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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.