



Highlights of GAO-04-533T, a report to Chairman, Senate Committee on Banking, Housing and Urban Affairs

Why GAO Did This Study

Since September 2003, widespread allegations of abusive practices involving mutual funds have come to light. An abuse called late trading allowed some investors, at times in collusion with pension plan intermediary, broker-dealer, or fund adviser staff, to profit at other investors' expense by submitting orders for fund shares to receive that day's price after the legal cutoff. Other investors were allowed to conduct market timing trades to take advantage of stale prices used by funds to calculate their net asset values at funds with stated policies against such trading. SEC and other regulators have responded with numerous proposals for new or revised practices. Based on a body of work that GAO has conducted involving mutual funds, GAO analyzed and provides views on proposed and final rules involving (1) fund pricing and compliance practices intended to address various mutual fund trading abuses that have come to light recently, (2) fund boards' independence and effectiveness, (3) fund adviser compensation of broker-dealers that sell fund shares, and (4) additional actions regulators could take to further improve transparency and investor understanding of the fees they pay.

What GAO Recommends

In this statement, GAO raises a number of issues for regulators to consider that could enhance the effectiveness of proposed rule changes.

www.gao.gov/cgi-bin/getrpt?GAO-04-533T.

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 or hillmarr@gao.gov.

March 10, 2004

MUTUAL FUNDS

Assessment of Regulatory Reforms to Improve the Management and Sale of Mutual Funds

What GAO Found

GAO commends SEC and other regulators for their swift regulatory response to recently revealed abusive mutual fund practices. However, some proposed actions need to be thoroughly assessed to ensure equitable treatment for all investors and others will need to be reinforced with enhanced compliance, enforcement, and investor education programs to be truly effective. In particular, to prevent further late trading, SEC has proposed that all mutual fund orders be received by funds or designated processors by 4:00 p.m. Eastern Time, but this action may unfairly impact some retail investors that place orders through financial intermediaries. Although GAO supports in the short run the proposed hard 4:00 p.m. close as a way of increasing the certainty that all orders have been legitimately received, GAO believes that SEC should continue to work with industry participants, including pension plan intermediaries, to address concerns that the hard close would adversely affect investors that use such intermediaries. To address market timing, SEC is proposing that funds make greater disclosure of market timing, securities pricing, and portfolio disclosure policies. GAO supports these steps and encourages regulators to educate investors about the importance of such disclosures.

To improve mutual fund corporate governance and oversight, SEC has also proposed increasing the proportion of independent directors to 75 percent and to require independent chairs. SEC is also proposing that fund advisers appoint compliance officers that report to fund boards. GAO sees these actions as giving increased prominence to independent members on fund boards of directors and providing them with additional tools to effectively oversee fund practices. However, additional actions may be needed to ensure that independent directors have no relationships with the fund adviser or its personnel that could impair their independence. SEC and other regulators have also proposed that the broker-dealers that sell fund shares make more extensive disclosures about payments they receive from fund advisers. SEC is also seeking comments on how to revise the fees they charge investors that also compensate broker-dealers for selling fund shares. GAO supports these actions as increasing the transparency of these costs to investors but recognizes that the effectiveness of these proposals could be enhanced by expanded compliance and investor education programs.

SEC is also seeking information on how fund advisers use investor dollars to obtain research under a practice called soft dollars. Given the increased spotlight that Congress and regulators are placing on the mutual fund industry, GAO believes the time is right to more effectively address the conflicts of interest created by soft-dollar arrangements. In addition, GAO identifies further actions that could be taken to improve disclosure of mutual fund fees to enhance competition among funds on the basis of the fees that are charged to shareholders.