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SEC MUTUAL FUND OVERSIGHT

Positive Actions Are Being Taken, but Regulatory Challenges Remain

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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 the reports' 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.

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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.

Mr. Chairman, Mr. Ranking Member, and Members of the Subcommittee:

I am pleased to be here today to discuss two recently issued GAO reports that assess the Securities and Exchange Commission's (SEC) response to trading abuses uncovered in the mutual fund industry. We prepared these reports at the request of Chairman Sensenbrenner and Ranking Member Conyers of the full committee.¹ As you know, trading abuses—including fraudulent market timing and late trading violations—were uncovered in many well-known companies in the mutual fund industry and raised significant concerns about the industry's ethical practices.² Maintaining public confidence in the mutual fund industry is critical because about 95 million Americans have invested more than \$8 trillion in mutual funds, a significant share of the nation's privately held wealth. Moreover, it is critical that SEC and NASD have the capacity to identify abusive practices and to bring enforcement actions that punish violators and deter those who are contemplating similar abuses.³

Questions have been raised as to why so many mutual fund companies and broker-dealers were able to engage in trading abuses, sometimes for years, without being detected by SEC and NASD. In fact, the trading abuses only came to light after the New York State Office of the Attorney General (NYSOAG) received a tip from a hedge fund insider, conducted an investigation, and, in September 2003, settled an enforcement action against a hedge fund company and a hedge fund official for market timing

¹GAO, *Mutual Fund Trading Abuses: Lessons Can Be Learned from SEC Not Having Detected Violations at an Earlier Stage*, [GAO-05-313](#) (Washington, D.C.: April 20, 2005) and *Mutual Fund Trading Abuses: SEC Consistently Applied Procedures in Setting Penalties, but Could Strengthen Certain Internal Controls*, [GAO-05-385](#) (Washington, D.C.: May 16, 2005).

²For purposes of this testimony, 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. Many mutual fund companies have no employees, although they typically have a board of directors, and rely on investment advisers to perform key functions such as providing management and administrative services.

³SEC is the primary regulator of the mutual fund industry. NASD has direct oversight responsibility for broker-dealers that may sell and execute other orders for investment products, including mutual funds.

and late trading of several mutual funds.⁴ The federal regulators' failure to identify the abuses at an earlier stage has generated concern about the effectiveness of their examination and other oversight procedures.

As we describe in our reports, market timing and late trading violations permitted favored customers to benefit at the expense of long-term mutual fund company shareholders. 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. Although market timing is not itself illegal, frequent trading can harm mutual fund shareholders because it increases transaction costs and lowers a fund's returns. However, market timing can constitute illegal conduct if, for example, it takes place as a result of undisclosed agreements between mutual fund investment advisers (companies that provide management and other services to mutual funds) and favored customers who are permitted to trade frequently and in contravention of stated company trading limits. Late trading, a significant but less widespread abuse than market timing violations, occurs when investors place orders to buy or sell mutual fund shares after the mutual fund has calculated price of its shares, usually once daily at the 4 p.m. Eastern Time close of the financial markets. Investors who are permitted to engage in late trading can profit from the knowledge of events in the financial markets that take place after 4 p.m., an opportunity that other fund shareholders do not have.

My testimony today focuses largely on the market timing area, because such abuses were more widespread than late trading violations, and on SEC, which is the mutual fund industry's frontline regulator. I will discuss late trading issues and NASD oversight activities to a lesser degree. More specifically, my testimony covers (1) the reasons that SEC did not detect the market timing abuses at an earlier stage and lessons learned from the agency not doing so, (2) the steps SEC has taken to strengthen its oversight of the mutual fund industry and strengthen industry business

⁴The term "hedge fund" generally refers to 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 which is excluded from the definition of 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. Pursuant to a new rule recently adopted by SEC, advisers of certain hedge funds are required to register with SEC under the Investment Advisers Act of 1940. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054 (2004) (to be codified in various sections of 17 C.F.R. Parts 275 and 279).

practices, and (3) enforcement actions taken by SEC and criminal prosecutors in response to these abuses and SEC management procedures related to the making of criminal referrals and ensuring staff independence from the mutual fund industry.

In summary:

Before September 2003, SEC did not examine fund companies for market timing abuses because agency officials (1) viewed other activities as representing higher risks, (2) concluded that companies had financial incentives to control frequent trading because it could lower fund returns, and (3) were told by company officials that the companies had established controls over frequent trading. While SEC faced competing examination priorities before September 2003 and had made good faith efforts to mitigate the known risks associated with legal market timing, lessons can be learned from the agency not having detected the abuses earlier. First, without independent assessments of controls over areas such as market timing during examinations (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 any evidence of potential risks. For example, a 2002 study estimated that market timing in certain funds resulted in about \$5 billion in annual losses to shareholders, and raised the possibility that investment advisers did not always act decisively to control such risks due to potential conflicts of interest.⁵

Third, we found that compliance staff at mutual fund companies often detected evidence of undisclosed market timing arrangements with favored customers but lacked sufficient independence within their organizations to correct identified deficiencies. Ensuring the independence of compliance staff is critical, and SEC could potentially benefit from using their work.

SEC has taken several steps to strengthen its oversight 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 the fund companies' internal controls. To improve its risk assessment capabilities, SEC also has created and is currently staffing a new office to help the agency better anticipate, identify, and manage emerging risks and

⁵Eric Zitzewitz, "Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds," Stanford Graduate School of Business Research Paper No. 1749 (October 2002).

market trends. To better ensure the independence of company compliance staff, SEC recently adopted a rule that requires compliance officers to report directly to the funds' boards of directors. While this rule has the potential to improve fund company operations and is intended to increase the independence of compliance officers, certain compliance officers may still face organizational conflicts of interest. For example, under the rule compliance officers may not work directly for mutual fund companies, but rather, may be employed by investment advisers—who manage the funds—whose interests may not necessarily be fully aligned with mutual fund customers. In addition, although the rule also requires compliance officers to prepare annual reports on their companies' compliance with laws and regulations, SEC has not developed a plan to routinely receive and review the reports. Without such a plan, SEC cannot be assured that it is in the best position to detect abusive industry practices and emerging trends. SEC has agreed to implement recommendations from our April 2005 report to help ensure the effectiveness of compliance officers and to determine how to best utilize the annual compliance reports, or the material findings cited in those reports.

The penalties SEC obtained in the market timing and late trading cases are among the largest in the agency's history and are generally consistent with penalties obtained in cases involving similarly egregious corporate misconduct. As of February 28, 2005, SEC had brought 14 enforcement actions against investment advisers and 10 enforcement actions against other firms for market timing and late trading abuses. It has also brought enforcement actions against several high ranking company officials. Penalties that SEC obtained in settling the 14 enforcement actions with investment advisers range from \$2 million to \$140 million, with an average penalty of about \$56 million. In contrast, penalties obtained in settlements for securities law violations before 2003 were typically under \$20 million. In reviewing a sample of cases involving investment advisers, we found that SEC followed a consistent process for determining penalties and that it coordinated penalties and other sanctions with interested states. However, we found certain weaknesses in SEC's overall procedures for referring securities cases to other agencies for potential criminal violations and ensuring that departing employees complied with conflict-of-interest laws and regulations. SEC has agreed to implement recommendations from our May 2005 report to strengthen these processes.

To address our reporting objectives, we conducted in-depth reviews of 11 SEC enforcement actions against mutual fund companies for market timing and other abusive practices. We reviewed examination reports for

these companies as well as related enforcement action documents. We interviewed representatives from SEC, NASD, mutual fund companies, broker-dealers, pension plan administrators, and other industry participants about practices and procedures industry participants use to prevent abuses and monitor trading activity. We also interviewed SEC staff in headquarters and various regional and district offices about how its oversight examination and enforcement efforts were conducted and how penalty amounts were determined. We also obtained information from Department of Justice (DOJ) officials and selected state regulators and attorney generals on criminal enforcement actions brought in cases involving market timing and late trading abuses. In addition, we reviewed relevant academic and other studies. We interviewed SEC staff regarding SEC's management procedures for making criminal referrals to DOJ and state criminal authorities and reviewed related SEC rules. We evaluated these rules using Standards for Internal Controls in the Federal Government.⁶ We reviewed federal laws and regulations that govern employees' ability to negotiate and take positions with regulated entities, such as mutual fund companies, and reviewed SEC and other financial regulators' policies and procedures for ensuring staff compliance with these laws. We conducted our work on these reports between May 2004 and May 2005 in accordance with generally accepted government auditing standards.

Lessons Learned from SEC Not Detecting Abusive Market Timing Can Be Useful in Preventing Future Abuses

SEC did not examine for market timing abuses or test company controls in that area, largely because the agency had competing examination priorities and believed that companies had financial incentives to control frequent trading. Lessons learned from SEC not having detected these abuses earlier can be useful to the agency in administering its examination program going forward.

SEC Did Not Examine for Market Timing Abuses

SEC 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. Examiners focused on discrete areas that staff viewed as representing the highest risks of presenting

⁶GAO, *Standards for Internal Controls in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.:1999).

compliance problems that could impact investors. SEC staff stated that before September 2003, they considered funds' portfolio trading (i.e., purchases and sales of securities on behalf of investors) and other areas as representing higher risks than potential market timing abuses and noted that examinations and enforcement cases in these other areas revealed many deficiencies and violations. SEC staff also said that they did not review market timing controls because they believed that fund companies had financial incentives to control frequent trading because it can lower fund share prices, thereby resulting in a loss of business.⁷ An SEC staff member also said that officials from mutual fund companies told agency examiners that they had appointed compliance staff called "market timing police" to enforce compliance with the funds' trading limit policies.

SEC staff said they were surprised in September 2003 when NYISOAG identified the market timing abuses. However, 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.

I would note that NASD's examinations of broker-dealers also did not discover market timing arrangements involving broker-dealers before September 2003. According to an NASD official, these arrangements went undetected because market timing was not illegal per se and, to the extent that a mutual fund company had stated customer trading limits, broker-dealers may not have perceived themselves as being responsible for enforcing such policies. Regarding late trading, NASD officials said that the organization did not have specific examination guidance to detect the violation before September 2003. NASD officials also said that some broker-dealers created fictitious accounts or otherwise falsified documents, so that detecting late trading violations was difficult.

⁷Since investment adviser fees are often based on the size of assets under management, SEC staff reasoned that companies would establish effective controls to help ensure that assets under management did not decline.

Key Regulatory Lessons Have Emerged from Mutual Fund Trading Abuses

We recognize that SEC faces competing examination priorities and had limited examination resources before September 2003. 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. Further, SEC staff made good faith efforts to control the known risks associated with legal market timing, such as issuing guidance on “fair value” pricing.⁸ Nevertheless, three key lessons can be drawn from this experience and used to strengthen SEC’s mutual fund oversight program going forward:

- First, performing independent assessments of company controls is essential to confirm views held by regulatory staff regarding risks and the adequacy of controls in place to mitigate those risks. 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 mitigate potential risks. 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. A variety of means can be used to independently test controls, including interviewing responsible officials, 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.
- Second, SEC 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. Our review identified information that was available prior to September 2003 and that was inconsistent with SEC staff’s views that market timing was a low-risk area because companies would necessarily act to protect fund returns from the harmful consequences of frequent trading. For example, academic studies indicated that market timing, while legal, remained a persistent risk prior to September 2003 and by one estimate was costing mutual fund shareholders approximately \$5 billion

⁸Fair value pricing involves mutual funds using the estimated market value of shares when market quotes are not readily available. Fair value pricing of mutual fund shares can minimize discrepancies between foreign and U.S. markets and thereby minimize market timing opportunities.

annually in certain funds. Further, these studies showed 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 they were benefiting financially from permitting frequent trading, as turned out to be the case.⁹ Moreover, a mutual fund company insider provided information to an SEC district office in early 2003 indicating that a company had poor market timing controls, but the office did not act promptly on this information. If the SEC office had acted on this tip in early 2003, it might have identified potentially illegal market timing activity by company insiders.

- Third, ensuring the independence and effective operation of mutual fund companies' compliance staff is central to preventing violations of the securities laws, regulations, and fund policies. In the majority of the 11 SEC mutual fund company enforcement cases we reviewed, compliance staff lacked such independence. Although the compliance staff—sometimes referred to as “market timing police”—often identified frequent trading that violated company limits, other company officials would routinely overrule the compliance staff's efforts to control such trading. We also found that routine communication with compliance staff could potentially enhance SEC's capacity to detect potential violations at an earlier stage if such staff are forthcoming with relevant information. In cases we reviewed, compliance staff were obviously aware of violations and, in two cases, had documented their findings regarding the harmful consequences of frequent trading in internal company reports. For example, in one case, the sales staff at a mutual fund company overrode the compliance staff's efforts to control hundreds of market timing transactions between 1998 and 2003. In another case, a company's chief compliance officer sent memorandums to the chief executive officer in 2002 and 2003 complaining about the effects of the company's market timing arrangements on long-term shareholders.

⁹Zitzewitz, (2002). Subsequent to September 2003, SEC determined that some favored investors agreed to place assets in mutual funds in exchange for market timing privileges (referred to as “sticky assets”). According to the author, he believed the potential existed that market timers were investing assets in mutual funds, which benefited the related investment advisers because such assets increased their fees.

SEC Has Taken Steps to Strengthen Mutual Fund Oversight, but It Is Too Soon to Assess the Effectiveness of Some Initiatives

SEC has taken several steps over the past two years to strengthen its oversight of the mutual fund industry and improve company practices. These steps include strengthening the agency's mutual fund examination program, establishing an office to better identify emerging risks, hiring additional staff, establishing new tip handling procedures, and enacting a series of rules and rule amendments. Although SEC has taken steps to strengthen its mutual fund company oversight program, it is generally too soon to assess the effectiveness of these initiatives.

To improve its examination program, SEC has instructed examiners to make additional assessments of internal controls at mutual fund companies. For example, SEC staff have identified a range of areas that potentially represent high-risk compliance problems, such as personal trading by company officials, and examiners have initiated independent examinations of these areas. SEC staff also plan to significantly revise the agency's approach to mutual fund company examinations. Rather than evaluating all mutual fund companies on a set cycle as they did between 1998 and 2003, SEC staff plan to begin focusing on the largest and riskiest companies on an ongoing basis. For example, SEC is creating monitoring teams of 2 to 3 individuals who would be responsible for reviewing the largest companies on a more continuous basis, and is placing more emphasis on examinations that target emerging risks. SEC also plans to review some portion of other mutual fund companies on a randomized basis. In a forthcoming report, we assess these and other planned changes to SEC's mutual fund company oversight program. I note that NASD has also recently implemented new examination procedures to better detect market timing and late trading abuses.

SEC also has established the Office of Risk Assessment (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. SEC staff said that ORA will seek to ensure that SEC has the information necessary to make better, more informed regulatory decisions. Although ORA may help SEC be more proactive and better identify emerging risks, it is too soon to assess its effectiveness. In this regard, at the close of our review, 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.

With increased appropriations over recent years, SEC also has hired additional staff to carry out its mutual fund and other oversight programs, potentially enhancing the agency's capacity to test a variety of controls. For example, Office of Compliance Inspections and Examinations staff dedicated to mutual fund company oversight increased by 38 percent between 2002 and 2005 (from 397 to an estimated 547 positions). While the additional staff has the potential to enhance SEC's capacity to oversee key areas within the mutual fund industry, we previously reported that the agency hired the staff without having an updated strategic plan.¹⁰ Without an updated strategic plan in place that identifies the agency's priorities and aligns these priorities with an effective human capital program, it is not clear that SEC's recent hiring decisions will ensure that it has the right amount of resources with the right expertise to do the most effective job possible. In August 2004, SEC revised its strategic plan. We are reviewing SEC's strategic workforce planning as part of a separate engagement.

In addition to hiring staff, SEC has centralized its processes and established new procedures for handling tips and complaints. For example, before the abuses were detected, the agency's Division of Enforcement (Enforcement) had no process under which regional and district office staff would refer complaints and tips to headquarters for review and similarly no process for centralized review of how staff handled complaints and tips. Under the new process, information concerning all enforcement-related tips and complaints, whether received through telephone calls, correspondence, emails, or in-person, is reported to and maintained by a dedicated group within SEC headquarters.

Additionally, SEC has adopted a series of rules and rule amendments designed to strengthen ethical and business practices at mutual fund companies. Among the most significant initiatives, SEC now requires that in order for a mutual fund company to use the agency's exemptive rules, at least 75 percent of its board of directors and the board chair must be independent of the company's investment adviser.¹¹ SEC believes that increasing boards' independence from investment advisers will help

¹⁰GAO, *SEC Operations: Oversight of Mutual Fund Industry Presents Management Challenges*, [GAO-04-584T](#) (Washington, D.C.: Apr. 20, 2004).

¹¹SEC's exemptive rules (i) allow mutual funds to engage in transactions that would otherwise be prohibited under the 1940 Act because they present inherent conflicts of interests and (ii) condition the exemptive relief on such transactions being subject to the approval or oversight of independent directors.

prevent the types of trading abuses that we have been discussing today. Further, SEC adopted rules that require mutual fund companies and investment advisers to appoint chief compliance officers (CCO) who are responsible for monitoring compliance with laws and regulations. SEC also requires mutual fund company CCOs to prepare annual reports on company policies and violations.

Although SEC's rulemaking has the potential to strengthen the operations of mutual fund companies and their investment advisers, the incentive structure these rules rely on may not always be sufficient, and further steps may be necessary. More specifically, in our April 2005 report we pointed out that under SEC's rule, fund company CCOs could be investment adviser officials. SEC permitted this arrangement because fund companies often do not have any staff. SEC also believes that it has instituted rules designed to prevent potential conflicts of interest; for example, a mutual fund company's board—including a majority of its independent directors—is solely responsible for removing the CCO. While such steps may mitigate potential conflicts, we recommended that SEC review CCOs' independence as part of the examination process to ensure that those who are advisory firm officials are actually acting independently. SEC agreed with this recommendation. We also pointed out that while SEC examiners planned to review CCO annual reports as part of examinations, the agency has not established a process to receive and review such reports on an ongoing basis. Without such a process, SEC is not in the best position possible to monitor the industry and identify emerging trends. SEC agreed with our recommendation to determine how to best utilize their annual compliance reports, and any material findings cited in those reports.

SEC Consistently Applied Procedures in Setting Mutual Fund Penalties, but Could Strengthen Certain Internal Processes

The penalties that SEC has obtained in enforcement cases related to market timing and late trading violations are among the highest in the agency's history and generally consistent with civil penalties obtained in cases involving similarly egregious corporate misconduct. Additionally, SEC appears to have followed its penalty-setting process consistently in setting penalties in the cases we reviewed. Federal and state prosecutors we contacted said that several factors complicate bringing criminal actions for market timing violations whereas late trading violations are more straightforward to prosecute. We also found certain weaknesses in SEC's overall procedures for referring securities cases to other agencies for potential criminal violations and ensuring that departing SEC employees comply with conflict-of-interest laws and regulations. SEC agreed to implement our recommendations to strengthen these processes.

Penalties in Mutual Fund Trading Abuse Cases Are Among SEC's Highest and Are Consistent with Penalties in Similarly Egregious Cases

Since NYISOAG announced its discovery of the trading abuses in the mutual fund industry in September 2003, SEC has brought 14 enforcement actions against investment advisers primarily for market timing abuses and 10 enforcement actions against broker-dealer, brokerage-advisory, and financial services firms for market timing abuses and late trading. SEC has entered into settlements in all 14 investment adviser cases and obtained penalties ranging from \$2 million to \$140 million (see fig. 1). These penalties are among the highest SEC has obtained for securities laws violations in its history. Before January 2003, penalties SEC obtained in settlement were generally under \$20 million. In contrast, 11 of the 14 penalties obtained in the investment adviser cases are over \$20 million, with 8 penalties at \$50 million or over. Pursuant to the fair fund provision of the Sarbanes-Oxley Act of 2002 (SOX),¹² SEC plans to use the penalties and disgorgement obtained (disgorgement forces firms to forfeit any ill-gotten gain), a total of about \$800 million and \$1 billion, respectively, to provide restitution to harmed investors.¹³ In addition to settling with investment advisers, as of February 28, 2005, SEC has settled with two broker-dealers, one brokerage-advisory firm, and two insurance companies, with penalties totaling \$17.5 million. I note that NASD has taken 12 actions against broker dealers for late trading and market timing abuses with fines and restitutions totaling more than \$6 million.

¹²SOX authorizes federal courts and SEC to establish "fair funds" to compensate victims of securities violations. Section 308(a) of SOX provides that if in an administrative or a civil proceeding involving a violation of federal securities laws an order requiring disgorgement is entered, or if a person agrees in settlement to the payment of disgorgement, any penalty assessed against such person may, together with the disgorgement amount, be deposited into a fair fund and disbursed to victims of the violation pursuant to a distribution plan approved by SEC. See Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in various sections of the United States Code). The "fair fund" provision is codified at 15 U.S.C. § 7246(a).

¹³We are reviewing SEC's implementation of the fair funds provision of SOX as part of a forthcoming report.

Figure 1: SEC Settlements with Investment Advisers for Market Timing Abuses, as of February 28, 2005 (in thousands of dollars)

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.

^aThe 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 roles 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.

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

^cFremont Investment Advisors, Inc. settled charges involving both abusive market timing and late trading.

The penalties SEC obtained in the 14 investment adviser cases are also consistent with penalties obtained in settled enforcement actions in two types of cases that senior Enforcement staff identified as being as egregious as the mutual fund trading abuses—the recent corporate accounting fraud and investment banking conflict-of-interest cases. The recent, large corporate accounting frauds surfaced in late 2000 and concerned publicly traded companies that allegedly used fraudulent accounting techniques to inflate their revenues and drive up stock prices. The investment banking analyst cases involved several investment firms that settled enforcement actions brought by SEC in 2003 for allegedly producing securities research that was biased by investment banking interests. Table 1 compares the range of penalties and average penalties SEC obtained in settled enforcement actions brought against firms for mutual fund trading abuses, corporate accounting fraud, and investment banking conflicts of interest. Although particular penalties reflect the facts and circumstances of each case, table 1 shows that the average penalties among the three types of cases have generally been consistent (when

excluding the record \$2.25 billion penalty obtained in a corporate accounting fraud case), particularly when compared with the lower penalties obtained in past years. In a public speech, the former Director of Enforcement said that the comparatively large penalties in these cases represented an effort to increase accountability and enhance deterrence in the wake of such extreme misconduct in the securities industry and noted that such penalties create powerful incentives for firms to institute preventative programs and procedures. Others, however, including two members of the Commission, have questioned the appropriateness of these relatively large penalties for public companies, arguing that the cost of penalties are borne by shareholders who are frequently also the victims of the corporate malfeasance.

Table 1: Average Penalties in SEC Settlements with Investment Advisers, Public Companies, and Investment Firms

Case type	Number of settled enforcement actions	Range of penalties	Average penalty
Investment adviser	14	\$2—\$140 million	\$56 million
Public company	11	\$3—\$250 million, \$2.2 billion	\$61.5 million ^a
Investment firm	12	\$5—\$150 million	\$43 million

Source: SEC.

^aThe average penalty SEC obtained in settled enforcement actions involving corporate accounting fraud at public companies does not include its record \$2.2 billion penalty obtained in its settlement with WorldCom, Inc., in July 2003. A federal district court order stated that the penalty would be satisfied, post bankruptcy, by the company's payment of \$500 million in cash and the transfer of common stock in the reorganized company valued at \$250 million to a court-appointed distribution agent.

In addition to bringing enforcement actions against firms, SEC has held individuals responsible for their roles in the trading abuses. As of February 28, 2005, SEC had brought enforcement actions against 24 individuals and settled with 18, obtaining penalties and industry bars in all cases (see table 2 for penalties) and disgorgements in some. Almost all of these settled enforcement actions involved high-level executives, including eight chief executive officers (CEO), chairmen, and presidents. The penalties SEC obtained in these settlements ranged from \$40,000 to \$30 million. The penalties obtained from three individuals are among the four highest in SEC's history—one for \$30 million (the highest) and two for \$20 million.

SEC also obtained a combined \$150 million in disgorgement from these three individuals.¹⁴ In addition, as part of its settlements, SEC permanently barred 5 individuals, including the 3 mentioned above, from association with investment advisers, investment companies, and in some cases other regulated entities, and barred the remaining 13 for various periods from their industries.

¹⁴SEC obtained an additional \$529,000 in disgorgement from five other individuals.

Table 2: Penalties SEC Obtained in Settlement from Individuals Charged in Investment Adviser Cases

Individuals charged, by investment adviser case^a	Penalty
Strong Capital Management, Inc.	
• Founder and former chairman ^b	\$30 million
• Former executive vice-president ^b	\$375,000
• Former director of compliance ^b	\$50,000
Pilgrim Baxter & Associates, Ltd.	
• Former president	\$20 million
• Former chief executive officer (CEO) ^b	\$20 million
Invesco Funds Group, Inc.	
• Former CEO	\$500,000
• Chief investment officer	\$150,000
• National sales manager	\$150,000
• Assistant vice president of sales	\$40,000
Massachusetts Financial Services, Co.	
• Former president	\$250,000
• Former CEO	\$250,000
RS Investment Management, LP	
• CEO	\$150,000
• Chief financial officer	\$150,000
Columbia Management Advisors, Inc.	
• Former portfolio manager	\$100,000
• Former chief operating officer	\$100,000
• Former national sales manager	\$50,000
Banc One Investment Advisors, Corporation	
• Former CEO of related fund	\$100,000
Fremont Investment Advisers, Inc.	
• Former CEO	\$100,000
Total	\$72,515,000

Source: SEC

^aSome individuals charged in the investment adviser cases had more than one title with the investment adviser or with an associated entity, such as the related mutual fund. Unless otherwise indicated, the position indicated refers to the position the individual held with the investment adviser.

^bSEC permanently barred this individual from association with certain regulated entities, including investment advisers and investment companies.

SEC Consistently Applied Procedures in Setting Penalties

In determining appropriate penalties to recommend to the Commission in the investment adviser cases we reviewed, SEC staff consistently applied criteria that the agency has established. These criteria require SEC to consider such things as the egregiousness of the conduct, the amount of harm caused, and the degree of cooperation and to compare proposed penalties with penalties obtained in similar cases. SEC staff may also consider litigation risks in determining appropriate penalties. For example, if SEC pursues an overly aggressive penalty, a defendant may be less likely to settle, and a judge or other arbitrator may not agree with SEC's analysis and impose a lesser penalty. A range of SEC officials participate in SEC's process for setting appropriate penalties—including the Commissioners—to help ensure that no one individual or small group has disproportionate influence over the final decision. Moreover, SEC has coordinated penalties and disgorgement with state authorities in many of its market timing and late trading cases, although some states obtained additional monetary sanctions.

Several Factors Have Complicated Criminal Prosecution of Market Timing, but State and Federal Authorities Have Brought Criminal Charges in Late Trading Cases

Officials from DOJ, NYSOAG, and the Wisconsin Attorney General's Office told us that they have declined to bring criminal charges for market timing, largely because market timing itself is not illegal. In instituting administrative proceedings in the 14 investment adviser cases discussed above, SEC alleged that the undisclosed market timing constituted securities fraud, conduct expressly prohibited under federal securities laws. According to DOJ officials, although state and federal criminal prosecutors can also seek criminal sanctions for securities fraud, such prosecutions may be more difficult to prove than civil actions. DOJ officials told us that criminal prosecutors must be able to prove beyond a reasonable doubt that the defendant committed fraud, whereas civil authorities generally need only show that a preponderance of the evidence indicated a fraudulent action. According to DOJ and NYSOAG officials, for a variety of reasons their review of cases involving market timing arrangements concluded that they did not warrant criminal fraud prosecutions.¹⁵ For example, in commenting on one case involving an investment adviser's undisclosed market timing arrangement, the Wisconsin Attorney General stated that the risk in trying to convince a jury beyond a reasonable doubt that the particular behavior was criminal

¹⁵ DOJ and NYSOAG officials said that the fact that a criminal case has not been brought against an investment adviser to date for entering into undisclosed market timing arrangements with favored investors does not preclude them from bringing one in the future if they believe the facts and circumstances warrant it.

motivated his office and other state prosecutors to instead pursue a civil enforcement action.

According to a recent law journal article, the ambiguous nature of some funds' prospectus language may have further weakened the ability of federal and state prosecutors to bring criminal charges against investment advisers that allowed favored investors to market time.¹⁶ The article stated that it is often unclear whether and to what extent a fund prohibits market timing. For example, many mutual funds merely "discouraged" market timing to the extent that it caused "harm" to the funds. According to the article, such language is subject to various interpretations as to what constitutes discouraging and what constitutes harm to fund performance. Further, it stated that even prospectus disclosures that allow a specific number of exchanges can be ambiguous because the term "exchange" is subject to various interpretations. Such ambiguities may hamper criminal prosecutors' efforts to prove that the market timing arrangements constituted a willful intent to defraud.¹⁷

In contrast, NYSOAG and DOJ have brought at least 12 criminal prosecutions against individuals involving late trading violations. In one case, NYSOAG charged a former executive and senior trader of a prominent hedge fund with conducting late trading on behalf of that firm through certain registered broker-dealers in violation of New York's state

¹⁶Roberto M. Bracer, "Late Trading and Market Timing," *Securities & Commodities Regulation*, vol. 37, no. 7 (2004).

¹⁷On April 16, 2004, SEC adopted amendments to Form N-1A requiring open-ended management investment companies (mutual funds) to disclose in their prospectuses both the risks to shareholders of frequent purchases and redemptions of the mutual fund's shares and the mutual fund's policies and procedures with respect to such frequent purchases and redemptions. If the mutual fund's board has not adopted such policies and procedures, the mutual fund must disclose the specific basis for the board's view that it is appropriate for the mutual fund to not have such policies and procedures. These rules are intended to require mutual funds to describe with specificity the restrictions they place on frequent purchases and redemptions, if any, and the circumstances under which any such restrictions will not apply. See Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 69 *Fed. Reg.* 22300 (2004) (amendments to Form N-1A; text of the amendments do not appear in the Code of Federal Regulations). Form N-1A is used by mutual funds to register under the Investment Company Act of 1940 and to file a registration statement under the Securities Act of 1933 to offer their shares to the public.

securities fraud statute.¹⁸ According to DOJ officials, criminal prosecution of late trading is fairly straightforward because the practice is a clear violation of federal securities laws.

Inadequate Documentation Procedures Limit SEC's Capacity to Effectively Manage the Criminal Referral Process

SEC staff said that as state and federal criminal prosecutors were already aware of and generally evaluated the mutual fund trading abuse cases for potential criminal violations on their own initiative, SEC staff did not need to make specific criminal referrals to bring these cases to their attention. However, in the course of our review we found that SEC's capacity to effectively manage its overall criminal referral process may be limited by inadequate recordkeeping. SEC rules provide for both formal and informal processes for making referrals for criminal prosecutions; however, senior Enforcement staff told us that SEC uses only the informal procedures (such as telephone calls to criminal authorities) for making criminal referrals, describing them as less time-consuming and more effective than the more cumbersome formal processes, which involved multiple levels of agency review and approval including review and approval by the Commission. While potentially efficient, SEC's informal procedures do not provide critical management information on the referral process. Specifically, SEC staff do not document referrals or reasons for making them. According to federal internal control standards, policies and procedures, including appropriate documentation, should be designed to help ensure that management's directives are carried out. Without proper documentation, SEC cannot readily determine and verify whether staff make appropriate and prompt referrals. Documentation of referrals might serve as an additional internal indicator of the effectiveness of SEC's referral process and is also important for congressional oversight of law enforcement efforts in the securities industry. In response to a recommendation in our report, SEC agreed to institute procedures requiring the documentation of referrals and the reasons for such referrals.

¹⁸The defendant pleaded guilty to a violation of New York's Martin Act, General Business Law § 352-c(6). This individual also settled a parallel civil enforcement action instituted by SEC. The SEC settlement order found that this individual willfully aided and abetted and caused violations of SEC Rule 270.22c-1 by engaging in late trading of mutual fund shares on behalf of a hedge fund operator.

SEC Efforts to Encourage Staff Compliance with Federal Conflict-of-Interest Laws On New Employment Do Not Include Tracking Post-SEC Employment Plans

SEC provides training and guidance to its staff on federal laws and regulations regarding employment with regulated entities¹⁹, and also requires former staff to notify it if they plan to make an appearance before the agency.²⁰ However, SEC does not require departing staff to report where they plan to work as do other financial regulators. According to SEC staff, they have not tracked postemployment information because SEC examiners and other staff are highly aware of employment-related restrictions. SEC staff also said that since agency examiners have traditionally visited mutual fund companies periodically to conduct examinations, they are less likely to face potential conflicts of interest than bank examiners who may be located full-time at large institutions. Nonetheless, as I described earlier, SEC is assigning staff to monitor large mutual fund companies on an ongoing basis. These SEC examination teams would likely have more regular contact with fund management over a potentially longer period of time. In addition, the new SEC rule requiring all mutual fund firms to designate CCOs may increase an existing demand for SEC examiners to fill open positions in the compliance departments at regulated entities. As a result, the potential for employment conflicts of interest might increase. In response to a recommendation in our report, SEC agreed to request that departing employees provide information on where they plan to work and institute procedures (including reviewing examination documentation) if agency staff believe that a departed employee's work products may have been compromised due to interactions with a regulated entity.

¹⁹ Federal laws place restrictions on the postfederal employment of executive branch employees. Specifically, these laws generally prohibit federal executive branch employees from participating personally and substantially in a particular matter that a person or organization with whom the employee is negotiating prospective employment has a financial interest. 18 U.S.C. § 208(a). In addition, former senior employees are prohibited for a period of 1 year following federal employment from communicating with or appearing before their former federal employer on behalf of anyone with the intent to influence agency action. 18 U.S.C. § 207(a). This "cooling-off" period is 2 years concerning any matter that was pending under a former employee's official responsibility during the 1 year period prior to termination of federal employment. 18 U.S.C. § 207(b). Violation of either the "seeking employment" or postfederal employment activity restrictions can result in civil and criminal sanctions. 18 U.S.C. § 216.

²⁰ 17 C.F.R. § 200.735-8(b)(1) requires former SEC staff to file a notice with SEC within 10 days after being employed or retained as the representative of any person outside of the government in any matter in which an appearance before, or communication with, SEC or its employees is contemplated. This rule applies to all former SEC staff for 2 years after leaving the agency.

Observations

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, before 2003, SEC did not identify the undisclosed arrangements between investment advisers and favored customers through the agency's oversight process. SEC staff faced competing examination priorities that may have affected its capacity to detect the abusive practices but 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 in regard to regulators (1) performing independent assessments of internal controls, (2) having the capacity to identify and evaluate evidence of potential risks, and (3) ensuring the independence of the compliance function at mutual fund companies. Accordingly, our April 2005 report included recommendations to enhance the effectiveness of SEC's mutual fund oversight program and help strengthen fund company operations, which SEC agreed to either implement fully or consider ways to implement them. Although our May 2005 report found that SEC consistently applied its penalty setting procedures in the cases we reviewed, it also identified weaknesses in the agency's procedures relating to the referral of securities cases to other agencies for potential criminal violations and ensuring that departing employees complied with conflict-of-interest laws and regulations. The report included recommendations to better ensure that these agency responsibilities are being met, which SEC agreed to implement.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions that you may have.

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