by increasing transaction costs and lowering fund returns. Questions have also been raised as to why the New York State Attorney General's Office disclosed the trading abuses in September 2003 before the Securities and Exchange Commission (SEC), which is the mutual fund industry's primary regulator. Accordingly, this report (1) identifies the reasons that SEC did not detect the abuses at an earlier stage and the lessons learned in not doing so, and (2) assesses the steps that SEC has taken to strengthen its mutual fund oversight program and improve mutual fund company operations.

### What GAO Recommends

GAO recommends that SEC routinely assess the effectiveness of compliance officers and plan to review compliance reports on an ongoing basis. SEC agreed with these recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-05-313.

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

### What GAO Found

Prior to September 2003, SEC did not examine for market timing abuses because agency officials viewed other activities as representing higher risks and believed that companies had financial incentives to control frequent trading because it could lower fund returns. While SEC faced competing examination priorities prior to September 2003 and made good faith efforts to mitigate the known risks associated with market timing, lessons can be learned from the agency not having detected the abuses earlier. First, without independent assessments during examinations of controls over areas such as market timing (through interviews, reviews of exception reports, reviews of independent audit reports, or transaction testing as necessary) the risk increases that violations may go undetected. Second, SEC can strengthen its capacity to identify and assess evidence of potential risks. Articles in the financial press and academic studies that were available prior to September 2003 stated that market timing posed significant risks to mutual fund company shareholders. Finally, GAO found that fund company compliance staff often detected evidence of undisclosed market timing arrangements with favored customers but lacked sufficient independence within their organizations to correct identified deficiencies. Ensuring compliance staff independence is critical, and SEC could potentially benefit from their work.

SEC has taken several steps to strengthen its mutual fund oversight program and the operations of mutual fund companies, but it is too soon to assess the effectiveness of certain initiatives. To improve its examination program, SEC staff recently instructed agency staff to conduct more independent assessments of fund company controls. To improve its risk assessment capabilities, SEC also has created and is currently staffing a new office to better anticipate, identify, and manage emerging risks and market trends. To better ensure company compliance staff independence, SEC recently adopted a rule that requires compliance officers to report directly to funds' boards of directors. While this rule has the potential to improve fund company operations and is intended to increase compliance officers' independence, certain compliance officers may still face organizational conflicts of interest. Under the rule, compliance officers may not work directly for mutual fund companies, but rather, for investment advisers whose interests may not necessarily be fully aligned with mutual fund customers. The rule also requires compliance officers to prepare annual reports on their companies' compliance with laws and regulations, but SEC has not developed a plan to routinely receive and review the annual compliance reports. Without such a plan, SEC cannot be assured that it is in the best position to detect abusive industry practices and emerging trends.

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## Abbreviations

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| 1940 Act | Investment Company Act of 1940 |
| Advisers Act | Investment Advisers Act of 1940 |
| CCO | chief compliance officer |
| ICI | Investment Company Institute |
| Investment Management | Division of Investment Management |
| NASD | National Association of Securities Dealers |
| NAV | net asset value |
| NSCC | National Securities Clearing Corporation |
| NYSOAG | New York State Office of the Attorney General |
| NYSE | New York Stock Exchange |
| OCIE | Office of Compliance Inspections and Examinations |
| ORA | Office of Risk Assessment |
| SEC | Securities and Exchange Commission |
| SRO | self-regulatory organization |

**United States Government Accountability Office**
**Washington, D.C. 20548**

April 20, 2005

The Honorable F. James Sensenbrenner, Jr.
Chairman
Committee on the Judiciary
House of Representatives

The Honorable John Conyers, Jr.
Ranking Minority Member
Committee on the Judiciary
House of Representatives

Recent trading abuses uncovered among some of the most well-known companies in the mutual fund industry identified significant lapses in the ethical standards of the industry and raised concerns about the quality of its oversight. A widespread type of violation engaged in by mutual fund companies involved market timing.[1] Market timing typically involves the frequent buying and selling of mutual fund shares by sophisticated investors, such as hedge funds, that seek opportunities to make profits on the differences in prices between overseas markets and U.S. markets or for other purposes.[2] Although market timing is not itself illegal, frequent trading can harm mutual fund shareholders because it lowers fund returns and increases transaction costs. However, market timing can constitute illegal conduct if, for example, it takes place as a result of undisclosed agreements between investment advisers (firms that may manage mutual fund companies) and favored customers such as hedge funds who are permitted to trade frequently and in contravention of stated fund trading limits. Market timing may also constitute illegal conduct, if as happened in some cases, investment adviser officials engage in frequent trading of fund

[1]For purposes of this report, the term "mutual fund companies" generally refers to mutual fund companies and their related investment advisers and service providers, such as transfer agents, unless otherwise specified. As described in this report, many mutual fund companies have no employees, although they typically have boards of directors, and rely on investment advisers to perform key functions such as providing management and administrative services.

[2]The term "hedge fund" generally identifies an entity that holds a pool of securities and perhaps other assets that is not required to register its securities offerings under the Securities Act and is excluded from the definition of an investment company under the Investment Company Act of 1940. Hedge funds are also characterized by their fee structure, which compensates the adviser based upon a percentage of the hedge fund's capital gains and capital appreciation.

shares in violation of fund policies and disclosures. Another type of violation commonly referred to as late trading was significant but less widespread than market timing violations. Late trading typically involved intermediaries, such as broker-dealers or pension plans that offer mutual funds, that permitted certain customers to place trades after the 4 p.m. Eastern Time close of the financial markets.[3] Investors who are permitted to engage in late trading can profit on knowledge of events in the financial markets that take place after 4 p.m., an opportunity that other fund shareholders do not have.

Questions have also been raised as to why securities industry regulators, such as the Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD), did not detect the undisclosed market timing arrangements and late trading abuses. Instead, the New York State Office of the Attorney General (NYSOAG) uncovered the abuses in the summer of 2003 after following up on a tip provided by a hedge fund insider. SEC, which has direct supervisory oversight responsibility for mutual fund companies, did not detect the undisclosed arrangements through its routine examination program. NASD, which regulates broker-dealers that may sell mutual funds as part of their overall business, also did not detect undisclosed market timing or late trading abuses through its examinations.[4] However, once early indications of undisclosed market timing arrangements and late trading surfaced, SEC surveyed mutual fund companies and initiated a series of examinations, as did NASD regarding broker-dealers, to determine the extent of the problem. By November 2003, SEC estimated that 50 percent of the 80 largest mutual fund companies had entered into undisclosed arrangements permitting certain shareholders to engage in market timing practices that appeared to be inconsistent with the funds' policies, prospectus disclosures, or fiduciary obligations. Additionally, SEC and NASD investigated and pursued companies and individuals found to have responsibility for market timing and late trading abuses through filing and settling enforcement actions, which have generated substantial fines and penalties. Nevertheless, the regulators'

[3]In this report, we assume for convenience that all funds choose to price their securities daily as of 4:00 p.m. Funds may, however, elect to price their securities more than once per day, and according to SEC, many funds price their securities earlier than 4:00 p.m.

[4]The New York Stock Exchange (NYSE) is also responsible for oversight of its member firms, but NASD typically conducts the sales practice portions of examinations for firms that are dually registered with it and NYSE. As a result, NYSE generally plays a lesser role in examining broker-dealers for matters involving mutual fund sales. We therefore did not include NYSE in the scope of this review.

failure to identify the abuses at an earlier stage has generated concern about the effectiveness of their examination and other oversight procedures.

This report responds to your requests that we review issues relating to regulatory oversight of the mutual fund industry. Because undisclosed market timing arrangements were more widespread than late trading violations and SEC is the mutual fund industry's frontline regulator, the report primarily focuses on SEC's oversight of the market timing area. The report also addresses NASD's oversight of broker-dealers that failed to prevent customers' late trading and market timing activities but does not discuss late trading at pension plans and plan administrators, which are subject to oversight by the Department of Labor. Accordingly, the report (1) identifies the reasons that SEC did not detect the abusive market timing agreements at an earlier stage and lessons learned from the agency's failure to do so; and (2) assesses steps that SEC has taken to strengthen its mutual fund oversight, deter abusive trading, and improve mutual fund company operations.

To accomplish our reporting objectives, we interviewed SEC staff at headquarters and at a judgmental sample of six regional and district offices located nationwide; NASD officials; and officials from the Investment Company Institute (ICI), which is the trade group that represents the mutual fund industry, a judgmental sample of large mutual fund companies; broker-dealers; pension plans; the National Securities Clearing Corporation (NSCC), which plays a role in processing certain mutual fund transactions; the Securities Industry Association; and other industry participants. At the six SEC offices, we also reviewed enforcement actions and examination reports for 11 large mutual fund companies that regulators identified as having entered into undisclosed market timing arrangements or where late trading violations took place. Each of these companies was among the 100 largest mutual fund companies in the United States as measured by assets under management on August 1, 2003. We also reviewed general financial regulation and auditing standards pertaining to the oversight of regulated entities and federal agencies as well as relevant academic and other studies. We reviewed relevant documentation and discussed the cases with knowledgeable SEC staff to provide a basis for understanding the reasons that the agency did not detect abuses at an earlier stage. Our work was performed in Atlanta, Ga.; Boston, Mass.; Chicago, Ill.; Denver, Colo.; New York, N.Y.; Philadelphia, Pa.; and Washington, D.C. We conducted our work between May 2004 and April 2005 in accordance with generally accepted government audit standards. Appendix I provides a detailed description of our scope and methodology.

## Results in Brief

Prior to September 2003, SEC staff did not examine for market timing abuses or assess company controls over that activity because agency staff (1) viewed market timing as a relatively low-risk area that did not involve per se violations; (2) determined that mutual fund companies had financial incentives to establish effective controls over frequent trading because such trading can reduce fund returns resulting in a loss of business; and (3) were told by company officials that they had designated compliance staff to monitor and control market timing. We recognize that SEC staff faced competing examination priorities and that detecting fraudulent activities, particularly previously unknown frauds such as the undisclosed arrangements between investment advisers and favored investors, is challenging. Further, SEC staff made good faith efforts to control the known risks associated with market timing through the regulatory process, such as by issuing guidance on "fair value" pricing.[5] Nevertheless, lessons can be learned to strengthen SEC's mutual fund company oversight program going forward from the agency not having detected the undisclosed market timing arrangements at an earlier stage. In particular, conducting independent assessments of controls (through a variety of means including interviews, reviews of exception reports, reviews of internal audit or other company reports, and transaction testing as necessary) over various activities within a mutual fund company, including areas perceived to represent relatively low risks at a sample of companies, is, at a minimum, an essential means to verify assessments about risks and the adequacy of controls in place to mitigate those risks. Without such independent assessments, the potential increases that violations will go undetected. Further, our review identified information that was available prior to September 2003 that was inconsistent with SEC staff's views that market timing was a low risk area and that companies would necessarily act to protect fund returns from the harmful consequences of frequent trading. For example, academic studies indicated that market timing by sophisticated investors, while legal, remained a persistent risk prior to September 2003 that by one estimate was costing mutual fund shareholders

[5]Fair value pricing involves mutual funds using the estimated market value of shares when market quotes are not readily available. As described in this report, fair value pricing of mutual fund shares can minimize discrepancies in pricing between foreign and U.S. financial markets and thereby minimize market timing opportunities.

approximately $5 billion annually in certain funds and that companies were not acting aggressively to control these risks through fair value pricing, despite SEC's guidance that they do so. The author of a 2002 study raised the possibility that certain investment advisers were not implementing fair value pricing because such advisers benefited financially from permitting frequent trading, which turned out to be the case.[6] Moreover, a mutual fund insider provided information to an SEC district office in early 2003 that indicated a company had poor market timing controls but the office did not act promptly on this information. SEC must develop the institutional capacity to identify and evaluate such evidence of potential risks and deploy examiners as necessary to assess company controls in such areas and help identify potential violations. Finally, our review found that company compliance staff in the majority of cases that we reviewed identified evidence of market timing arrangements with favored customers as early as 1998 but lacked sufficient independence within their organizations to correct identified deficiencies. Ensuring compliance staff independence is critical, and SEC staff could potentially better assess company risks and controls through routine interactions with such staff and reviewing relevant documentation.

SEC has taken several steps to strengthen its mutual fund oversight program and the operations of mutual fund companies over the past 2 years, but it is too soon to assess the effectiveness of several key initiatives. To improve its examination program, SEC has instructed examiners to make additional assessments of mutual fund company controls. For example, SEC staff has identified a range of areas that potentially represent high-risk compliance problems, such as personal trading by mutual fund company officials, and examiners have initiated independent examinations of these areas, as well as obtaining more internal documentation, such as e-mails about these control areas. In a forthcoming report, we assess SEC staff's implementation of these revised examination guidelines. To improve its capacity to anticipate, identify, and manage emerging risks and market trends in the securities industry, SEC has created a new office that reports directly to the agency's chairman. However, it is too soon to assess the effectiveness of the new office as it had only 5 of 15 planned employees as of February 2005 and was still defining its role within the agency.

[6] Eric Zitzewitz "Who cares about shareholders? Arbitrage-proofing mutual funds," Stanford Graduate School of Business Research Paper No. 1749 (October 2002). As described later in this report, some favored investors agreed to place assets in mutual funds in exchange for market timing privileges (referred to as "sticky assets"). Investment advisers' fees are often based on the size of assets under management.

Additionally, SEC has adopted rules designed to improve mutual fund company operations, including rules that require registered investment companies (mutual funds) and investment advisers to each designate a chief compliance officer (CCO). The CCO of the investment company reports directly to the company's board of directors and is responsible for preparing annual reports on company compliance with federal laws and regulations. By requiring the CCO to report directly to the board of directors, SEC helped ensure the independence of the compliance function, with one potentially important exception. Because many investment companies do not have any employees, SEC provided that an investment company's CCO could be an employee of an investment adviser. As described in this report, investment adviser staff frequently entered into undisclosed market timing arrangements with favored customers at the expense of mutual fund shareholders. Although the rule provides safeguards to ensure the independence of CCOs, it is too soon to reach definitive judgments on their effectiveness.[7] Moreover, SEC has not developed a plan to ensure that agency staff receive and can review the annual compliance reports on an ongoing basis. Without such a plan, SEC cannot ensure that it has taken full advantage of opportunities to enhance its mutual fund oversight program and detect potential violations on a timely basis.

Among other steps, this report recommends that SEC, through the examination process, ensure that investment company CCOs operate independently and are effective in carrying out their responsibilities and that SEC develop a plan to assess the feasibility of receiving and reviewing annual compliance report findings on an ongoing basis. SEC provided written comments on a draft of this report that are reprinted in appendix IV. SEC commented that the agency has taken several steps to strengthen its mutual fund oversight program and agreed with these recommendations. SEC's comments are discussed in more detail at the end of this report. NASD provided technical comments as did SEC, which have been incorporated where appropriate.

[7]As described in this report, SEC also amended rules that require that in order for mutual funds to rely on any of 10 commonly used exemptive rules, the chairperson and at least 75 percent of the members of mutual fund boards of directors be independent of the funds' investment advisory firms. SEC believes the fact that mutual fund boards have sole authority to designate and remove compliance offices will help ensure the officers' independence. The exemptive rules (i) exempt mutual funds or their affiliated persons from provisions of the Investment Company Act of 1940 that can involve serious conflicts of interest and (ii) condition the exemptive relief on the approval or oversight of independent directors.

## Background

Although it is typically organized as a corporation, a mutual fund's structure and operation differ from that of a traditional corporation. In a typical corporation, the firm's employees operate and manage the firm, and the corporation's board of directors, elected by the corporation's stockholders, oversees its operations.[8] Mutual funds also have a board of directors that is responsible for overseeing the activities of the fund and negotiating and approving contracts with an adviser and other service providers. Unlike a typical corporation, a typical mutual fund has no employees; another party, the adviser, which contracts with the fund for a fee, administers fund operations. The adviser is an investment adviser/management company that manages the fund's portfolio according to the objectives and policies described in the fund's prospectus.[9] Advisers may also perform various administrative services for the funds they operate, although they also frequently subcontract with other firms to provide these services. Functions that a fund adviser or other firms may perform for a fund include the following:

- *Custodian*: A custodian holds the fund assets, maintaining them separately to protect shareholder interests.
- *Transfer agent*: A transfer agent processes orders to buy and redeem fund shares and has customer recordkeeping responsibilities.
- *Distributor*: A distributor sells fund shares through a variety of distribution channels, including directly through telephone or mail solicitations handled by dedicated sale forces, or through third-party intermediaries' sales forces.

Mutual funds are also structured so that each investor in the fund owns shares, which represent a percentage of the fund's investment portfolio, and investors share in the fund's gains, losses, and costs. Mutual fund families offer investors multiple funds from which to choose, each with varying investment objectives and levels of risk. Investors may exchange

[8]Although the Investment Company Act of 1940, as amended, does not dictate a specific form of organization for mutual funds, most funds are organized either as corporations governed by a board of directors or as business trusts governed by trustees. When establishing requirements relating to the officials governing a fund, the act uses the term "directors" to refer to such persons, and this report also follows that convention.

[9]In some cases, the adviser may contract with other firms to provide investment advice, the latter firms becoming subadvisers to those funds.

assets between funds within a fund family at any time. Investors also may purchase shares directly from their mutual fund company or through intermediaries such as broker-dealers or pension plans that offer mutual fund company products to their customers. Intermediaries typically aggregate customer mutual fund orders and submit them to mutual fund companies at one time on a daily basis and may perform certain customer recordkeeping functions on behalf of mutual fund companies. NSCC, a SEC-registered clearing agency, is responsible for processing and clearing most of the mutual fund transactions that take place between broker-dealer intermediaries and mutual fund companies. Appendix II provides detailed information on mutual fund trade processing and recordkeeping.

Mutual fund companies are subject to SEC registration and regulation (unless an exemption from registration applies), and numerous requirements established for the protection of investors. Mutual fund companies are regulated primarily under the Investment Company Act of 1940 (1940 Act) and the rules adopted under that act. For example, mutual fund company boards are required to have members who are independent of the company's investment advisers to help ensure that fund companies act in the best interest of their shareholders. SEC has authority under the 1940 Act to promulgate rules to address the changing financial services industry environment in which mutual funds and other investment companies operate. The advisory firms that manage mutual funds are regulated under the Investment Advisers Act of 1940 (Advisers Act), which among other provisions requires certain investment advisers to register with SEC and conform to regulations designed to protect investors. Subject to SEC oversight, NASD, which is a self-regulatory organization (SRO), is responsible for regulation of its member broker-dealers that sell various investment products, including mutual funds. NASD, however, has no jurisdiction over investment companies or their advisers. NASD carries out its oversight responsibilities by issuing rules, conducting examinations, and pursuing enforcement actions as necessary. However, certain other intermediaries that may offer mutual fund products to their customers are outside of SEC's regulatory jurisdiction. For example, the Department of Labor is responsible for regulating pension plans and their administrators.

In addition to its rulemaking authority, SEC carries out its mutual fund oversight responsibilities through examinations. SEC's Office of Compliance Inspections and Examinations (OCIE) establishes examination policies and procedures and has primary responsibility for conducting mutual fund company and adviser examinations. Between 1998 and 2003, OCIE and its regional and district staff typically conducted routine examinations, which were scheduled on a regular basis (such as every 2 to 5 years), depending on their size or SEC's assessments of the risks that they represented to shareholders.[10] SEC may also conduct "sweep" examinations, which involve reviewing particular issues—such as securities valuation procedures—at a number of mutual fund companies or advisers to determine whether deficiencies or violations exist industrywide for a particular issue. Additionally, SEC may conduct "cause" examinations, which are based on indications, allegations, or tips regarding wrongdoing or inappropriate conduct at a firm. The goal of a cause examination is to quickly determine whether there is a problem at a particular entity. SEC's Division of Enforcement is responsible for pursuing civil enforcement actions for violations of securities laws or regulations that are identified through SEC examinations, referrals from other regulatory organizations such as NASD, tips from fund insiders or the public, and other sources. SEC may also refer cases to criminal authorities, such as the Department of Justice, for violations that appear to indicate criminal activity.

Market timing, although not illegal per se, can be unfair to long-term fund investors because it provides the opportunity for selected fund investors to profit from fund assets at the expense of long-term investors. Typically, sophisticated investors may engage in market timing to take advantage of differences in prices between stocks in overseas markets—particularly Asia—and U.S. markets and for other reasons. Mutual funds that fail to update their share prices are particularly vulnerable to sophisticated market timing. SEC examiners identified this phenomenon in 1997 after the Asian markets crisis when some funds "fair valued" their holdings and were not subject to market timing by shareholders while other funds that did not "fair value" their holdings were subject to market timing. Market timing may require fund managers to hold additional cash to redeem frequent trading orders, which lowers long-term investors' overall returns since the fund may hold fewer securities than would be the case in the absence of market timing. In addition, market timing increases transaction costs—such as trading fees—further lowering shareholder returns. Consequently, many mutual funds have established limits on the number of trades that individual customers may place per year—such as four trades—and disclose these limits in fund prospectuses. However, prior to September

[10]In 2004, SEC staff developed plans to revise its examination program so that teams of examiners monitored the largest mutual fund companies on an ongoing basis rather than on a regular schedule. We are assessing SEC's planned strategy as part of a separate engagement.

2003, certain investment advisers entered into undisclosed arrangements with favored customers, including hedge funds, allowing the customers to circumvent the established limits. These undisclosed agreements sometimes allowed favored customers to place hundreds of trades annually at the expense of long-term shareholders, who were subject to established trading limits. In exchange for market timing privileges, favored customers often secretly agreed to make investments in certain mutual funds or other investment vehicles that were managed by that company (commonly referred to as "sticky assets" arrangements).

Unlike market timing, late trading is illegal under all circumstances. Under SEC rules, mutual fund companies accept orders to purchase and redeem fund shares at a price based on the current net asset value (NAV), which most funds calculate once a day at 4:00 p.m. Eastern Time. As previously discussed, intermediaries—such as broker-dealers and pension funds—typically aggregate orders received from investors and submit a single purchase or redemption order that nets all the individual shares their customers are seeking to buy or sell. Because processing takes time, SEC rules permit these intermediaries to forward the order information to funds after 4:00 p.m. However, late trading occurs when some investors submit orders to purchase or sell mutual fund shares after the 4:00 p.m. close of U.S. securities markets (or the mutual fund's pricing time) and receive that same day pricing for the orders. Although late trading can involve mutual fund company personnel, late trading violations have typically occurred at intermediaries, before these institutions submitted their daily aggregate orders to mutual fund companies for final settlement. An investor permitted to engage in late trading could be buying or selling shares at the current day's 4:00 p.m. price with knowledge of developments in the financial markets that occurred after 4:00 p.m. Such investors thus have unfair access to opportunities for profit that are not provided to other fund shareholders.

## Lessons Can Be Drawn from SEC Not Having Detected Market Timing Arrangements

Prior to September 2003, SEC did not examine for market timing abuses because agency staff viewed market timing as a relatively low-risk area and believed that companies had financial incentives to establish effective controls, that is, by maximizing fund returns in order to sell fund shares. SEC staff also said that agency examiners were told by company officials that they had established "market timing police" to control frequent trading. In retrospect, SEC staff's inability to detect the widespread market timing violations demonstrates the importance of (1) conducting independent assessments of the adequacy of controls over areas such as market timing, (2) developing the institutional capability to identify and analyze evidence of potential risks, and (3) ensuring the independence and effectiveness of company compliance staff and potentially using their work to benefit the agency's oversight program.

## SEC Did Not Examine for Mutual Fund Company Market Timing Abuses

OCIE staff have stated that given the number of mutual fund companies, the breadth of their operations, and limited examination resources, SEC's examinations were limited in scope and examiners focused on discrete areas that staff viewed as representing the highest risks of presenting compliance problems that could impact investors. OCIE staff stated that prior to September 2003, they considered funds' portfolio trading (i.e., the fund's purchases and sales of securities on behalf of investors) and other areas as representing higher risks than potential market timing abuses. For example, examiners focused on whether funds were trying to inflate the returns of the fund, or taking on undisclosed risk. SEC's staff's concern was that in attempting to produce strong investment returns to attract and maintain shareholders, fund portfolio managers had an incentive to engage in misconduct in the management of the fund. As a result, SEC examination protocols instructed that significant attention be focused on portfolio management, order execution, allocation of investment opportunities, pricing and calculation of NAV, advertising returns, and safeguarding fund assets from theft. SEC staff stated that examinations and enforcement cases in these areas revealed many deficiencies and violations. Our discussions with SEC staff nationwide, review of selected examination reports, and discussions with officials of mutual fund companies verified that the agency did not review market timing controls prior to September 2003.

OCIE and SEC district staff we contacted said that the agency also did not review mutual fund market timing controls because market timing is not illegal per se, and they viewed fund companies as having financial incentives to control frequent trading. That is, since frequent trading can reduce shareholder returns, fund companies had incentives to establish controls that would prevent market timing. Failure to establish such controls could result in a loss of new sales and assets under management, which would harm investment advisers because they are compensated based on the amount of assets under management. Thus, SEC staff concluded the advisers had a financial incentive to grow or maintain assets under management in order to receive higher fees. SEC staff also said that mutual fund company officials told agency examiners that they had appointed "market timing police" to enforce compliance with the funds' trading limit policies.

SEC staff also stated that they were surprised when the NYSOAG identified abusive market timing and late trading violations in September 2003. SEC staff said that they did not anticipate that mutual fund companies would enter into market timing arrangements that were detrimental to fund performance because poor performance could impact sales and have a negative effect on the fee received by the adviser. After the abusive practices were identified, SEC moved aggressively to assess the scope and seriousness of the problem. For example, SEC surveyed about 80 large mutual fund companies and determined that nearly 50 percent had some form of undisclosed market timing arrangement with certain customers that appeared to be inconsistent with internal policies, prospectus disclosure, or fiduciary duties. SEC also initiated immediate "cause" examinations and investigations at many of these mutual fund companies to further review potential violations. As described in a later section, SEC also initiated numerous enforcement actions to penalize violators and deter the abusive mutual fund trading practices.

NASD in its examinations of broker-dealers also did not discover market timing arrangements involving broker-dealers before September 2003. According to an NASD official, this was because market timing was not illegal per se and, to the extent a mutual fund company had stated customer trading limits, broker-dealers may not have perceived themselves as being responsible for the enforcement of such policies. Regarding late trading, NASD officials said that the organization did not have specific examination guidance to detect the violation prior to September 2003. NASD officials also said that some broker-dealers created fictitious accounts or otherwise falsified documents, which made the detection of late trading violations difficult.

## Independent Assessments of Controls are Essential

We recognize that SEC faces competing examination priorities and had limited examination resources prior to September 2003. In a 2002 report, we noted that over the previous decade the size and complexity of financial markets had increased substantially, whereas SEC's staff size had remained essentially flat, which significantly increased the agency's workload.[11] In

[11]GAO, *SEC Operations: Increased Workload Creates Challenges*, GAO-02-302 (Washington, D.C.: Mar. 5, 2002).

particular, our report noted the large increase in investment company and investment adviser assets under management over a 10-year period, relative to the growth in examination staff. As discussed later in this report, in recent years, Congress has provided SEC with substantial budgetary increases to assist in overseeing the securities markets. Some of these new resources were allocated to oversight of mutual funds. We also recognize that SEC examiners cannot anticipate every potential fraud, particularly novel frauds such as the undisclosed market timing arrangements between investment advisers and favored customers, such as hedge funds.

Although we recognize that SEC faced competing priorities, the fact that the agency subsequently found that about half of the largest mutual fund companies had entered into undisclosed arrangements with certain shareholders, demonstrates the importance of examination and auditing standards that call for independent assessments of the adequacy of controls to prevent or detect abusive practices. SEC's examination standards acknowledge the importance of independent control testing. For example, SEC examination guidance in effect since 1997 states:

> A primary task and responsibility of the SEC inspection staff is to review a fund's control environment and underlying internal control or compliance system(s). By applying certain examination procedures and techniques, examiners should be able to evaluate the control environment and determine the effectiveness of each system in ensuring compliance.

In addition, commonly accepted examination and auditing guidelines call for a degree of professional skepticism in assessing controls (such as mutual fund company market timing controls) and independent verification of their adequacy to confirm other assessments of potential risks or statements by company officials. Conducting independent testing of controls at a sample of companies, at a minimum, could serve to verify that areas, such as market timing, do in fact represent low risks and that effective controls are in place. Independent control assessments can be accomplished through a variety of means including interviewing officials responsible for the control, assessing organizational structure to ensure that compliance staff have adequate independence to carry out their responsibilities, reviewing internal and external audit reports, reviewing exceptions to stated policies, and testing transactions as necessary. If examiners or auditors detect indications of noncompliance with stated policies or requirements, they are expected to expand the scope of their work to determine the extent of identified deficiencies.

We also note that SEC examination guidance potentially limited examiners' capacity to develop overall assessments of mutual fund company risks and controls and identify potential violations---such as market timing abuses—outside of identified or perceived high-risk areas. Specifically, SEC examination guidance of March 2002 generally instructed examiners to request only a sample of selected internal audit reports when reviewing a registrant's internal control or supervisory systems or as part of a review of a particular problem, rather than instructing examiners to routinely request all internal audit and compliance reports or listings thereof. According to SEC staff, SEC has the legal authority to request and obtain access to all investment adviser and transfer agent books and records—including internal audit reports. Although restrictions exist on SEC's access to investment company books and records, SEC staff said that the agency can generally obtain needed documents through investment advisers or transfer agents, which typically keep documents similar to investment companies.[12] However, SEC staff said that routinely requesting all internal audit reports in planning for examinations could have unintended negative consequences. For example, SEC staff said that routinely requesting all audit reports may discourage companies from establishing effective internal audit departments out of concern that findings in internal audit reports could result in SEC investigations. In a May 2004 report that addressed SEC's oversight of SRO listing standards, SEC staff made similar arguments regarding the "chilling effect" of requesting internal audit reports.[13] However, we pointed out that it is standard practice among financial regulators to request a range of internal audit reports in planning examinations and that SRO internal audit reports contained information relevant to SEC's listing oversight responsibilities. Accordingly, we recommended that SEC review SRO internal audit reports as part of its

[12]Under the Advisers Act, SEC has the authority to examine all adviser books and records, whether the agency has enacted regulations requiring particular records to be maintained. However, under the 1940 Act, SEC has the authority to examine those books and records of mutual fund companies that are required by statute or rule to be maintained. Although SEC has authority under the 1940 Act Section 31(b)(3) (codified at 15 U.S.C. § 80a-30(a)(2)) to prescribe recordkeeping rules it deems necessary or appropriate for investors, the statute directs SEC to "take steps to avoid unnecessary recordkeeping by, and minimize the compliance burden on" regulated entities. The 1940 Act Section 31(b)(3) (codified at 15 U.S.C. § 80a-30(b)(3)) further directs SEC to exercise its examination authority with "due regard to the benefits of internal compliance departments and procedures and the effective implementation and operation thereof."

[13]GAO, *Securities Markets: Opportunities Exist to Enhance Investor Confidence and Improve Listing Program Oversight*, GAO-04-75 (Washington, D.C.: Apr. 8, 2004). Listing standards are the minimum financial and nonfinancial requirements that issuers must meet to become and remain listed for trading on a market. SROs, such as NASD and NYSE, have responsibility to regulate their members under the oversight of the SEC.

examinations and the agency agreed to do so. Moreover, SEC staff's assertion of a "chilling effect" is based on a questionable premise. In fact, companies may have the opposite incentive knowing that SEC staff will not routinely review all of their internal audit reports. As described later in this report, internal staff at two mutual fund companies produced internal compliance reports in 2002 that documented evidence of undisclosed market timing arrangements and their negative consequences for shareholders.[14] SEC staff has revised its policy on requesting internal reports and this is also described later in this report.

In contrast, federal bank regulators had implemented procedures that directed examiners to use a range of information sources to help develop an overall and independent perspective on bank risks and the adequacy of their controls. The Federal Reserve System and the Office of the Comptroller of the Currency (OCC), typically assign on-site examiners to large institutions on an ongoing basis but may conduct examinations of smaller institutions every 12 to 18 months or more (SEC also has typically examined mutual funds on a regular schedule). Under the Federal Reserve System's commercial bank examination guidelines dated May 2000, examiners were required to make an evaluation of the overall risks facing large and small banks and the controls that were in place to manage those risks, including the adequacy of internal audit and compliance departments. (As discussed later in this report, SEC adopted a revised risk-based examination approach in 2002.)[15] Among the potential range of steps specified in such standards, examiners could assess controls by interviewing compliance or audit staff and reviewing internal audit or other relevant internal reports without restrictions. While we recognize that there are important differences between the safety and soundness focus of bank examinations and the traditional compliance and enforcement focus of SEC examinations, as well as staffing of the various agencies, bank regulator approaches to carrying out their responsibilities provided a

[14]We note that these reports were not produced by the companies' internal audit departments. However, SEC's March 2002 examination guidance defined a range of internal compliance reports and limited examiners' discretion to request such reports during examinations. Additionally, the responsible SEC district office staff did not examine the companies during the period in which the internal reports were produced. However, district office staff said they would have not requested any studies regarding market timing even if they had reviewed the companies because market timing was not perceived as a high-risk area.

[15]Our work did not include an analysis of whether bank regulators actually implement these standards during bank examinations.

practical means for examiners to verify control adequacy and identify potential deficiencies.

## SEC Can Strengthen Its Capacity to Identify and Evaluate Potential Risks

We also identified information that was available prior to September 2003—including academic studies and a tip from an industry insider—that was inconsistent with SEC examination staff's rationale for not independently assessing mutual fund company market timing controls. That is, the staff viewed market timing as a relatively low risk area, had been told by company officials that they had established effective controls, and believed that fund companies had financial incentives to establish such controls to ensure high fund returns. Although the available information did not directly identify evidence of undisclosed arrangements between investment advisers and favored customers, it did identify significant and persistent risks associated with market timing by sophisticated investors and suggested that mutual fund companies were not always acting aggressively to control these risks potentially due to conflicts of interest. We note that SEC staff in the Division of Investment Management (Investment Management) were also aware of these market timing risks and had attempted to mitigate them through the regulatory process, with limited success according to academic studies.[16] In retrospect, the information suggested that market timing was an area that might have merited the focus of the agency's examination function and that the agency needed to strengthen its capacity to identify and evaluate evidence of potential risks. As described later in this report, SEC has established a new risk assessment office.

Articles in the financial press and academic studies that were available prior to September 2003 stated that market timing posed significant risks to mutual fund company shareholders.[17] For example, a 2002 academic study estimated that mutual fund company shareholders were losing nearly $5 billion per year in certain international and other funds due to such market

[16]The Division of Investment Management oversees and regulates the investment management industry and administers the securities laws affecting investment companies (including mutual funds) and investment advisers.

[17]Mercer Bullard, "Your International Fund May Have the Arbs Welcome Sign Out" *The Street.com* (June 10, 2000) and Mercer Bullard, "International Funds Still Sitting Ducks for Arbs" *The Street.com* (July 1, 2000). Also, William Goetzmann with Zoran Ivkovic and K. Geert Rouwenhorst, "Day Trading International Mutual Funds: Evidence and Policy Solutions," *Journal of Financial and Quantitative Analysis* 36 (3) (September 2001): 287-309 and Zitzewitz (2002).

timing activity.[18] In 2001 and 2002, a senior Investment Management staff member also made public statements that market timing posed risks to mutual fund company shareholders by requiring companies to, among other things, hold excess cash. These articles and the statements of the SEC staff member focused on the hesitant approach of many mutual fund companies to meet their legal obligations under the 1940 Act to adopt "fair value" pricing of their securities despite SEC guidance that they do so.[19] Establishing fair value prices in international and other funds was viewed, including by SEC staff, as an essential means to minimize arbitrage opportunities for sophisticated investors and thereby minimize the negative consequences for fund performance. In 1999, 2001, and 2002, SEC staff wrote "interpretive" letters to the mutual fund industry reminding industry officials of their obligations to adopt fair value pricing and providing guidance and regulatory assistance in controlling market timing.[20] For example, in November 2002, SEC staff wrote to ICI—the trade group that represents the mutual fund industry—to state that a fund company may, consistent with the 1940 Act provisions, make an exchange on a specified delayed basis, so long as the offer is fully and clearly disclosed in the fund's prospectus. [21]

Several reasons have been advanced for mutual fund companies' failure to adopt fair value pricing and thereby help avoid losses due to market timers. Among other reasons, a 2002 article suggested that mutual fund company boards with a higher percentage of directors who are independent of their investment advisers were more likely than boards

[18]Zitzewitz (2002) estimated the total annualized loss at $4.9 billion per year, $4.3 billion of which is in international equity funds.

[19]The 1940 Act requires mutual funds to value their portfolio securities by using the market value of the securities when market quotations for the securities are not readily available.

[20]Letter from Douglas Scheidt, Associate Director and Chief Counsel, SEC's Division of Investment Management, to Craig S. Tyle, General Counsel, ICI (Dec. 8, 1999); letter from Scheidt to Tyle on April 30, 2001; and Division of Investment Management Letter to Investment Company Institute re: Delayed Exchange of Fund Shares, (Nov. 13, 2002).

[21]Under a delayed exchange policy, exchange transactions (in which proceeds from shares are redeemed in one fund are used to purchase shares in another fund) are executed on a delayed basis, such as the next business day. Delaying an exchange transaction can help deter market timing because market timing relies on effecting transactions on specific days to take advantage of perceived market conditions.

with fewer independent directors to adopt fair value pricing.[22] The article also suggested that investment advisers may face conflicts of interest regarding fund shareholders and may benefit from permitting arbitrage. According to the author, he believed the potential existed that market timers were investing assets in mutual funds, which allowed investment advisers to increase their fees for assets under management, in exchange for market timing privileges. As discussed previously, SEC later determined that many investment advisers did benefit from such “sticky assets.” Senior SEC staff cited other reasons for the industry’s slow implementation of fair value pricing. For example, the staff said the companies were concerned about the lack of objectivity in using estimated prices and due to concerns about lawsuits from market timers whose trading strategies would be negatively affected. Nevertheless, the study suggested that companies were not always acting aggressively to ensure optimal performance, as SEC staff assumed they would do, and that conflicts of interest may have compromised companies’ willingness to adopt corrective measures.

Finally, by not acting promptly on information suggesting that a large mutual fund company had not established effective market timing controls, an SEC office may have missed an opportunity to detect violations. In early 2003, an insider at a Boston-based fund company provided information and documentation to SEC’s Boston district office suggesting that company management failed to control widespread abusive market timing by fund customers. According to SEC district staff, they reviewed the information provided by the insider but did not act on it because they did not view the alleged activity as representing a violation of federal securities laws or regulations. For example, the district staff said that the fund company’s disclosures to investors were vague and that they could not conclusively demonstrate that the company had violated its prospectus disclosures. Subsequently, the insider turned the information over to the Massachusetts Securities Division, which settled state charges against the fund company related to the insider’s allegations. Although SEC staff subsequently began a review of the fund company in response to a separate tip in September 2003 and initiated a related enforcement action in October, this action was related to market timing by fund insiders rather than fund customers as alleged earlier by the fund insider. SEC district staff said the fact that SEC did not bring an enforcement action against the mutual fund company for the actions alleged by the insider substantiated their original position not to act on the initial tip. While we do not dispute SEC’s contention that the

[22]Zitzewitz (2002).

insider's allegations did not necessarily involve violations of federal laws or regulations, they did indicate a failure by the company's management to establish effective controls against market timing as SEC staff assumed was in the company's interests to do. If the district office had pursued this information in early 2003, the potential exists that examiners would have identified other weaknesses, such as the market timing abuses by company insiders sooner than they did in late 2003.

## Independent and Effective Company Compliance Staff Are Essential to Detecting and Preventing Trading Abuses

In the majority of the 11 SEC enforcement cases that we reviewed, company compliance staff—the first line of defense in ensuring company adherence to laws, regulations, and internal policies—lacked the independence necessary to carry out their responsibilities. According to SEC examination reports, enforcement actions, and discussions with SEC staff, the compliance staff—in some cases referred to as "market timing police"—were often successful in identifying and controlling market timing by certain customers, typically those who did not have special arrangements with the companies. The compliance staff reviewed trading data in funds considered vulnerable to market timing—such as international funds—and notified customers who exceeded specified limits on the number of trades placed within a specified period that their trading privileges would be suspended if the violations continued. When customers continued to violate company restrictions, SEC staff and related documents indicated that the companies would suspend their trading. However, contrary to established financial and corporate standards regarding the proper role of compliance staff, the compliance staff at these firms did not have sufficient independence to ensure that corrective actions always were taken to address violations.[23] Consequently, when the compliance staff identified violations of company trading standards by favored customers, other company officials would routinely overrule their efforts to limit the customers' trading. In some cases, the compliance staff

[23]For example, Federal Deposit Insurance Corporation revised compliance examination procedures state that a bank's "…board and senior management must grant a compliance officer sufficient authority and independence to…effect corrective action." The U.S. Sentencing Commission has established minimum standards for compliance and ethics programs for companies that seek reductions in their sentences for criminal convictions. Companies that establish effective compliance and ethics programs to detect and prevent criminal conduct can obtain reduced penalties. Among other requirements, the compliance and ethics program must, at a minimum, be promoted and enforced consistently throughout the organization.

kept separate lists of customers who were permitted to exceed the companies' specified trading limits.

Although the companies' compliance staff were generally ineffective in controlling market timing by favored customers, our review suggests that routine communications with such compliance staff could potentially enhance SEC's capacity to detect potential violations at an earlier stage, if compliance staff are forthcoming about the problems they detect. At these companies, the compliance staff obviously were aware of violations of company policies for several years and, in some cases, had documented their findings in internal reports. In one case, the sales staff at the mutual fund company overrode the compliance staffs' efforts to control hundreds of market timing transactions between 1998 and 2003. In another case dating from 2002, the company's compliance officer sent a memorandum to the company's chief executive officer complaining about the long-term effects of market timing arrangements on long-term shareholders. In a January 2003 memorandum, the compliance officer notified the chief executive officer that the company was a "timer-friendly complex" and had granted numerous exceptions to company trading restrictions, which was not consistent with protecting customer interests. In another case, an internal company study from the fall of 2002—that was widely circulated among company executives—found similar abuses and recommended that the company terminate market timing arrangements, but the company did not do so until the summer of 2003.

In cases we reviewed, company compliance staff or other officials had taken action against company officials for failure to comply with market timing policies, but their actions did not always deter this behavior. In 2000, compliance staff at one company found that the chairman had engaged in market timing contrary to shareholder interests and warned him to stop the practice. However, the chairman continued to engage in market timing until SEC identified his abusive practices in 2003. Compliance staff of another investment adviser to a large fund identified a senior fund manager who engaged in market timing in violation of internal policies in 2000. Officials warned the fund manager to stop the practice, but he resisted and continued the market timing until 2003.

## SEC Has Taken Steps to Strengthen Its Mutual Fund Oversight Program, but It Is Too Soon to Assess the Effectiveness of Several Key Initiatives

Over the past 2 years, SEC staff has taken steps to better detect abusive practices in the mutual fund industry and plans significant changes to its overall examination program. For example, SEC staff has implemented guidance instructing examiners to conduct expanded reviews of company controls and make increased use of internal company reports in doing so, although examiners still are not expected to request listings of all relevant reports. SEC has also established the Office of Risk Assessment (ORA) to help the agency better anticipate, identify, and manage emerging risks and market trends. However, it is too soon to assess ORA's effectiveness. SEC and NASD have also brought numerous enforcement actions for mutual fund violations, and SEC has hired additional staff and established new procedures for handling tips. In addition, SEC has amended existing rules and adopted new rules to help improve fund operations and better protect investors, including a requirement that in order for mutual funds to rely on certain exemptive rules, the chairperson and at least 75 percent of a mutual fund's board be independent of the mutual fund's investment adviser.[24] SEC also adopted a compliance rule that requires mutual fund company boards to designate CCOs whose duties include preparing annual reports on the adequacy of the company's policies and procedures to ensure compliance with the federal securities laws. Although the compliance rule has the potential to strengthen mutual fund company operations, certain CCOs may still face organizational conflicts of interest in carrying out their duties, of which SEC must be cognizant in its oversight responsibilities. Moreover, SEC has not developed a plan to ensure that its staff receive and review the annual reports prepared by CCOs on an ongoing basis to detect potential violations and identify emerging trends in the mutual fund industry.

[24]Section 10(a) of the 1940 Act, 15 U.S.C. § 80a-10(a), requires that at least 40 percent of the members of the mutual fund board of directors be independent directors. To enhance the independence and effectiveness of fund boards, in January 2001, the SEC adopted a fund governance requirement that required the board of directors of a fund seeking to rely on any of the SEC's commonly used exemptive rules to be comprised of a majority of independent directors. The exemptive rules allow funds to engage in transactions that would otherwise be prohibited under the 1940 Act and that present conflicts between the fund and its management company. In the wake of recent enforcement actions related to late trading, market timing and misuse of nonpublic information about fund portfolios, and in recognition of the fact that a simple majority of independent directors may not adequately ensure that independent directors dominate the decision-making process, SEC strengthened this fund governance requirement for 10 exemptive rules by adopting the 75 percent independence and independent board chair requirements in August 2004. 69 *Fed. Reg.* 46378 -79 (August 2, 2004).

## SEC's Examination-Related Initiatives Were Designed to Strengthen Mutual Fund Oversight

SEC staff has issued guidance designed to provide examiners with an overall perspective on the risks facing mutual fund companies and the adequacy of controls to mitigate those risks. For example, in November 2003, SEC staff directed its examination staff to request in planning examinations that mutual fund company officials provide written summaries of any compliance problems or violations, or repeated compliance problems, that occurred after the company's last examination. According to SEC staff, this information previously had been requested orally but SEC staff were not confident that fund companies were providing all information orally, and thus formalized this process. According to testimony by OCIE's director on March 10, 2004, the agency has also begun to make increased use of interviews of company officials in conducting mutual fund examinations. The director stated that interviews had begun to play an increased role in assessing companies' critical risks and control environments.

In late 2002, nearly a year before the NYSOAG identified the market timing and late trading violations, SEC staff revised its guidance for mutual fund examinations, including expanded requests for internal company documents, but it is not clear that the revised guidance is sufficient to fully assist in identifying abusive practices. Under the revised risk-based guidelines, SEC examiners are expected to complete "scorecards" during routine examinations for specific areas, such as personal trading by company insiders, which SEC staff has identified as presenting possible risks to mutual fund companies.[25] In general, each scorecard requires SEC examiners to perform several steps to assess the adequacy of company controls for each risk area. For example, examiners are expected to identify the company official responsible for establishing controls for each risk area and identify the documentation reviewed to assess the adequacy of identified controls. Additionally, the scorecards direct SEC examiners to record their overall observations about the adequacy of company controls for each of the risk areas. As part of the examination planning process, SEC staff also now request that mutual fund companies provide copies of management reports, self-assessments, exception reports, and internal audit and other reports relevant to the 13 risk areas. Although requesting

[25]Other areas assessed include portfolio management, brokerage arrangements and best execution, allocations of trades, pricing of clients' portfolios and calculation of net asset value, information processing and protection, performance advertising, marketing and fund distribution activities, safety of clients' funds and assets, fund shareholder order processing, anti-money laundering, and corporate governance.

these internal reports should enhance SEC's capacity to oversee mutual fund companies, we note that other areas that the agency has not considered could pose significant risks. To illustrate, prior to the detection of the mutual fund trading abuses in September 2003, SEC staff did not anticipate that investment advisers would enter into undisclosed market timing arrangements with favored customers. Therefore, it is not clear that SEC's expanded procedures for collecting internal audit and other reports would have resulted in companies producing any reports that addressed this activity.

SEC staff has also implemented examination procedures designed to detect market timing abuses. More specifically, SEC staff now instruct examiners to review (1) fund sales and redemption (shareholder turnover) data to detect patterns of market timing; (2) a sample of internal e-mails of fund executives to detect misconduct not reflected in the fund's books and records, such as agreements to allow certain investors to market time; and (3) the personal trading of fund executives. In addition, SEC staff directs examiners to speak with company compliance officials regarding their efforts to control market timing.

SEC staff also plan to significantly revise its approach to mutual fund examinations and are evaluating the development of a surveillance system to monitor the industry. (We review both initiatives in a forthcoming report.) Traditionally, SEC has relied on routine examinations of all mutual funds over a specified cycle to carry out its oversight responsibilities. Between 1998 and 2003, SEC established an examination cycle that would ensure that each investment company and its advisers would be examined once every 5 years. In mid-2004, SEC staff told us that they planned to move from scheduled examinations of all mutual fund companies to a system where they focused examination resources on the largest and riskiest companies and advisers (200 fund groups and 600 advisers). To focus on the largest entities, SEC staff is creating monitoring teams of two or three examiners to review the companies' operations on an ongoing basis. According to OCIE staff, they have not yet determined the specific roles and responsibilities of the monitoring teams but generally expect the teams also would monitor their assigned fund company by periodically contacting fund compliance staff and conducting a program of continuous inspections. According to the staff, they would also continue to examine advisers and funds with higher risk profiles every 2 to 3 years, and conduct random inspections of some portion of the remaining firms. We note that SEC's planned approach for large mutual fund companies is similar to the bank regulators' approach to bank supervision, in which examiners are permanent members of a monitoring team assigned to monitor the largest institutions. Concerning the surveillance system, an SEC task force is currently considering the development of an automated system that would allow agency staff to monitor the industry by reviewing company financial and other data that may indicate systemic risks or potential problems at individual companies. According to SEC staff, such information could help target examination resources toward the highest potential risks. SEC staff also said that the task force has been making progress but has not set a time frame for providing SEC with its proposal.

According to NASD officials, in response to the recent mutual fund scandals, NASD has also changed its examination modules to detect market timing and late trading abuses at broker-dealers, making these issues more prominent in broker-dealer examinations. NASD examiners ask a series of questions and review documentation of broker-dealers to help determine if inappropriate activity is taking place. NASD also employs a risk-assessment strategy to rate the level of risk associated with a broker-dealer and determines how often it will be examined.

## SEC Established a New Office to Identify and Manage Emerging Risks

SEC has established ORA to assist the agency in carrying out its overall oversight responsibilities, including mutual fund oversight. The office's director reports directly to the SEC chairman. According to SEC staff, ORA will enable agency staff to analyze risk across divisional boundaries, focusing on early identification of new or resurgent forms of fraudulent, illegal, or questionable behavior or products. ORA's duties include (1) gathering and maintaining data on new trends and risks from external experts, domestic and foreign agencies, surveys, focus groups, and other market data; (2) analyzing data to identify and assess new areas of concern across professions, companies, industries, and markets; and (3) preparing assessments and forecasts on the agency's risk environment. SEC staff said that ORA will seek to ensure that SEC will have the information necessary to make better, more informed decisions on regulation. This new office is to work in coordination with internal risk teams established in each of the agency's major program areas and a Risk Management Committee responsible for reviewing implications of identified risks and recommending appropriate courses of action. Working with other SEC offices, ORA staff expect to identify new technologies, such as data mining systems that can help agency staff detect and track risks. Although ORA may help SEC be more proactive and better identify emerging risks, it is too soon to assess its effectiveness. In this regard, we note that as of February 2005, ORA had established an executive team of 5 individuals but still planned to hire an additional 10 staff to assist in carrying out its responsibilities.

## SEC and NASD Have Taken a Number of Enforcement Actions for Abusive Market Timing and Late Trading

Based on examination findings both SEC and NASD have taken enforcement actions against investment advisers to mutual fund companies, broker-dealers, and other regulated persons and entities who have engaged in market timing and late trading. As of February 28, 2005, SEC had settled 14 enforcement actions against investment advisers generally for facilitating market in their own funds (see fig. 1). SEC has also brought 10 enforcement actions against broker-dealer, brokerage-advisory, and financial services firms for market timing abuses and late trading and, as of February 28, 2005, settled five of these cases for about $17 million. SEC also has brought enforcement actions against individuals associated with investment advisers and other firms and has obtained significant penalties ($30 million in one case) and barred several officials from the securities industry for life. The penalties and disgorgements (which force firms to give up ill-gotten gains) SEC has obtained in all of the settlements total about $2 billion. In addition to penalties and disgorgements, SEC settlements contained undertakings that required companies to improve their corporate governance structure and practices. NASD has taken 12 actions against broker-dealers for late trading and market timing abuses with fines and restitutions totaling more than $6 million. NASD has also imposed restrictions on broker-dealers. A forthcoming GAO report will address all SEC enforcement actions related to the mutual fund trading abuses in greater detail.

**Figure 1: SEC Settled Enforcement Actions against Investment Advisers Related to Market Timing Violations as of February 28, 2005 (dollars in thousands)**

| Investment adviser case[a] | Penalty | Disgorgement | Total |
|---|---|---|---|
| Banc of America Capital Management, LLC[b] | $125,000 | $250,000 | $375,000 |
| Invesco Funds Group, Inc. | 140,000 | 235,000 | 375,000 |
| Alliance Capital Management, LP | 100,000 | 150,000 | 250,000 |
| Massachusetts Financial Services, Co. | 50,000 | 175,000 | 225,000 |
| Columbia Management Advisors, Inc. | 70,000 | 70,000 | 140,000 |
| Janus Capital Management, LLC | 50,000 | 50,000 | 100,000 |
| Pilgrim Baxter & Associates, Ltd. | 50,000 | 40,000 | 90,000 |
| Strong Capital Management, Inc. | 40,000 | 40,000 | 80,000 |
| Putnam Investment Management, LLC | 50,000 | 5,000 | 55,000 |
| Banc One Investment Advisors, Corporation | 40,000 | 10,000 | 50,000 |
| PIMCO Advisors Fund Management, LLC | 40,000 | 10,000 | 50,000 |
| Franklin Advisers, Inc. | 20,000 | 30,000 | 50,000 |
| RS Investment Management, LP | 13,500 | 11,500 | 25,000 |
| Fremont Investment Advisors, Inc.[c] | 2,000 | 2,146 | 4,146 |
| | **790,500** | **1,078,646** | **1,869,146** |

Source: SEC.

[a]The entities named in this column are investment advisers associated with these cases. In some cases, SEC simultaneously charged other entities, such as an associated investment adviser, distributor, or broker-dealer for their role in the market timing abuses. The penalties and disgorgements shown for each case are the totals obtained in settlement from all the entities associated with the case.

[b]Bank of America settled charges involving both abusive market timing and late trading on the part of its investment adviser and broker-dealer subsidiaries, respectively.

[c]Fremont Investment Advisors, Inc. settled charges involving both abusive market timing and late trading.

## SEC Has Hired Additional Staff to Carry Out Its Oversight Responsibilities

In recent years, Congress has given SEC substantial budgetary increases to assist it in overseeing the securities markets and increase the agency's effectiveness. SEC staff positions in the areas that pertain to the agency's regulation and oversight of the mutual fund industry are shown in table 1. Between 2002 and 2005, SEC increased the staffing for OCIE and the Division of Enforcement by 38 and 29 percent, respectively. SEC also increased staffing within Investment Management by 16 percent. SEC staff told us that many of the new personnel have been working on mutual fund issues. While the additional staff has the potential to enhance SEC's capacity to oversee key areas such as the mutual fund industry, we previously reported that the agency hired the staff without having updated its strategic plan.[26] In the absence of a strategic plan that identified the agency's priorities and aligned those priorities with an effective human capital program, it is not clear that SEC's hiring decisions ensured that the right individuals were in place to do the most effective job possible. In August 2004, SEC revised its strategic plan. We are reviewing SEC's strategic workforce planning effort as part of a separate engagement.

**Table 1: Staff Positions for SEC Divisions and Offices with Responsibilities for Mutual Fund Regulation, Oversight, and Enforcement, as of February 2005**

| SEC Unit | Actual 2002[a] | Actual 2003[a] | Actual 2004[a] | Estimated 2005[a] | Percent change 2002-2005[a] |
|---|---|---|---|---|---|
| Division of Investment Management[b] | 173 | 167 | 190 | 200 | 16% |
| OCIE[c] | 397 | 439 | 513 | 547 | 38 |
| Division of Enforcement[d] | 980 | 1,016 | 1,308 | 1,338 | 37 |

Source: GAO analysis of SEC data.

[a]Fiscal years.

[b]Includes staff in the office that administers the Public Utility Holding Company Act of 1935.

[c]The amounts for OCIE include all staff in SEC's headquarters and regional offices who support or conduct examinations of mutual funds and investment advisers.

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

## SEC Has Acted to Improve Its Tip Handling Processes

Since the mutual fund trading abuses surfaced, SEC has acted to improve its processes for handling tips and complaints. SEC's Division of Enforcement, which receives enforcement-related tips and complaints, has centralized its process for receiving, analyzing, and responding to tips from the public. According to the head of the office that administers the division's tip handling process, before the abuses were detected the division had no process for regional and district office staff to refer complaints and tips to headquarters for review and no system by which management could review how staff handled complaints and tips. Under

[26]GAO, *SEC Operations: Oversight of Mutual Fund Industry Presents Management Challenges*, GAO-04-584T (Washington, D.C.: April 20, 2004).

the new process, information concerning all enforcement-related tips and complaints, whether received through telephone calls, correspondence, e-mails, or in-person, is reported to and maintained by a dedicated group within SEC headquarters. That group maintains a centralized log of all complaints and tips, which includes the date of the complaint or tip, the name, address, and telephone number of the complainant, and the nature of the complaint or tip. It also includes a summary of the action taken by staff in response to the complaint or tip—such as assigned to division staff for follow-up, referred to another SEC unit for further investigation, or referred to another agency. According to the office head, senior management within the division review the log regularly to confirm that each complaint or tip was appropriately handled by staff. Additionally, Investment Management and OCIE have taken recent steps to strengthen their collection and analysis of tips received from the public or referrals of potential violations received from other SEC offices or regulatory agencies.

## SEC Has Adopted Rules Designed to Improve Mutual Fund Company Operations, but Questions Remain about the Implementation of the Compliance Rule

Since late 2003, SEC has adopted seven new rules and 3 amendments designed to improve fund operations and to protect investors (see table 2). Among the most significant initiatives, SEC adopted a series of amendments to its exemptive rules on July 27, 2004, that are intended to strengthen mutual fund company governance. In SEC's press release regarding these rule amendments, SEC stated that investment advisers may dominate mutual fund company boards and management and that the advisers have inherent conflicts of interest in carrying out their responsibilities. SEC further stated that independent board members can minimize these potential conflicts of interest and act to protect shareholder interests. Accordingly, SEC now requires that in order for a mutual fund company to rely on the exemptive rules, at least 75 percent of the members of its board of directors must be independent and the board chair must also be independent. SEC also required fund directors to assess at least annually the performance of the fund board and its committees. This annual self-assessment requirement is intended to improve fund performance by strengthening directors' understanding of their role and fostering better communications and greater cohesiveness. Moreover, SEC believes that the annual review will assist fund boards in identifying potential weaknesses in the boards' performance.

**Table 2: SEC Mutual Fund-related Rules, Adopted after September 2003**

| Rule name | Date adopted | Description of rule |
|---|---|---|
| Compliance Rule | December 17, 2003 | Requires each investment company and investment adviser registered with SEC to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws and the Advisers Act, respectively, review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and designate a chief compliance officer (CCO) to be responsible for administering the policies and procedures. |
| Shareholder Reports and Quarterly Portfolio Disclosures of Registered Management Investment Companies | February 24, 2004 | Requires a registered management investment company to include in its shareholder reports disclosure of fund expenses borne by shareholders during the reporting period. Also permits a registered management investment company to include a summary portfolio schedule of investments in its reports to shareholders, provided that the complete schedule is filed with SEC and is provided to shareholders upon request, free of charge. |
| Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings | April 16, 2004 | Requires open-ended management investment companies to disclose in their prospectuses both the risks to shareholders of frequent purchases and redemptions of investment company shares, and the investment company's policies and procedures with respect to such frequent purchases and redemptions. |
| Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies | June 23, 2004 | Requires a registered management investment company to provide disclosure in its reports to shareholders regarding the material factors and the conclusions with respect to those factors that formed the basis for the board's approval of advisory contracts during the most recent fiscal half-year. |
| Investment Adviser Codes of Ethics | July 2, 2004 | Requires that registered investment advisers adopt codes of ethics that sets forth standards of conduct expected of advisory personnel and address conflicts that arise from personal trading by advisory personnel. Among other things, the rule requires advisers' supervised persons to report their personal securities transactions, including transactions in any mutual fund managed by the adviser. |
| Investment Company Governance | July 27, 2004 | A series of amendments to certain exemptive rules under the 1940 Act that are designed to enhance the independence and effectiveness of fund boards and to improve their ability to protect the interests of the funds and fund shareholders they serve. The amended rules require that in order for mutual funds to rely on any of 10 commonly used exemptive rules, the chairperson and at least 75 percent of the members of mutual fund boards of directors be independent of the funds' investment advisory firms. |
| Disclosure Regarding Portfolio Managers of Registered Management Investment Companies | August 23, 2004 | A series of amendments to forms prescribed under the Securities Act of 1933, the Securities and Exchange Act of 1934, and the 1940 Act, which among other things extends the existing requirement that a registered management company provide basic information in its prospectus regarding its portfolio managers to include the members of management teams. The amendments also require a registered management investment company to disclose additional information about its portfolio managers, including other accounts they manage, compensation structure, and ownership of securities in the investment company. |

(Continued From Previous Page)

| Rule name | Date adopted | Description of rule |
|---|---|---|
| Prohibition on the Use of Brokerage Commissions to Finance Distribution | September 2, 2004 | Amends rule under the 1940 Act that governs the use of assets of open-end management investment companies to distribute their shares. The amended rule prohibits funds from paying for the distribution of their shares with brokerage commissions. According to SEC, the amendments are designed to end a practice that poses significant conflict of interest and may be harmful to funds and fund shareholders. |
| Registration Under the Advisers Act of Certain Hedge Fund Advisers | December 2, 2004 | Requires advisers to certain private investment pools (hedge funds) to register with the SEC under the Advisers Act. The rule and amendments are designed to provide the protections afforded by the Advisers Act to investors in hedge funds. |
| Mutual Fund Redemption Fees | March 11, 2005 | Prohibits funds from redeeming shares within 7 calendar days after purchase, unless (i) the fund's board has either approved a redemption fee or determined that a redemption fee is not necessary or appropriate; (ii) the fund (or its principal underwriter) has entered into a written agreement with each of its financial intermediary under which the intermediary agrees to provide certain shareholder transaction information to the fund and to execute the fund's instructions to restrict or prohibit future purchases or exchanges by any shareholder; and (iii) the fund maintains copies of such agreements with its financial intermediaries for at least six years. The rule authorizes funds that adopt a redemption fee to impose a redemption fee up to 2 percent of the amount redeemed. |

Source: GAO analysis of the *Federal Register.*

Additionally, SEC adopted compliance rules on December 17, 2003, that required all investment companies and investment advisers that are registered or should be registered with SEC to adopt policies and procedures reasonably designed to prevent violation of federal securities laws and the Advisers Act, and designate a CCO to be responsible for administering the policies and procedures. The CCO should be in a position of authority to compel others to adhere to the compliance policies and procedures, and the investment company CCO must report directly to the company's board of directors. The rules further require that each investment company and investment adviser conduct at least annually reviews of their policies and procedures and that the CCOs submit a written report to the board regarding their policies and procedures. An investment company must also review and the CCO must report on the policies and procedures of its investment adviser and certain other service providers. Under the investment company compliance rule, these reports, at a minimum, must address (1) the operation of the policies and procedures of each fund and each investment adviser, principle underwriter, administrator, and transfer agent for the fund; (2) any material changes to those policies and procedures since the date of the last report; (3) any material changes to the policies and procedures recommended as a result of the annual review; and (4) each material compliance matter that occurred since the date of the last report. The rules require that investment companies and investment advisers maintain copies of all policies and procedures that are or were in effect in the previous 5 years and maintain records documenting annual reviews. Investment companies must retain copies of the written reports for 5 years. According to SEC staff, the compliance rule provides companies flexibility in carrying out provisions relating to the annual reviews. For example, SEC staff said that a CCO could use company internal audit departments to assess company compliance with laws and regulations rather than hiring separate staff. SEC staff also said that the companies may continue to use internal audit departments to carry out internal compliance and other reviews and that such departments will likely work closely with CCOs.[27]

Although the compliance rules have the potential to improve mutual fund company operations and address compliance staff independence deficiencies, certain CCOs may face organizational conflicts of interest. By requiring a fund's CCO to report to the board of directors and to meet separately, at least annually, with the independent directors, the rule helps ensure that compliance findings would not be routinely overruled by the investment adviser or other officials. However, in the rule, SEC also contemplates that the CCO could be an employee of the investment adviser. SEC stated that permitting the CCO to be an employee of the adviser is necessary because many investment companies do not have any employees. SEC found that prohibiting CCOs from being employees of an investment adviser company would result in a situation where the investment company's CCO would be divorced from the day-to-day fund operations and totally dependent on information filtered through the adviser. SEC stated that the rule mitigates potential conflicts of interest by prohibiting removal of the fund company's CCO without the approval of the fund company's board of directors, including a majority of the independent directors. However, given that investment advisers typically entered into market timing arrangements to the detriment of mutual fund shareholders, the fact that a mutual fund's CCO could be employed by an investment adviser raises potential concerns about the effectiveness of such officers, a situation of which SEC must be cognizant when overseeing the rule's implementation. SEC staff said that they plan to review implementation of the compliance rules and requirements as part of the investment company and investment advisers examination process, as resources permit.

[27]See C.F.R. § 270.38-1 and 17 C.F.R. § 275.20b(4)-7.

SEC staff also said that the agency plans to use the compliance reports as part of the examination planning process. An OCIE staff member said that by requesting the compliance reports and reviewing them prior to examinations, agency examiners may be able to identify problems at mutual fund companies and determine whether the companies have implemented corrective actions. However, the OCIE staff member said that the rule does not require mutual fund companies to submit the annual reports to the agency for its ongoing review.

By not establishing a process for SEC staff to receive the compliance reports on an ongoing basis, SEC may be missing an opportunity to enhance its mutual fund oversight program. Under the rule, CCOs are required to perform comprehensive assessments of mutual fund operations and report on their findings annually. As demonstrated in this report, compliance staff may be well aware of violations that SEC and other regulators had not even considered. Given that SEC has limited examination resources and certain companies may not be examined for extended periods, reviewing the compliance reports on an ongoing basis could provide valuable information to SEC by indicating emerging problems at mutual fund companies or unmitigated risks at individual companies. Further, reviewing the reports could provide insights to SEC as to how the compliance rule is being implemented within the mutual fund industry. With such information—potentially in conjunction with a surveillance system—the agency may be able to better target examinations towards high-risk areas and identify emerging trends in the mutual fund industry.

We also note that SEC has adopted two specific rules designed to address market timing and is working on a rule designed to prevent late trading. On March 11, 2005, SEC adopted a rule that allows mutual fund companies to establish redemption fees on a voluntary basis.[28] The rule prohibits funds from redeeming shares within 7 calendar days after they are purchased, unless, among other requirements, the fund's board has previously determined that the imposition of a redemption fee on shares redeemed within the 7-day holding period is either in the best interest of the fund or

[28]Securities and Exchange Commission, "Mutual Fund Redemption Fees," Release No. IC-26782 (Mar. 11, 2005).

that such a fee is not necessary or appropriate.[29] By imposing redemption fees on, for example, the proceeds of fund shares redeemed within 7 calendar days of a purchase, SEC believes that mutual fund companies may be able to increase the costs associated with frequent trading and the financial incentives to do so. Also, directly addressing the market timing issue, SEC adopted a rule on April 16, 2004, requiring funds to make disclosures regarding market timing and selective disclosure of portfolio holdings. To stop late trading, SEC in late 2003, proposed that all orders for fund transactions be received by mutual funds or designated processors, which are regulated by SEC, no later than the time the fund calculates its current day's price (usually 4:00 p.m.) in order to receive that day's price (the "hard 4" close proposal).[30] However, due, in part, to industry concerns about the fairness and potential costs of the proposal, SEC has not yet adopted it and is assessing whether there are more cost-effective ways to achieve the same result. SEC is continuing to work with industry officials and considering alternative proposals that would address industry concerns while curtailing late trading. We discuss the proposed rule in more detail in appendix III.

## Conclusions

The undisclosed market timing arrangements and late trading abuses detected in September 2003 represented one of the most widespread and serious scandals in the history of the mutual fund industry. SEC has determined that undisclosed market timing arrangements, in particular, existed at many large mutual fund companies for as long as 5 years. However, prior to 2003, SEC did not identify the undisclosed arrangements between investment advisers and favored customers through the agency's oversight process. Although SEC staff faced competing examination priorities that may have affected its capacity to detect the abusive practices and has taken several recent steps intended to strengthen its mutual fund company oversight program and improve company operations, several lessons can be drawn from the experience.

[29] The rule permits a fund board that adopts a redemption fee to determine, in its judgment, whether a period longer than 7 calendar days is necessary or appropriate to protect fund shareholders.

[30] SEC also has proposed, but not yet acted on, rule changes that would require broker-dealers to disclose to investors prior to purchasing a mutual fund, at the point of sale and in order confirmations, whether the broker-dealer receives revenue sharing payments or portfolio commissions from that fund adviser as well as other cost-related information.

- First, performing independent assessments of company controls is critical to confirm agency views regarding risks and the adequacy of controls in place to address those risks. Even where regulated entities may have a seeming interest in controlling a particular risk, abusive or fraudulent activity can take place. Over the past 2 years, SEC has hired additional examination staff and implemented a risk-based approach to mutual fund company examinations that provides for increased assessments of controls.[31] SEC's staff's revised examination guidance also expands the types of written reports (such as internal audit reports) that examiners are to request in planning examinations, although SEC still does not direct examiners to request listings of all such reports. Requesting such listings could assist SEC staff in detecting potential violations at an earlier stage.

- Second, the agency must develop the institutional capacity to identify and evaluate evidence of potential risks and deploy examination staff as necessary to review controls and potentially detect violations in these areas. SEC has established ORA to help guide the agency in better assessing new or emerging risks, but the office is still hiring staff and establishing its position within the agency. SEC has also implemented revised tip handling procedures, which have the potential to enhance the agency's capacity to detect potential abuses. It remains to be seen how well these new procedures work.

- Third, ensuring the independence of the compliance function is central to preventing violations of the securities laws, regulations, and fund policies. Company compliance staff must have sufficient independence to carry out their responsibilities. By adopting the compliance rule, SEC created a system that has the potential to significantly improve mutual fund companies' compliance with laws and regulations and help ensure the independence of compliance staff. CCOs also may serve as valuable partners to SEC by reviewing and testing a variety of controls. However, in adopting the rule, SEC also made a conscious trade-off between the need to improve industry compliance and the costs that would be imposed on mutual fund companies. In permitting an investment company's designated CCO to be employed by the advisory firm, SEC recognized that CCOs might face organizational conflicts of interest in fulfilling their responsibilities. The fact that fund company boards, with the approval of a majority of the independent directors, have sole

[31]As previously discussed, we assess the revised program in a forthcoming report.

authority to remove fund company compliance officers may mitigate some of these risks. However, it is uncertain at this time how effectively CCOs faced with potential conflict of interests, including possibly conflicting financial incentives as illustrated in some of the cases we reviewed, will carry out their responsibilities. Given the widespread nature of the abuses identified at mutual fund companies, we believe that the failure of companies to comply with the rule's provisions would likely warrant a significant response by SEC through the agency's civil enforcement authority or referrals to criminal authorities as deemed necessary.

We also note that while SEC staff plans to request annual reports prepared by CCOs under the compliance rule during the examination planning process, SEC staff does not require fund companies to submit the annual reports to SEC on an ongoing basis. Obtaining access to the annual compliance reports and regularly reviewing them or their material findings is essential to assist SEC in monitoring mutual fund companies during the potentially long intervals between examinations of certain companies.

## Recommendations

To enhance the effectiveness of SEC's mutual fund oversight program and help strengthen company operations, we recommend that the Chairman, SEC, take the following three actions:

- Consistent with the agency's legal authority, request lists of all compliance-related internal company reports during the examination planning process and review such reports as necessary to obtain a broad perspective on the risks identified by individual companies and the adequacy of controls in place to monitor those risks;
- Ensure that examination staff assess the independence and effectiveness of mutual fund company CCOs as a component of all mutual fund company examinations; and
- Develop a plan to receive and review mutual fund company and adviser annual compliance reports, or the material findings thereof, on an ongoing basis.

## Agency Comments and Our Evaluation

SEC provided written comments on a draft of this report, which are reprinted in appendix IV. SEC and NASD also provided technical comments, which were incorporated into the final report, as appropriate. SEC generally agreed with our recommendations. SEC noted the importance of its testing of internal controls, and that SEC examiners now review mutual fund controls for market timing and fair value pricing and that it anticipates providing additional guidance to assist funds and their advisers in adopting appropriate controls over the use of fair value pricing. SEC indicated that it had started assessing the role of CCOs and that it is preparing formal examination guidance for its examination staff to use in these assessments. Additionally, SEC noted that it is considering how to best utilize the new mutual fund annual compliance reports, of which any required filing with the agency may require further rulemaking.

SEC did not directly address our recommendation on requesting listings of all compliance-related internal reports, but suggested that such reviews would be included in its testing of internal controls. We continue to believe that requesting lists of all reports would be beneficial for SEC's oversight program by assisting staff in detecting potential violations.

SEC identified a number of steps it has taken to strengthen its mutual fund oversight program. Our assessment of some of these recent actions will be addressed in a forthcoming report.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution of this report until 30 days from the report date. At that time we will provide copies of this report to SEC, NASD, and interested congressional committees. We will also make copies available to others upon request. In addition, the report will be available at no cost on GAO's Web site at http://www.gao.gov.

If you or your staff have any questions about this report, please contact Wesley M. Phillips, Assistant Director, or me at (202) 512-8678. GAO staff who made major contributions to this report are listed in appendix V.

Richard J. Hillman
Director, Financial Markets and
Community Investment

# Objectives, Scope, and Methodology

Because market timing violations were more widespread than late trading violations and the Securities and Exchange Commission (SEC) is the mutual fund industry's frontline regulator, the report primarily focuses on SEC's oversight of the market timing area. The report also addresses the National Association of Securities Dealers' (NASD) oversight of broker-dealers that failed to prevent customers' market timing and late trading activity but does not discuss late trading at pension plans and their administrators, which are subject to Department of Labor oversight. Accordingly, the report (1) identifies the reasons that SEC did not detect the abusive market timing agreements at an earlier stage and lessons learned from the agency's failure to do so; and (2) assesses steps that SEC has taken to strengthen its mutual fund oversight, deter abusive trading, and improve mutual fund company operations.

To determine why SEC did not detect the abusive market timing agreements at an earlier stage and what lessons can be learned from the agency not doing so, we interviewed SEC staff at a judgmental sample of six regional and district offices located nationwide, NASD officials; representatives from the New York State Office of the Attorney General, the Investment Company Institute (ICI), a judgmental sample of large mutual fund companies, and we contacted academic officials. We also reviewed relevant agency testimony, academic and other studies, and other documents. At the six SEC offices, we reviewed documentation pertaining to 11 mutual fund companies against which SEC had filed enforcement actions for market timing abuses and late trading violations. These mutual fund companies were among the largest 100 mutual fund companies nationwide as measured by the size of customer assets under management as of August 1, 2003. We reviewed the enforcement actions pertaining to these companies, related documentation, and SEC examinations for each of these companies or their investment advisers dating back several years. In addition, we reviewed examination guidelines at the Federal Deposit Insurance Corporation, the Federal Reserve System, and the Office of the Comptroller of the Currency, and generally accepted government auditing standards, particularly the standards relating to internal control reviews. We then compared SEC staff's approach to reviewing mutual fund market timing controls with these general examinations and auditing standards. We also discussed with NASD the reasons that it did not detect mutual fund-related abuses at broker-dealers for which it has direct oversight responsibility.

To identify steps regulators had taken to strengthen mutual fund oversight programs and enhance controls at mutual fund companies and intermediaries, we interviewed SEC and NASD staff and reviewed relevant agency documents as well as GAO reports and testimonies. We determined what modifications the regulators had made to their examination programs or plan to make, reviewed various final rules adopted since September 2003 to improve mutual fund company operations and investor protection, reviewed a proposed rule regarding late trading, and reviewed regulators' enforcement actions for market timing and late trading. In addition, we reviewed SEC procedures for handling tips and complaints. Additionally, we interviewed officials of the National Securities Clearing Corporation (NSCC), ICI, the Securities Industry Association, pension plans, broker-dealers, and mutual fund companies.

Our work was performed in Atlanta, Ga.; Boston, Mass.; Chicago, Ill., Denver, Colo.; New York, N.Y.; Philadelphia, Pa.; and Washington, D.C. We conducted our work between May 2004 and April 2005 in accordance with generally accepted government audit standards. SEC provided written comments on a draft of this report, which are reprinted in appendix IV. SEC and NASD also provided technical comments, which were incorporated into the final report, as appropriate. Our evaluation of these comments is presented in the agency comments and our evaluation section.

# Mutual Fund Trade Processing and Recordkeeping

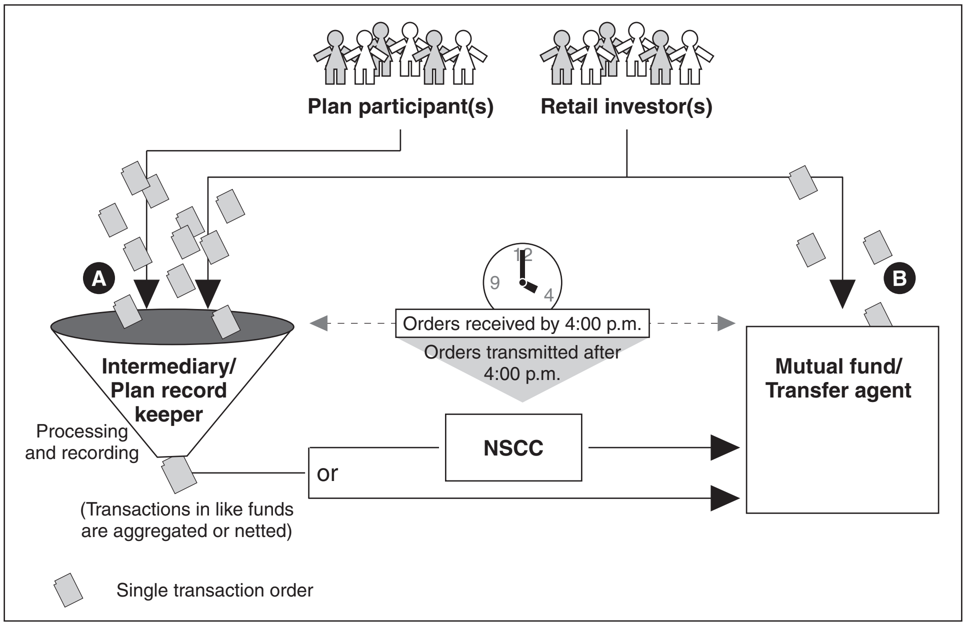
Individual investors generally can purchase, exchange, or sell fund shares through multiple channels either directly from fund companies or through various intermediaries such as broker-dealers, financial planners, banks, insurance companies, retirement plan sponsors, and fund "supermarkets." To simplify and reduce the costs of mutual fund transactions, intermediaries collect orders throughout the day and then aggregate all the transactions they receive for a particular fund. Those intermediaries that are licensed, such as broker-dealers, may net, or match, purchase and redemption orders for the same funds among their own clients. In a simplified example, if one investor were to purchase 15 shares of fund A, and another investor were to redeem 10 shares of fund A, at the end of the day the intermediary could simply transmit one order to purchase 5 shares of fund A—the net result of the day's orders. Intermediaries then transmit the net results of aggregate transactions to the mutual fund companies, where the intermediaries hold omnibus accounts representing the collective shares of their clients. Mutual fund companies generally do not have information about the identities and specific transactions of the individual investors in intermediaries' omnibus accounts. Intermediaries have contact with their clients, such as defined contribution plan participants and other individual investors ("retail investors"), and control access to information about their trading activity. ICI officials told us that, presently about 80 percent of mutual fund orders are through intermediaries and most of these are processed through omnibus accounts.

Mutual fund intermediaries accept purchase and redemption orders throughout the day and are supposed to submit to funds only those orders received by 4:00 p.m. Eastern Time to receive that same day's net asset value (NAV), but an order received at 4:01 p.m. or later would be submitted to receive the next day's NAV. According to Securities and Exchange Commission Rule 22c-1 under the 1940 Act, mutual funds are required to calculate current NAV at least once every business day at a specific time (usually at 4:00 p.m.).[1] However, intermediaries are allowed to aggregate the orders they receive prior to fund's designated price calculation time and submit them to mutual fund companies as omnibus account transactions later in the evening for settlement, either directly or through their transfer

[1]In this discussion, we assume for convenience that all funds choose to price their securities daily as of 4:00 p.m. Funds may, however, elect to price their securities more than once per day, and according to SEC, many funds price their securities earlier than 4:00 p.m.

agents or NSCC.[2] Figure 2 illustrates how orders for mutual fund transactions are transmitted from retail investors and plan participants to mutual fund companies, either directly or through intermediaries.

**Figure 2: Processing Paths of Mutual Fund Transactions**




Source: GAO.

Most employers that sponsor defined contribution plans subcontract the various administrative tasks of plan recordkeeping to companies that have expertise in the administration of plans or investments. Pension plan record keepers are intermediaries that keep track of day-to-day

[2]See *Staff Interpretive Position Relating to Rule 22c-1*, Investment Company Act Release No. 5569 (December 27, 1968). Mutual funds employ transfer agents to conduct recordkeeping and related functions. Transfer agents maintain records of shareholder accounts, calculate and disburse dividends, and prepare and mail shareholder account statements, federal income tax information, and other shareholder notices. NSCC is currently the only clearing agency registered with SEC that operates an automated system, called Fund/SERV, for processing orders for mutual funds and other securities. Fund/SERV provides a central processing system that collects order information from clearing brokers and others, sorts all the incoming order information according to fund, and transmits the order information to each fund's primary transfer agent.

transactions for each plan participant's account. The recordkeeper is responsible for transactions—such as crediting accounts with employee and employer contributions, processing changes in participant-directed investment allocations, updating account values (usually each business day) to reflect changes in the values of mutual fund shares held by each plan participant—and acting as a mutual fund intermediary when participants make exchanges between funds. In addition, recordkeepers may function as the primary source of plan information and customer service for plan participants.

# SEC Proposed Rule to Prevent Late Trading

Late in 2003, SEC proposed amending the rule that governs how mutual funds price and receive orders for share purchases or sales.[1] Since many of the cases of late trading involved orders submitted through intermediaries, including banks and pension plans not regulated by SEC, the proposed amendments would have required that orders to purchase or redeem mutual fund shares be received by a fund, its transfer agent, or a registered clearing agency—entities that are regulated by SEC—before the time of pricing (usually 4:00 p.m. Eastern Time). However, SEC has not yet acted on the "hard 4" close proposal due in part to industry concerns about the associated costs and other factors, and is assessing whether there are more cost effective ways to achieve the same result.

Many organizations that purchase mutual fund shares, particularly those that administer retirement savings plans have expressed concerns that such a "hard close" would unfairly prohibit some of their participants from receiving the same day's price on share purchases. Because intermediaries generally combine individual investor orders and submit single orders to funds to buy or sell, many officials at such firms are concerned that the time required to complete this processing will not allow them to meet the 4:00 p.m. deadline. In such cases, investors purchasing shares from western states or through intermediaries would either have to submit their trades earlier than other investors in order to receive the current day's price or receive the next day's price. Some plan sponsor organizations and plan recordkeepers have also argued that they would face significant administrative costs in adopting systems to accommodate the 4:00 p.m. hard close.[2]

An alternative approach to control late trading, proposed by retirement plans and some broker-dealers, is referred to as the "smart 4" approach, which would require all companies that want to accept orders until the market close, and process them thereafter, to adopt a three-part series of controls: (1) electronic time stamping of all transactions so all trades could be tracked from the initial customer to the mutual fund company; (2) annual certifications by senior executives that their companies have procedures to prevent or detect unlawful late trading and that those

[1]Securities and Exchange Commission, "Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares," Release No. IC-26288 (Dec. 11, 2003).

[2]See GAO, *Mutual Funds: SEC Should Modify Proposed Regulations to Address Some Pension Plan Concerns*, GAO-04-799 (Washington, D.C.: July 9, 2004) for a discussion of how the proposal could affect pension plan participants.

procedures are working as designed; and (3) annual, independent audits. Representatives of intermediaries told us that they should be given an opportunity to prove that they can comply with the same policies and procedures as mutual fund companies in accepting and processing fund orders. However, SEC staff have expressed concerns about the proposal. As previously noted, SEC does not have regulatory jurisdiction over all entities that process mutual fund share orders.

Another approach to prevent late trading, which has been suggested by some industry participants, is to establish a central clearinghouse for mutual fund trades. The clearinghouse proposal would require all mutual fund orders to be time-stamped electronically by an SEC-registered central clearing entity before the market close to receive that day's fund price. The clearing entity's time stamp would be considered the official time of receipt of an order for a mutual fund transaction. NSCC is currently the only SEC-registered clearing agency operating an automated processing system for mutual fund orders. The clearinghouse proposal would expand NSCC's role, capabilities, and capacity to handle all orders of mutual fund transactions. Each mutual fund company and fund intermediary would consider its technological capabilities and other factors in deciding how to meet the requirement of submitting orders to NSCC by 4:00 p.m. Eastern Time in order to receive same-day pricing. However, many intermediaries that do not use NSCC to process transactions oppose the clearinghouse proposal because, among other reasons, developing links to NSCC could be prohibitively expensive.

SEC is continuing to review alternatives to develop an acceptable solution to prevent late trading. SEC staff told us that staff have been meeting with industry participants and considering alternative proposals but were uncertain about when a rule to prevent late trading could be adopted.

# Comments from the Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF COMPLIANCE
INSPECTIONS AND
EXAMINATIONS

April 1, 2005

Richard J. Hillman
Director, Financial Markets and
Community Investment
United States Government Accountability Office
Washington, DC 20548

Dear Mr. Hillman:

Thank you for the opportunity to comment on your draft report concerning *mutual fund market timing abuses.* As your report describes, SEC examinations and enforcement investigations revealed that many mutual fund employees had entered into secret arrangements with favored customers to allow those customers to frequently trade fund shares, in contravention of the prospectus or other disclosures, or the internal policies of the fund. This frequent trading activity harmed other mutual fund shareholders. When this misconduct came to light the SEC took comprehensive action, including rule making, enforcement actions, and enhanced examination oversight.

The GAO report describes many of the steps taken by the SEC to improve compliance by funds and investment advisers, both generally and specifically with respect to deterring and detecting abusive market timing. As the report notes, the Commission adopted rules: requiring funds and advisers to have a Chief Compliance Officer, to adopt formal compliance programs, and to provide an annual compliance report to the fund's board of directors; requiring funds to provide enhanced disclosure of their policies with respect to the allowed frequency of trading in fund shares; requiring all investment advisers to adopt a Code of Ethics; requiring mutual funds to have a majority of independent directors and an independent chairman; and allowing funds to impose redemption fees to deter market timing.

The GAO report also describes many of the changes to the SEC's examination oversight of mutual funds and advisers. Specifically, the SEC's examination program has adopted a risk-based approach to oversight that emphasizes the prompt identification and investigation of emerging compliance risks. As the report notes, SEC has implemented a risk-assessment process, and has created an Office of Risk Assessment that is designed to identify emerging risks that face the securities markets and the SEC. Based on the risk-identification process, SEC examiners now conduct many stand-alone "risk targeted reviews" that are designed to quickly probe discrete areas of compliance risk. These examinations, along with comprehensive "wall-to-wall" examinations, complement routine examinations, as they may indicate risk areas that should be included in the routine examination protocol. SEC staff are also evaluating the type of data that may further assist in better targeting attention to firms and activities that pose the greatest risk of compliance problems.

Richard J. Hillman
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In addition, as GAO notes, prior to the identification of market timing abuses, in mid-2001, SEC examiners adopted an approach for routine examinations that was designed to evaluate the quality of internal controls, including by testing controls in key operational areas. We fully agree with GAO's suggestion that testing of internal controls is critical to evaluate their effectiveness. Such testing takes a variety of forms – including reviews of exception reports, internal audit reports, reviewing email and other internal communications that might indicate collusive or other undisclosed arrangements, transaction testing and use of other forensic data. As the report notes, in light of the market timing abuses, SEC examiners now review mutual funds' controls for "fair value" pricing and market timing, including shareholder turnover rates, during routine examinations. To assist funds in adopting appropriate controls over the use of fair value, the SEC anticipates providing guidance for mutual funds and their advisers.

The GAO report also recommends that examination staff assess the independence and effectiveness of the Chief Compliance Officers required under the new SEC rule. We agree with this recommendation, have been assessing their role since the rule became effective in October 2004, and are preparing formal examination guidance for SEC examination staff. We also recently initiated a program called "*CCOutreach*" designed to provide information to these new Chief Compliance Officers that might assist in them in their important responsibilities.

Finally, the GAO report recommends that SEC develop a plan to assess the feasibility of integrating the new mutual fund annual compliance reports (or material findings in those reports) into an SEC surveillance program. We are considering how best to utilize these reports and note that any required filing of the reports with the SEC would require rulemaking by the SEC.

* * *

We appreciate the GAO's attention to these issues.

Sincerely,

Lori A. Richards
Director

# GAO Contacts and Staff Acknowledgments

## GAO Contacts

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## Staff Acknowledgments

In addition to those named above, Fred Jimenez, Stefanie Jonkman, Marc Molino, Omyra Ramsingh, Barbara Roesmann, Rachel Seid, and David Tarosky made key contributions to this report.

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