SEC MUTUAL FUND OVERSIGHT

Positive Actions Are Being Taken, but Regulatory Challenges Remain

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Highlights

Highlights of GAO-05-692T, a testimony to the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, House of Representatives

Why GAO Did This Study

Trading abuses—including market timing and late trading violations—uncovered among some of the most well-known companies in the mutual fund industry permitted favored customers to profit at the expense of long-term shareholders. Questions have also been raised as to why the New York State Office of the Attorney General identified the trading abuses in September 2003 before the industry's primary regulator: the Securities and Exchange Commission (SEC). Based on two recently issued GAO reports, this testimony discusses (1) the reasons SEC did not detect the abusive practices at an earlier stage and lessons learned from the agency not doing so, (2) steps the agency has taken to strengthen its mutual fund oversight program, and (3) enforcement actions taken by SEC and criminal prosecutors in response to these abuses and SEC management procedures for making criminal referrals and ensuring staff independence.

What GAO Recommends

Among other steps, the GAO reports recommend that SEC develop a plan to review annual compliance reports on an ongoing basis and document criminal referrals and the post-employment plans of departing staff. SEC generally agreed to implement these recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-05-692T.

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

What GAO Found

Prior to September 2003, SEC did not examine mutual fund companies for trading abuses such as market timing violations because agency staff viewed other activities as representing higher risks and believed that companies had financial incentives to establish effective controls. While SEC has competing examination priorities, it can draw lessons from not detecting the trading abuses earlier. First, by conducting independent assessments of controls in areas such as market timing (through interviews, reviews of exception reports, reviews of independent audit reports, or transaction testing as necessary), SEC could reduce the risk that violations may go undetected. Second, SEC could further develop its capacity to identify and evaluate evidence of potential risk (for example, academic studies completed between 2000 and 2002 identified certain market timing concerns as a persistent risk to mutual fund customers). Third, ensuring the independence of company compliance staff is critical and SEC staff could better assess company risks and controls through routine interactions with such staff.

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 several key initiatives. For example, SEC has instructed its staff to make additional assessments of company controls and established a new office to identify and assess potential risks. SEC also adopted a rule that requires mutual fund companies to appoint independent compliance officers who are to prepare annual reports on their companies' policies and violations. However, SEC has not developed a plan to receive and review these annual reports on an ongoing basis and thereby enhance its capacity to detect potential violations.

Since September 2003, SEC has brought 14 enforcement actions against mutual fund companies and 10 enforcement actions against other firms for mutual fund trading abuses. Penalties obtained in settlements with mutual fund companies are among the agency's highest—ranging from $2 million to $140 million and averaging $56 million. In contrast, penalties obtained in settlements for securities law violations prior to 2003 were typically under $20 million. In reviewing a sample of investment adviser cases, GAO found that SEC followed a consistent process for determining penalties and that it coordinated penalties and other sanctions with interested states. However, GAO found certain weaknesses in SEC's management procedures for making referrals to criminal law enforcement and ensuring staff independence. In particular, SEC does not require staff to document whether a criminal referral was made or why. Without such documentation, SEC cannot readily determine whether staff make appropriate referrals. Further, SEC does not require departing staff to report where they plan to work, information gathered by other financial regulators to assess staff compliance with federal laws regarding employment with regulated entities. In the absence of such information, SEC's capacity to ensure compliance with these conflict-of-interest laws is limited.