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Report to Congressional Requesters

August 2005

MUTUAL FUND INDUSTRY

SEC's Revised Examination Approach Offers Potential Benefits, but Significant Oversight Challenges Remain

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Highlights

Highlights of GAO-05-415, a report to congressional requesters

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Why GAO Did This Study

As the frontline regulator of mutual funds, the Securities and Exchange Commission (SEC) plays a key role in protecting the nearly half of all U.S. households owning mutual funds, valued around $8 trillion in 2005. Mutual fund abuses raised questions about the integrity of the industry and quality of oversight provided by SEC and self-regulatory organizations (SRO) that regulate broker-dealers selling funds. This report assesses (1) changes SEC has made to, or is planning for, its mutual fund exam program; (2) key aspects of SEC's quality control framework for routine fund exams; and (3) the adequacy of SEC's oversight of NASD and the New York Stock Exchange in protecting shareholders from mutual fund sales abuses.

What GAO Recommends

This report makes four recommendations to SEC designed to help ensure that it is using its resources effectively to oversee mutual funds and broker-dealers selling mutual funds, to improve aspects of its quality control framework for routine fund exams, and to enhance its oversight of SRO exams of broker-dealers selling mutual funds. In its written comments, SEC provided additional information on the benefits of its revised exam strategy for overseeing funds and advisers and on the benefits of its broker-dealer oversight exams.

www.gao.gov/cgi-bin/getrpt?GAO-05-415.

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

What GAO Found

SEC is initiating several changes intended to strengthen its mutual fund exam program but faces challenges overseeing the fund industry. In the wake of the fund abuses, SEC has revised its past approach of primarily conducting routine exams of all funds on a regular schedule. It concluded these exams were not the best tool for identifying emerging problems, since funds were not selected for examination based on risk. To quickly identify problems, SEC is shifting resources away from routine exams to targeted exams that focus on specific risks. It will conduct routine exams on a regular schedule but only of funds deemed high risk. SEC also is forming teams to monitor some of the largest groups of advisers and funds. Although SEC is seeking to focus its resources on higher risk funds and activities, the resource tradeoffs it made in revising its oversight approach raise significant challenges. The tradeoffs may limit SEC's capacity not only to examine funds considered lower risk within a 10-year period but also to accurately identify which funds pose higher risk and effectively target them for routine examination. Potentially taxing its resources further, SEC recently adopted a rule to require advisers to hedge funds (investment vehicles generally not widely available to the public) to register with it. This rule is expected to increase SEC's exam workload, but the precise extent is not yet known.

SEC has integrated some quality controls into its routine exams, but certain aspects of its framework could be improved. It relies on experienced staff to oversee all exam stages but does not expressly require supervisors to review work papers or document their review. GAO found deficiencies in key SEC exam work papers, raising questions about the quality of supervisory review. SEC also does not require examiners to prepare written exam plans, though they use considerable judgment in customizing each exam. Written plans could serve as a guide for conducting exams and reviewing whether exams were completed as planned. As done by other regulators, SEC also could review a sample of work papers to test compliance with its standards.

A primary tool that SEC uses to assess the adequacy of SRO oversight of broker-dealers offering mutual funds provides limited information for achieving its objective and imposes duplicative costs on firms. To assess SRO oversight, SEC reviews SRO exam programs and conducts oversight exams of broker-dealers, including their mutual fund sales practices. SEC's oversight exams take place 6 to 12 months after SROs conduct their exams and serve to assess the quality of SRO exams. However, GAO reported in 1991 that SEC's oversight exams provided limited information in helping SROs to improve their exam quality, because SEC and the SROs used different exam guidelines and their exams often covered different periods. GAO found that these problems remain, raising questions about the considerable resources SEC devotes to oversight exams. GAO also found that SEC has not developed an automated system to track the full scope of work done during its oversight exams. Thus, SEC cannot readily determine the extent to which these exams assess mutual fund sales practices.

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Abbreviations

FDIC	Federal Deposit Insurance Corporation
MRO	Midwest Regional Office
NERO	Northeast Regional Office
NFA	National Futures Association
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of the Currency
OCIE	Office of Compliance Inspections and Examinations
ORA	Office of Risk Assessment
PDO	Philadelphia District Office
SEC	Securities and Exchange Commission
SRO	self-regulatory organization
STARS	super tracking and reporting system

United States Government Accountability Office
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August 17, 2005

The Honorable Barney Frank
Ranking Member
Committee on Financial Services
House of Representatives

The Honorable Paul E. Kanjorski
Ranking Member
Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises
Committee on Financial Services
House of Representatives

Nearly half of all U.S. households own mutual funds, with total assets of about $8 trillion as of February 2005, and roughly one-third of the total assets are held in retirement accounts.[1] Recent trading abuses implicating well-known mutual funds have called into question the integrity of the mutual fund industry and quality of oversight provided by the Securities and Exchange Commission (SEC), which is the industry's frontline regulator. State regulators rather than SEC were the first to uncover in the summer of 2003 abuses involving market timing, which typically involves the frequent buying and selling of mutual fund shares by sophisticated investors seeking opportunities to profit from differences in prices between overseas and U.S. markets. Although market timing is not itself illegal, it can constitute illegal conduct if, for example, investment advisers (firms that manage mutual funds) enter into undisclosed agreements with favored customers, such as hedge funds, permitting them to trade frequently and in contravention of fund prospectuses—as certain advisers

[1]The term "mutual fund" refers to an open-end management company, which is a type of investment company and comprises the largest segment of the investment company industry.

did before September 2003.[2] Another type of abuse commonly referred to as late trading was significant but less widespread than market timing abuses. Late trading occurs when investors place orders to buy or sell mutual fund shares after the mutual fund has calculated the price of its shares, usually once daily at the 4:00 p.m. Eastern Time (ET) market close, but receive that day's fund share price.[3] Investors who are permitted to late trade can profit from their knowledge of events in the financial markets that take place after 4:00 p.m., an opportunity that other fund shareholders do not have. Although late trading can involve fund personnel, late trading violations typically have occurred at intermediaries, such as broker-dealers that offer mutual funds to their customers, before these institutions submit their daily aggregate orders to mutual funds for final settlement.

SEC's initial inability to detect the market timing abuses before late 2003 raised questions about the agency's mutual fund examination program, which is the agency's primary means of detecting deficiencies and violations and thereby protecting investors.[4] However, following the detection of the mutual fund trading abuses, SEC initiated a series of examinations to determine the extent of the abuses, vigorously pursued enforcement actions against violators of securities laws, and issued new rules to overhaul the regulatory framework in which funds operate. The agency also initiated changes to its examination program that are intended to make it more focused on detecting abuses and emerging problems more quickly.

[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 an 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).

[3]Unlike market timing, late trading is illegal. Under SEC rules, mutual funds accept orders to sell and redeem fund shares at a price based on the current net asset value, which most funds calculate once a day at the 4:00 p.m. ET close of the U.S. securities markets.

[4]We discuss the reasons that SEC did not detect the market timing and late trading abuses in a recently issued report. See GAO, *Mutual Fund Trading Abuses: Lessons Can Be Learned from SEC Not Having Detected Violations at an Earlier Stage*, GAO-05-313 (Washington, D.C.: Apr. 20, 2005).

In addition, the involvement of some broker-dealers in the recent mutual fund trading abuses has raised concerns about regulatory oversight of that industry. NASD and the New York Stock Exchange (NYSE) are self-regulatory organizations (SRO) and have primary responsibility for regulating and examining their member broker-dealers, including their mutual fund sales practices. Although NASD is primarily responsible for assessing broker-dealer mutual fund sales practices, it did not detect the trading abuses through examinations or other means.[5] SEC is responsible for overseeing the quality of SRO regulation of broker-dealers and does so through on-site inspections of SRO regulatory programs. SEC also conducts oversight examinations of broker-dealers recently examined by SROs to assess the quality of their examination programs.

This report responds to your request that we review various issues concerning SEC's oversight of the mutual fund industry. Specifically, you asked us to (1) identify and assess changes SEC has made to, or is planning for, its mutual fund examination program; (2) assess key aspects of the quality control framework of SEC's routine mutual fund examinations; and (3) determine the adequacy of SEC's oversight of NASD and NYSE, particularly in regard to the SROs' oversight of mutual fund sales practices.

To accomplish our reporting objectives, we reviewed policies, procedures, and other guidance applicable to SEC's mutual fund examination program as well as laws and regulations related to mutual funds. We also reviewed policies, procedures, and other guidance applicable to SEC's oversight of NASD's and NYSE's broker-dealer examination programs. At three SEC field offices that accounted for the largest number of completed routine fund examinations in fiscal year 2004, we reviewed all routine examinations of funds completed that year. In addition, we interviewed officials at SEC headquarters and four field offices, NASD, NYSE, the Investment Company Institute, and other industry participants about SEC's oversight of mutual funds or broker-dealers. Finally, we interviewed officials from the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC), NASD, NYSE, and the National Futures Association (NFA) about their examination programs. We also

[5]Although NYSE is also responsible for regulating its member broker-dealers, 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.

reviewed guidance related to those programs. We performed our work in Boston, Massachusetts; Chicago, Illinois; New York, New York; Philadelphia, Pennsylvania; and Washington, D.C. We conducted our work between February 2004 and July 2005 in accordance with generally accepted government auditing standards. Appendix I provides a detailed description of our scope and methodology.

Results in Brief

Although SEC is initiating several significant changes intended to strengthen its mutual fund examination program, it faces challenges in effectively overseeing the mutual fund industry. In the wake of the recent mutual fund trading abuses, SEC has revised its traditional approach of primarily conducting routine examinations of all funds generally within a 5-year period to oversee the industry. Agency staff concluded that these examinations were not the best tool for identifying emerging compliance problems, because funds were selected for examination based on the passage of time and not based on risk. To more proactively identify and address compliance risks, SEC is shifting resources away from routine examinations to targeted examinations that narrowly focus on specific risks (e.g., market timing) at individual or groups of funds based on tips or other information. SEC is continuing to conduct routine examinations on a regular schedule but only of funds it perceives to pose higher risk. It will randomly select a sample of lower risk advisers and funds for routine examination each year. In addition, SEC plans to implement a pilot program to assign examination teams to continuously monitor some of the largest mutual funds, an approach modeled after the use of similar teams by federal bank regulators to supervise large banks. Although SEC is seeking to focus its resources on higher risk advisers and funds as well as higher risk activities, the resource tradeoffs it made in revising its oversight approach raise significant challenges. Specifically, the tradeoffs may limit SEC's capacity to examine funds considered lower risk within a 10-year period. In turn, this outcome could limit SEC's capacity to accurately identify which mutual funds pose relatively higher or lower risk and effectively target higher risk funds for routine examination. Potentially taxing its examination resources further, SEC recently adopted a rule to require hedge fund advisers—some of which were involved in the recent mutual fund abuses—to register with the agency. This rule is expected to increase SEC's examination workload, but the precise extent is not yet known.

SEC has integrated some quality controls into its routine mutual fund examinations, but quality control improvements could further ensure that examinations are conducted in a thorough and consistent manner throughout SEC field offices. Under its revised examination priorities, SEC's routine examinations are continuing to serve as the primary regulatory tool for testing whether higher risk mutual funds are complying with the federal securities laws. As part of its quality controls, SEC relies extensively on experienced supervisory examiners to oversee all stages of the routine examination process, but three controls could be enhanced to facilitate and ensure the adequacy of supervisory review. First, although SEC has standards for preparing examination work papers, it does not expressly require supervisors to review work papers or document their review. Requiring documented supervisory review could further ensure that work is reviewed and meets SEC standards. Deficiencies we found raise questions about the adequacy or completeness of supervisory review of completed risk scorecards—work papers that play a key role in determining the scope of a fund's routine examination and the timing of the fund's next routine examination. Second, SEC standards do not require examiners to prepare written examination plans for supervisory review, even though examiners use considerable judgment in customizing the examination scope to the particular risks of a mutual fund. Written plans could serve as a guide for conducting examinations, coordinating examination work, and reviewing whether examinations were completed as planned. Third, while SEC uses several methods to ensure examination quality and consistency, federal bank and other regulators take the additional step of reviewing some completed examinations and work papers to test compliance with and evaluate the effectiveness of applicable policies and procedures. SEC officials cited staff resource constraints for not reviewing completed examinations and work papers. While reviews of a sample of completed examinations and work papers involve resource tradeoffs, they can yield important benefits and are an integral part of an effective quality control system.

A primary tool that SEC uses to assess the adequacy of SRO oversight of broker-dealers offering mutual funds to customers provides limited information for achieving its objective and imposes duplicative regulatory costs on the securities industry. To assess SRO oversight, SEC reviews SRO examination programs and conducts oversight examinations of broker-dealers, including their mutual fund sales practices. SEC's oversight examinations take place 6 to 12 months after SROs conduct their examinations of broker-dealers and are intended to assess the quality of SRO examinations. However, we reported in 1991 that SEC's broker-dealer examination program had significant problems.[6] For example, we reported that the way in which SEC conducted these broker-dealer oversight examinations provided limited information in helping SROs to improve the quality of their examination programs. This was because SEC and the SROs used different broker-dealer examination guidelines, and their examinations often covered different periods of time. Our recent work found that these problems still remain, which raises questions about SEC's goal of conducting about 40 percent of its broker-dealer examinations as oversight examinations. Another deficiency we found during our review is that SEC has not developed an automated system to track the full scope of work performed during broker-dealer examinations. Absent such an automated system, SEC managers cannot readily determine the extent to which the agency's broker-dealer examinations assess mutual fund sales practices or other issues. Given the resource challenges that SEC faces in its role as the frontline regulator of mutual funds, SEC's current commitment of staff to broker-dealer oversight examinations may need to be reexamined.

This report makes four recommendations to the SEC Chairman for improving oversight of mutual funds and SRO oversight of broker-dealers that sell mutual funds. First, we recommend that SEC periodically assess the level of resources allocated to the various types of examinations in light of their regulatory benefits to help ensure that the agency is using its resources efficiently and effectively to oversee the mutual fund industry, including broker-dealers that offer mutual funds. As part of this assessment, SEC should seek to ensure that it allocates sufficient resources to mitigate any regulatory gaps that may currently exist concerning the timely examination of mutual funds perceived to represent lower risk; complete fund risk assessments within a more reasonable period; and fulfill its new oversight responsibilities of the hedge fund industry. Second, in so doing, we recommend that SEC assess its methodology for conducting broker-dealer oversight examinations and whether some portion of the resources currently devoted to these examinations could be better utilized to perform mutual fund examinations. Third, to strengthen SEC's approach to mutual fund examinations, we recommend that SEC establish additional policies or procedures for improving its controls to ensure examination quality and consistency throughout SEC field offices. Fourth, we recommend that SEC

[6]GAO, *Securities Industry: Strengthening Sales Practice Oversight*, GAO/GGD-91-52 (Washington, D.C.: Apr. 25, 1991).

electronically track information about the full scope of work performed during broker-dealer oversight examinations.

We received comments on a draft of this report from SEC, which are included in appendix III. SEC also provided technical comments on a draft of the report, which were incorporated into the final report, as appropriate. SEC focused most of its comments on providing further elaboration on the potential benefits of its examination strategy for overseeing mutual funds and investment advisers and on the benefits obtained from its broker-dealer oversight examinations. In addition, SEC briefly commented that it will consider our recommendation directed at improving its quality controls for routine fund examinations and that it has formed a working group to explore ways to enhance the value of its broker-dealer oversight examinations.

Background

SEC oversees mutual funds primarily through its Office of Compliance Inspections and Examinations (OCIE), Division of Investment Management, and Division of Enforcement. OCIE examines mutual funds to evaluate their compliance with the federal securities laws, to determine if they are operating in accordance with disclosures made to investors, and to assess the effectiveness of their compliance control systems. The Division of Investment Management administers the securities laws affecting funds and advisers. It reviews disclosure documents that mutual funds are required to file with SEC and engages in other regulatory activities, such as rulemaking, responding to requests for exemptions from federal securities laws, and providing interpretation of those laws. Finally, SEC's Division of Enforcement investigates and prosecutes violations of securities laws related to mutual funds.

SEC regulates mutual funds under the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933, and the Securities Exchange Act of 1934. The Investment Company Act was passed specifically to regulate mutual funds and other types of investment companies. Under the act, mutual funds are required to register with SEC, subjecting their activities to SEC regulation. The act also imposes requirements on the operation and structure of mutual funds. Its core objectives are to

- ensure that investors receive adequate and accurate information about mutual funds,

- protect the integrity of fund assets,
- prohibit abusive forms of self-dealing,
- prevent the issuance of securities that have inequitable or discriminatory provisions, and
- ensure the fair valuation of investor purchases and redemptions.

The Investment Advisers Act requires mutual fund advisers to register with SEC, imposes reporting requirements on them, and prohibits them from engaging in fraudulent, deceptive, or manipulative practices. The Securities Act requires fund shares offered to the public to be registered with SEC and regulates mutual fund advertising. Under the Securities Act and Investment Company Act, SEC has adopted rules to require mutual funds to make extensive disclosures in their prospectuses. The Securities Exchange Act, among other things, regulates how funds are sold and requires persons distributing funds or executing fund transactions to be registered with SEC as broker-dealers.

SEC, NASD, and NYSE regulate broker-dealers, including their mutual fund sales practices, by examining their operations and reviewing customer complaints. Broker-dealers that are members of NYSE and do business with the public are typically also required to be members of NASD. Historically, NASD has conducted the mutual fund 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 mutual fund sales practices. NASD has established specific rules of conduct for its members that provide, among other things, standards for advertising and sales literature, including filing requirements, review procedures, approval and recordkeeping obligations, and general standards. NASD also tests members to certify their qualifications as registered representatives.

SEC evaluates the quality of NASD and NYSE oversight in enforcing their member compliance with federal securities laws through SRO oversight inspections and broker-dealer oversight examinations. SROs are private organizations with statutory responsibility to regulate their own members through the adoption and enforcement of rules of conduct for fair, ethical, and efficient practices. As part of this responsibility, they conduct examinations of the sales practices of their broker-dealer members. SEC's SRO oversight inspections cover all aspects of an SRO's compliance, examination, and enforcement programs. The inspections determine whether an SRO is (1) adequately assessing risks and targeting its examinations to address those risks, (2) following its examination procedures and documenting its work, and (3) referring cases to enforcement authorities when appropriate. Under its broker-dealer oversight examinations, SEC examines some of the broker-dealers that SROs recently examined. SEC conducts these examinations to assess the adequacy of the SRO examination programs. In addition to its oversight examinations, SEC conducts cause, special, and surveillance examinations of broker-dealers, but these examinations do not serve to assess the quality of SRO examinations.

SEC's Revised Mutual Fund Examination Program Offers Potential Benefits but also Poses Significant Oversight Challenges

Since the detection of the mutual fund trading abuses in the summer of 2003, SEC has made significant changes to its traditional examination approach, which generally focused on conducting routine examinations of all funds on an established schedule. To better detect potential violations, SEC has reallocated or plans to reallocate its staff to conducting targeted examinations focusing on specific risks and monitoring larger funds on a continuous basis. SEC's revised examination approach offers the potential for the agency to more quickly identify emerging risks and better understand the operations of large and complex funds, although it is too soon to reach definitive judgments. However, due to the limited number of SEC's examination staff relative to the number of mutual funds and advisers for which the agency has oversight responsibility, the decision to focus examination resources on particular areas involved tradeoffs that raise regulatory challenges. In particular, SEC's capacity to examine lower risk advisers and funds within a reasonable time period and develop industry risk ratings has been limited.

SEC Has Revised Its Traditional Mutual Fund Examination Approach in the Wake of the Mutual Fund Trading Abuses

Historically, routine examinations of mutual fund complexes—groups or families of funds sharing the same adviser or underwriter—have served as the cornerstone of SEC's mutual fund oversight, accounting for 85 percent of the total fund examinations done from 1998 through 2003. During that period, SEC generally tried to examine each complex at least once every 5 years.[7] Due to resource constraints, SEC examinations typically focused on discrete areas that staff viewed as representing the highest risks of presenting compliance problems that could harm investors. Major areas of review have included portfolio management, order execution, allocation of trades, and advertising returns. In late 2002, SEC implemented a revised approach to conducting routine examinations that included a systematic process for documenting and assessing risks and controls for managing those risks in a range of areas related to the asset management function.[8] Besides routine examinations, SEC conducts sweep examinations to probe specific activities of a sample of funds identified through tips, complaints, the media, or other information. The agency also conducts cause examinations when it has reason to believe something is wrong at a particular fund. Sweep and cause examinations accounted for about 5 and 10 percent, respectively, of the total examinations done during 1998 through 2003.

After the detection of the market timing and late trading abuses in the summer of 2003, SEC officials concluded that the agency's traditional focus on routine examinations had limitations. In particular, SEC staff said that routine examinations were not the best tool for broadly identifying emerging compliance problems, since funds were selected for examination based largely on the passage of time, not based on their particular risk characteristics.[9] In addition, SEC officials stated that they concluded the growth in the number of mutual fund companies and the breadth of their operations, combined with the need to perform more in-depth examinations of discrete areas, did not allow SEC to maintain its existing routine examination cycle.

[7]In late 2003, SEC established a 2 or 4-year examination cycle based on the size or risk level of the fund complex. However, this cycle was not fully implemented before SEC made significant changes to its mutual fund examination program as described in this section.

[8]Under this process, examiners use a set of standardized work papers called control or risk scorecards to guide and document their assessment of the effectiveness of a fund's compliance controls designed to prevent or detect violations of the federal securities laws. Based on that assessment, examiners assign the fund an overall compliance risk rating of low, medium, or high.

[9]In an earlier report, we found that SEC's focus on areas traditionally considered to be high risk hindered its capacity to detect violations not traditionally considered to be high risk, such as market timing abuses. We concluded that SEC needed to test controls in a variety of areas at least at a sample of companies to validate its assumptions about risks and verify the adequacy of controls in place to mitigate them.

To focus its resources on issues and funds presenting the greatest risk of having compliance problems that may harm investors, SEC has made significant revisions to its examination priorities and oversight processes as described below:

- First, SEC is placing a higher priority on sweep and cause examinations and a lower priority on routine examinations. SEC has directed its 10 field offices that conduct fund examinations to give priority to initiating, as warranted, sweep examinations of funds or advisers, focusing particularly on operational or compliance issues.[10] To address the market timing and late trading abuses surfacing in late 2003, SEC shifted resources away from routine examinations to support sweep and cause examinations, according to SEC officials. As a result, sweep and cause examinations accounted for 87 percent of the 690 fund examinations completed in fiscal year 2004. SEC officials said that about 17 percent of these examinations resulted in referrals to the agency's Division of Enforcement for potential violations of securities laws and regulations. (We note that the large increase in the number of sweep and cause examinations in fiscal year 2004 as well as the number of referrals was likely due to SEC's focusing a substantial amount of resources on detecting market timing and late trading abuses.)

- Second, SEC no longer will routinely examine all funds and advisers on a regular basis, but it will conduct routine examinations of funds and advisers perceived to be high risk, once every 2 to 3 years. In addition, SEC will randomly select a sample of advisers and their affiliated funds perceived to be low risk for routine examination each year. Because these firms will be selected randomly, each firm will have an equal chance of being examined each year. According to SEC officials, the random selection process will enable agency staff to project the examination findings to the population of firms deemed low risk and assess the possible existence of problems within the population.

- Third, SEC plans to provide more continuous and in-depth oversight of the largest mutual funds. Specifically, SEC is creating teams of examiners dedicated to regularly interacting with and closely monitoring and examining the activities of firms in the largest and most complex groups of affiliated advisers and mutual funds. SEC initially plans to form teams under a pilot program to monitor 10 large advisory

[10] SEC has 11 field offices, but 1 office does not have fund examination staff.

groups. Any decision to form additional monitoring teams will depend on how the pilot program develops, according to an SEC official. SEC officials said that the monitoring teams are loosely modeled on the federal bank regulators' use of on-site teams to continuously monitor operations of large banks. However, unlike the bank regulator approach, SEC staff said the monitoring teams would not be located on-site at large mutual fund companies.

- Fourth, an SEC task force is considering the development of a surveillance program to support the agency's oversight of all funds and advisers. The purpose of this program is to obtain from firms information that would enable examiners to identify aberrant patterns in fund and adviser activities and the possible existence of fraud or abusive schemes that require follow-up through examinations. In its fiscal 2006 budget request, SEC reported that the agency expects the surveillance system to begin operations during the second half of 2006.[11]

- Fifth, SEC has promulgated rules that require investment advisers and investment companies to appoint independent chief compliance officers (CCO) who are responsible for ensuring that their companies adopt policies and procedures designed to prevent violations of federal securities laws and regulations.[12] Fund CCOs are also responsible for preparing annual reports that must, among other things, identify any material compliance matter at the company since the date of the last report. SEC staff said that they plan to review such annual compliance reports while conducting examinations to assist in identifying problems at mutual funds and determine whether the funds have taken corrective actions. (As described later in this report, SEC is missing opportunities to take full advantage of CCO compliance reports to detect potential violations in the mutual fund industry.)

- Finally, SEC has established the Office of Risk Assessment (ORA) to assist the agency in carrying out its overall oversight responsibilities, including mutual fund oversight. ORA's director reports directly to the SEC Chairman. According to SEC staff, ORA will enable the agency to analyze risk across divisional boundaries, focusing on new or resurgent

[11]SEC, *In Brief: Fiscal 2006 Congressional Budget Request* (Feb. 2005).

[12]SEC, *Final Rule: Compliance Programs of Investment Companies and Investment Advisers*, 68 Fed. Reg. 74714 (Dec. 24, 2003).

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, industries, and markets; and (3) preparing assessments of the agency's risk environment. ORA is to work in coordination with internal risk teams established in each of the agency's major program areas—including OCIE—and a Risk Management Committee responsible for reviewing implications of identified risks and recommending appropriate courses of action.

SEC's Revised Oversight Approach Reflects Some of the Lessons Learned from the Recent Mutual Fund Scandals

As we recently reported, the market timing and late trading abuses that surfaced in 2003 revealed weaknesses in SEC's mutual fund oversight approach.[13] We noted in the report that lessons can be learned from SEC not having detected market timing arrangements at an earlier stage. The key initiatives that SEC is taking to strengthen its mutual fund oversight program are largely intended to focus the agency's resources on the largest and highest risk funds and activities. Although it is too soon to assess the effectiveness of the initiatives in light of their recent or planned implementation, the initiatives are consistent with some of the lessons learned concerning 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.

By placing greater priority on sweep examinations, SEC may be better positioned to independently assess, as needed, the adequacy of fund controls designed to prevent and detect abusive practices. As we reported, SEC staff did not examine mutual funds for market timing abuses before late 2003, because they viewed market timing as a relatively lower risk area since agency staff believed that funds had adequate financial incentives to establish effective controls for it. In that regard, we noted the importance for SEC to conduct independent assessments of controls at a sample of funds, at a minimum, to verify that areas viewed as low risk, such as market

[13] GAO-05-313.

timing, are in fact low risk and effective controls are in place. SEC's revised examination priorities, particularly their emphasis on initiating sweep examinations that focus on operational or compliance issues, may provide the agency with greater opportunity to conduct independent assessments of controls for emerging risks, in part to validate critical assumptions about such risks and confirm the adequacy of controls in place to address those risks.

By forming examiner teams dedicated to monitoring the largest and most complex groups of affiliated advisers and funds, SEC may have the opportunity to more efficiently or effectively use its resources and help ensure the independence and effectiveness of the monitored firms' compliance staff. SEC estimates that the 100 largest advisory groups of affiliate advisers and funds accounted for about $7.1 trillion, or 85 percent, of the fund assets under management as of the end of September 2004. Thus, focusing on the largest advisory groups may enable SEC to attain the greatest dollar coverage with its limited examination resources. Focusing on the largest advisory groups may also be appropriate due to the control deficiencies that have been found at such companies. For example, SEC determined that nearly 50 percent of the 80 largest mutual funds had entered into undisclosed arrangements permitting certain shareholders to engage in market timing that appeared to be inconsistent with the funds' policies, prospectus disclosures, or fiduciary obligations. In our earlier mutual fund work, we also found that compliance staff at some funds identified market timing but lacked the independence or authority necessary to control it. This finding suggested that routine communications with fund compliance staff could enhance SEC's capacity to detect potential violations at an earlier stage, if compliance staff are effective and forthcoming about the problems they detect. SEC's monitoring teams will provide agency staff with the opportunity to be in routine communication with fund compliance staff, including CCOs. Furthermore, such communications, combined with examinations, could help SEC ensure that fund CCOs, as required under SEC's compliance rules, are in a position of authority to compel others to adhere to applicable compliance policies and procedures.

By creating ORA, SEC is laying an important part of the foundation for developing the institutional capability to identify and analyze evidence of potential risks. SEC staff said that ORA will seek to ensure that SEC will have the information necessary to make better, more informed decisions on regulation. 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. SEC's compliance rules create opportunities for ORA to leverage the knowledge of fund CCOs, including their annual compliance reports. 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.

Finally, SEC's fund and adviser surveillance system is in the exploratory stage but, if properly designed and implemented, may help the agency to leverage its limited resources to augment its examinations and oversee funds and advisers. Federal bank and other regulators use off-site surveillance programs to complement their on-site examinations. Each federal bank regulator has an off-site surveillance program to monitor the financial condition of banks between examinations. Information from off-site monitoring is used in setting bank examination schedules and determining the allocation of examiner resources for higher risk banks. Similarly, a recently deployed NASD surveillance program is used to analyze trends in broker-dealer activities and identify unusual patterns that indicate potential problems.[14] NASD uses surveillance analyses to initiate cause examinations and to help its examiners focus on high-risk areas during their routine broker-dealers examinations.

SEC's Revised Examination Approach Raises Oversight Challenges

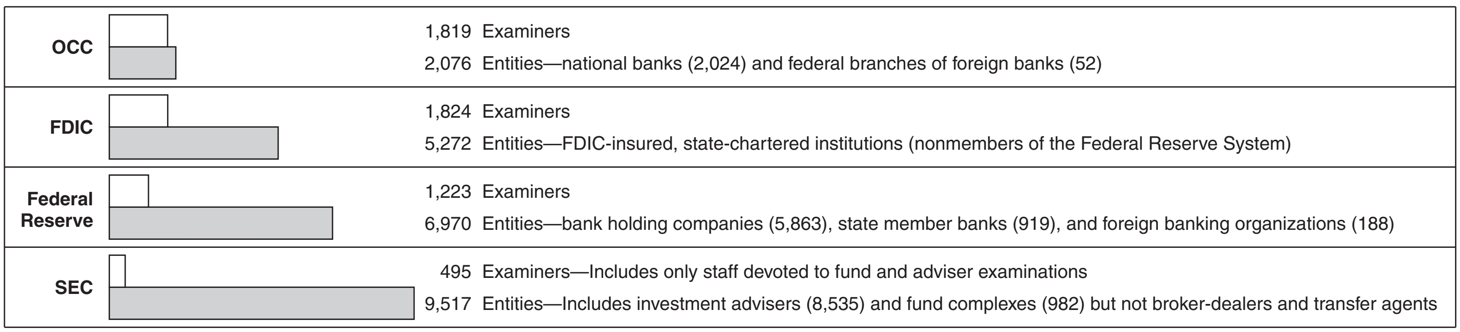
SEC's planned changes to its mutual fund examination program offer potential advantages, but they also involve significant tradeoffs that raise important regulatory challenges for the agency. In comparison to federal bank regulators, SEC has significantly less examiners relative to the number of entities it regulates (see fig. 1), although bank and mutual fund regulatory regimes, including their examinations, differ from each other.[15] As reflected in SEC's revised oversight approach, any decision by SEC to focus additional examination resources on one or more fund areas involves tradeoffs that could result in less oversight of, or create a regulatory gap in, other areas. We are particularly concerned about SEC's capacity going

[14]NASD's surveillance program is called Integrated National Surveillance and Information Technology Enhancements.

[15]SEC recently reported that mutual funds and other investment companies managed roughly $8 trillion in assets at the start of fiscal year 2005, nearly double the $4.5 trillion in insured deposits at commercial banks and about equal to the $8 trillion of financial assets at commercial banks.

forward to review the operations of firms considered to be lower risk, conduct risk assessments of the industry, and potentially oversee the hedge fund industry.

Figure 1: Number of Examiners and Entities Subject to Examination by SEC and Federal Bank Regulators in 2004



Sources: SEC, the Federal Reserve, FDIC, and OCC.

By shifting examination resources to targeted sweep and cause examinations as well as monitoring teams for larger funds, SEC may be limiting its capacity to examine the operations of funds perceived to pose lower risk (generally smaller funds) within a reasonable period. As stated previously, between 1998 and 2003, SEC generally sought to conduct routine examinations of all funds once every 5 years and shortened the cycle to 2 or 4 years in fiscal year 2004 following an increase in resources.[16] However, under SEC's revised examination program, some mutual funds may not be examined within a 10-year period. This is because SEC plans to annually review the operations of 10 percent of the funds deemed lower risk on a random basis. While reviewing funds on a random basis means each firm will have an equal chance of being reviewed annually, it is not clear that this approach will have more of an effect in deterring abuses than if each fund was assured of being examined every 5 years or less. Moreover, if SEC lacks sufficient resources to annually examine 10 percent of the funds deemed lower risk, its approach would have less of a deterrent effect. We recognize that through sweep examinations, SEC may review particular facets of funds deemed lower risk much more frequently than

[16]In fiscal year 2004, SEC sought to conduct routine examinations of (1) the 20 largest funds as well as funds and advisers posing high risk every 2 years and (2) all other funds, including their advisers, every 4 years.

every 10 years or more. At the same time, sweep examinations are much more narrowly scoped than routine examinations and may exclude other potential areas of noncompliance at individual firms.

Similarly, SEC's inability to conduct examinations of all mutual funds within a reasonable period may limit its capacity to accurately distinguish relatively higher risk funds from lower risk funds and effectively conduct routine examinations of higher risk funds. Between late 2002 and October 2004, SEC routinely examined 297, or 30 percent, of the existing fund complexes and used its revised examination guidelines to assess the effectiveness of the funds' compliance controls in deterring and preventing abuses and to assign the funds risk ratings of low, medium, or high. Had SEC not decided in late 2003 and 2004 to shift examination resources to sweep and cause examinations, it might have been able to assign risk ratings to all 982 fund complexes within the following 3 years in accordance with its routine examination cycle. Completing risk ratings for all fund complexes would have provided SEC with an additional basis for allocating resources to the highest risk firms.[17] Over time, SEC's risk ratings can become outdated, or stale, raising the possibility for funds deemed lower risk to become higher risk. For example, changes in a fund's management, such as CCO, could lead to changes that weaken the fund's compliance culture and controls. However, because SEC may not examine all fund complexes within a 10-year period under its revised examination program, its ability to assign risk ratings to all fund complexes and routinely examine all higher risk funds may be limited.[18]

In a previous report, we found that SEC may be missing opportunities to obtain useful information about the compliance controls of mutual funds, including those perceived to represent lower risks and may not be

[17]Absent a compliance risk rating for a fund complex, SEC officials stated that an alternative risk rating assigned to the fund's adviser will be used to determine when the fund will be routinely examined. The alternative rating captures risks inherent in the adviser's business such as conflicts of interests but does not measure the effectiveness of the adviser's compliance controls designed to mitigate conflicts of interest or other risks that could harm mutual fund shareholders.

[18]We note that, as described later in this report, our work has identified deficiencies in SEC's implementation of its revised mutual fund examination guidelines, which raise questions about the quality of risk assessments made between 2002 and 2004. Further, risk ratings completed in 2002 and much of 2003 do not reflect the quality of fund controls over market timing and late trading as SEC did not view these as high-risk areas. SEC subsequently implemented revised procedures to test these areas at each mutual fund that it examined.

examined within a reasonable period of time.[19] While SEC plans to review investment company CCO annual compliance reports during examinations, the agency has not developed a plan to receive and review the reports on an ongoing basis. Obtaining access to such annual reports and reviewing them on an annual basis could provide SEC examiners with insights into the operations of all mutual funds, including those perceived to represent lower risks, and could serve as a basis for initiating examinations to correct potential deficiencies or violations. SEC noted that it is considering how best to utilize the annual reports but noted any required filing of the reports with SEC would require rulemaking by SEC.

A final oversight challenge facing SEC's mutual fund examination program involves a new rule requiring hedge fund advisers to register with the agency.[20] Issued in December 2004, the new rule requires hedge fund advisers to register with SEC as investment advisers by February 2006. The rule is designed, in part, to enhance SEC's ability to deter or detect fraud by unregistered hedge fund advisers, some of which were involved in the recent mutual fund abuses. Once hedge fund advisers register, SEC will have the authority to examine their activities. The rule is expected to increase SEC's examination workload, but because of data limitations the precise extent will not be known until hedge fund advisers actually register. Currently, comprehensive information on the number of hedge funds and advisers is not available, but SEC estimates that from 690 to 1,260 additional hedge fund advisers may be required to register under the new rule, increasing the pool of registered advisers by 8 to 15 percent.[21]

SEC officials estimate that at least 1,000 hedge fund advisers have previously registered as investment advisers with SEC to meet client needs or requirements. Under its examination program, SEC has examined these hedge fund advisers in the same way it has examined all other registered advisers. According to SEC officials, it is anticipated that the additional hedge fund advisers that register with SEC will be treated the same as all other registered advisers under SEC's examination program. SEC has

[19]GAO-05-313.

[20]SEC, *Final Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers*, 69 Fed. Reg. 72054 (Dec. 18, 2004).

[21]For additional detail on how SEC arrived at its estimates, *see Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Release No. IA-2266, File No. S7-30-04 (July 20, 2004).

recognized that providing oversight of the additional registered hedge fund advisers will pose a resource challenge and has identified options for addressing the challenge. It could require fewer hedge fund advisers to register with SEC by raising the threshold level of assets under management required for adviser registration. It also has the option of seeking additional resources from Congress for the increased workload resulting from an increased number of registered advisers. Whatever approach is ultimately taken, SEC will have to consider the potential resource implications of the new rule for its oversight of mutual funds.

SEC Can Improve Certain Mutual Fund Examination Quality Control Measures

SEC has integrated quality controls into its routine examinations but could benefit from additional controls to ensure that policies and procedures are being implemented effectively and consistently throughout SEC field offices. Under its new initiatives, SEC's routine examinations will continue to be the primary regulatory tool for determining whether all funds and advisers are complying with the federal securities laws. Examination quality controls provide, among other things, assurances that important documents are provided supervisory review, and examinations are conducted according to agency policies, procedures, and individual examination plans.[22] SEC could improve its quality control measures in three areas: supervisory review of risk scorecards, preparation of written examination plans, and review of completed examinations and work papers. Bank and other financial regulators have quality control measures that provide assurances above and beyond those measures used by SEC.

SEC Standards for Reviewing Mutual Fund Risk Scorecards Do Not Ensure Accuracy or Completeness

The risk scorecards prepared by SEC during each mutual fund examination are critical work papers, providing the basis for determining areas to review in depth and an overall risk rating for a fund. A set of individual scorecards has been developed to assist examiners in assessing and documenting a fund's compliance controls in 13 strategic areas and to determine the amount of additional testing examiners will do.[23] (See table 1.)

[22] GAO, *An Audit Quality Control System: Essential Elements*, GAO/OP-4.1.6 (Washington, D.C.: August 1993).

[23] When first implemented in October 2002, the risk scorecards covered 10 areas related to the asset management function. In July 2003, OCIE developed three additional risk scorecards.

Table 1: Strategic Areas Covered by SEC's Risk Scorecards as of April 2005

Name of scorecard area
Firm Maintains a Strong Compliance Culture
Minimize Ability of Dominant Individual to Override Control System
Consistency of Portfolio Management with Clients' Mandates
Order Placement Practices Consistent with Seeking Best Execution and Disclosures
Personal Trading of Access Persons Is Consistent with Code of Ethics
Fair Allocation of Blocked and Initial Public Offering Trades
Fund/Advisory Clients' Assets Are Priced and Fund Net Asset Values Are Calculated Accordingly
Accuracy and Fairness of Performance Information
Information That Is Created, Recorded, Maintained, and Reported Is Protected from Unauthorized Alterations
Safety of Clients' Funds and Assets
Third Party Sends Periodic Account Statement to Clients
Fund/Shareholder Order Processing and Cash-Book Reconciliations
Fund Corporate Governance

Source: SEC.

If controls in an area are strong, examiners may do limited or no additional testing to detect potential abuses, but if weak, additional testing is expected to be performed. Collectively, the 13 areas reviewed with the set of individual scorecards provides the basis for determining a mutual fund's overall risk rating, which OCIE uses to determine how frequently the fund will be examined. While the risk scorecards currently cover 13 areas, SEC officials stated that each scorecard serves, in concept, as a model for assessing controls in a particular area of a firm's activities. As such, SEC staff could create additional scorecards to assist them in their review of areas not covered by existing scorecards or modify existing scorecards not suitable for reviewing the controls used by a firm in a critical area. OCIE and field office officials told us that all applicable risk scorecards generally should be completed during routine examinations, but if there are time constraints due to extenuating factors, all scorecards may not be completed.

Even though risk scorecards are important work papers for documenting and assessing fund compliance controls, SEC standards do not expressly require that they receive supervisory review. Current OCIE standards for preparing examination work papers, including scorecards, specify that they should be prepared in an organized manner facilitating supervisory review and examination reporting. The standards do not provide further supervisory review requirements such as who should do the review, how, or when. While the review of scorecards is not expressly required, OCIE headquarters and SEC field office officials stated that supervisors do review scorecards and other examination work papers but typically do not sign or initial them to document that they have been reviewed. In addition, we were told that lead examiners and branch chiefs review work papers throughout the examination process. These officials also review risk scorecards and other work papers when reviewing final examination reports, making sure that all findings are adequately supported and summaries of the scorecard findings included in the examination reports are accurate. After completing their review of examination reports, branch chiefs sign a form to document their review.

In contrast to OCIE, federal bank and other regulators have standards requiring supervisors to document that they have reviewed examination work papers. Examples of the work paper standards include:

- Federal Reserve guidance requires examiners-in-charge or other experienced examiners to review all work papers as soon as practicable and to sign or initial the applicable documents to evidence their review.

- OCC guidance requires examiners-in-charge or other experienced examiners to sign or initial work paper cover sheets to evidence their review. The guidance allows reviewers to tailor the thoroughness of their review based on the experience of the examiner preparing the work paper.

- According to NYSE and NFA officials, the organizations require senior staff to review and sign work papers. NFA officials said that their work papers are electronic, so staff mark a checkbox to evidence their work paper review.

While SEC officials stated that the review of the scorecards is documented indirectly by the supervisor's signature on the examination report, without the supervisor's signature or initials on the scorecards themselves, there is no way to readily verify that the scorecards were reviewed. Our review of 546 scorecards from 66 routine examinations of funds completed in fiscal year 2004 by SEC's Midwest Regional Office (MRO), Northeast Regional Office (NERO), and Philadelphia District Office (PDO) disclosed a number of deficiencies potentially stemming from quality control weaknesses. Most of the scorecards did not contain evidence of supervisory review as expected, based on statements by SEC officials, but 34 scorecards, or about 6 percent, were signed or initialed as evidence of review. Regardless of whether the completed scorecards were signed or initialed, we found deficiencies in four areas that raise questions about the adequacy or completeness of supervisory review.

- First, each scorecard should be marked as to whether examiners rated the compliance controls in the area as highly effective, effective, or ineffective. We found 32, or about 6 percent, of the total scorecards where the control rating was not marked.
- Second, copies of scorecards should be included with the work papers to facilitate supervisory review, but we found 11, or about 17 percent, of the 66 examinations lacked any scorecards and 15, or about 23 percent, were missing one or more scorecards.[24]
- Third, documentary evidence should be cited on scorecards to support effective and highly effective ratings, but we found 25, or about 5 percent, of the total scorecards did not cite documentary evidence supporting such ratings.
- Fourth, scorecard ratings are included in examination reports, but we found the ratings marked on 21, or about 4 percent, of the total scorecards had ratings that differed from the ones in the examination reports.

SEC supervisors document their review of examination reports, which include a summary of the risk scorecard findings. Nonetheless, without documenting that the scorecards themselves were reviewed, SEC does not know if deficiencies resulted from a lack of or inadequate supervisory review. The systematic supervisory review of work papers, particularly risk scorecards, is essential for ensuring examination quality. Such reviews help to ensure that the work is adequate and complete to support the assessment of fund compliance controls as well as report findings and conclusions. Likewise, documentation of the review is important to ensure

[24]Of the 11 examinations lacking any risk scorecards, 8 of them covered funds organized as unit investment trusts. MRO and NERO officials told us that the risk scorecards were not designed for unit investment trusts and, thus, staff did not always complete the scorecards for such types of funds. In one of the other examinations, staff noted on the scorecards that they found extensive violations at the fund and did not have time to complete the scorecards.

that all critical areas are reviewed. The reviewer's initials or signature are written verification that a specific employee checked the work.

Written Examination Plans for Fund Examinations Are Not Required but Would Be Useful for Documenting Agreements Reached on Review Areas

Written examination plans that document the scope and objectives of routine examinations are not required by OCIE. Instead, OCIE officials stated that written examination plans are optional. OCIE allows branch chiefs and lead examiners to decide whether to prepare written plans, with branch chiefs typically meeting with examination teams to discuss the preliminary scope of examinations. Each routine examination is somewhat different because of the risk-based approach used by OCIE. Under this approach, all areas of compliance or fund business activities are not reviewed and instead review areas are judgmentally selected based on their degree of risk to shareholders. As a result, each examination is customized to the activities of the particular fund under examination, with the success of routine examinations depending, in part, on proper planning. The documentation of this planning is important for tracking agreements reached on examination scope and objectives and can be used as a guide for the examination team. Furthermore, the plan can be used to determine whether the examination was completed in accordance with the planned scope. According to OCIE officials, written plans may be helpful in planning examinations of large fund complexes, but many of the examinations conducted are of small firms that have five or fewer employees. For these small firms, the officials said that it may not be necessary to prepare a written examination plan, especially if the examination team conducting the work consists of one or two persons.

While OCIE does not require the preparation of written examination plans, we found that SEC's NERO requires examiners to prepare a planning memorandum to document examination scope and objectives, including firms to be examined within a fund complex, areas considered high risk, and areas to be reviewed. NERO branch chiefs approve the memorandums before the on-site work begins, and the memorandums effectively serve as examination plans. In contrast, SEC's MRO and PDO do not require planning memorandums or examination plans. Instead, branch chiefs in these two offices meet with the examination teams to discuss the scope of examinations and then let the staff decide whether to prepare a written plan, according to MRO and PDO officials. MRO officials said that some branch chiefs will recommend that for large funds, teams prepare written examination plans since it helps coordinate the work. For 66 routine examinations we reviewed at these three offices, about half, or 53 percent, had written planning memorandums or examination plans. Examinations of the larger fund complexes that were managing more than $1 billion in assets also had examination plans for about half, or 54 percent.

In contrast to OCIE, federal bank and other regulators require their staff to prepare written examination plans before conducting examinations. Examples of examination plan requirements include:

- FDIC guidance requires the examiner-in-charge to prepare a scope memorandum to document, among other things, the preliminary examination scope; areas to be reviewed, including the reasons why; and areas not to be included in the examination scope, including the reasons why.

- Federal Reserve guidance requires that a comprehensive risk-focused supervisory plan be prepared annually for each banking organization. The guidance also requires the examiner-in-charge, before going on-site, to prepare a scope memorandum to document, among other things, the objectives of the examination and activities and risks to be evaluated; level of reliance on internal risk management systems and internal and external audit findings; and the procedures that are to be performed. To ensure consistency, the guidance requires the scope memorandum to be reviewed and approved by Reserve Bank management.

- OCC guidance requires the examiner-in-charge or portfolio manager to develop and document a supervisory strategy for the bank that integrates all examination areas and is tailored to the bank's complexity and risk profile. The strategy includes an estimate of resources that will be needed to effectively supervise the bank and outlines the specific strategy and examination activities that are planned for that supervisory cycle. The strategies are reviewed and approved by the examiner-in-charge's or portfolio manager's supervisor.

- NYSE and NFA officials told us that staff are required to prepare written examination or audit plans. NYSE officials said that staff meet with examination directors to reach agreement on the scope of their examination plans. NFA officials said that staff complete a planning module that includes a series of questions that staff answer to determine the scope of the audit, and the completed planning module serves as the audit plan.

Examination planning meetings between SEC branch chiefs and examination teams are important for providing the opportunity to discuss and reach decisions about critical areas of examination scope and objectives. These discussions by themselves, however, do not provide a record of the agreements reached and may not result in a clear and complete understanding for examiners about the scope and objectives of a particular examination. A written examination plan would provide such a record—potentially enabling branch chiefs to better supervise examinations and assisting lead examiners to better communicate the examination strategy to the examination team. Such quality control is especially important given that staff must exercise considerable judgment for examination scope under SEC's risk-based approach.

SEC Efforts to Ensure Quality Do Not Include Review of Work Papers of Completed Mutual Fund Examinations

SEC uses several methods to ensure the quality of its examinations but does not review completed examinations and work papers as done by other regulators to determine whether the examinations were conducted according to procedures or done consistently across field offices. OCIE has issued various policies and procedures to promote examination quality and consistency across the 10 SEC field offices that conduct the majority of its examinations. To help ensure that these policies and procedures are followed, SEC relies on experienced supervisors in its field offices to oversee all stages of routine examinations. Specifically, branch chiefs meet with examination staff to discuss the preliminary scope of examinations, advise staff during the fieldwork, and review all examination reports. Assistant directors in SEC field offices also assist in overseeing examinations and review all examination reports. Also, associate directors and regional or district administrators in SEC field offices may review examination reports. In addition, SEC field offices send each report and deficiency letter, if any, to an OCIE liaison, who reviews them. Finally, OCIE annually evaluates each field office examination program based on factors such as the overall quality of the office's examination selection and findings; new initiatives and special projects; use of novel or effective risk assessment approaches; and overall productivity, including achievement of numerical examination goals.

In contrast to OCIE, we were told that federal bank and other regulators have quality assurance programs that include reviews of completed examinations or other activities. Examples of such reviews include:

- FDIC guidance states that the agency reviews each regional office's compliance examination program every 2 years, in part, to evaluate the consistency of supervision across the regions and compliance with policies and procedures. According to the guidance, evaluations include a review of examination reports and work papers.

- Federal Reserve officials said that the agency conducts on-site operations reviews of the banking supervision function of individual Reserve Banks at least every 3 years. The review targets each Reserve Bank's risk-focused supervision program and includes a review of a sample of examination reports, work papers, and other supporting documentation. It also encompasses the bank's ongoing quality management function, or the processes, procedures, and activities the bank uses to ensure that examination reports and related documents are of high quality and comply with established policy.

- OCC officials told us that the agency reviews its large bank examination program, including specific examination procedures. It conducts reviews to determine whether lead examiners are supervising banks according to plans. It also assesses specific examination procedures across samples of banks. Agency officials said that teams periodically review how examiners are conducting certain procedures to ensure that they are being implemented consistently throughout all field offices.

- NASD conducts quality and peer reviews to improve the quality, consistency, and effectiveness of its examination program. Under quality reviews, each NASD district office annually evaluates its performance in two or three areas. Under peer reviews, staff go on-site to district offices to evaluate particular program areas.

- NFA officials told us that the organization randomly selects completed audits for review on a quarterly basis and, as part of the review, supervisory teams review work papers to determine whether the audits complied with established policies and procedures.

While OCIE staff evaluate all completed examinations by reviewing the final examination report, they do not review a sample of completed examinations and work papers to periodically assess examination quality and consistency across SEC's field offices. SEC officials stated that after-the-fact reviews of underlying work papers may not be a cost-effective use of resources, given that key findings and evidentiary materials should be discussed and described in the examination report itself, which is reviewed by OCIE staff. Further, it would be difficult to second-guess decisions made by examiners when on-site, since reviewers would not have access to the same information. Finally, agency officials said that OCIE resources are limited, and time spent reviewing completed examination work papers would result in less time spent on conducting examinations. While reviewing completed examination work papers involves resource tradeoffs, it may yield important benefits. OCIE may be able to better determine whether its examiners are complying with established policies and procedures and whether its built-in quality controls are working. A review of underlying work papers also may allow OCIE to better assess the consistency of examination quality within and across SEC's field offices as well as the extent to which existing quality controls are helping to ensure that quality is maintained.

According to SEC officials, the agency is implementing a computer-based document management system. Under this system, it is anticipated that most, if not all, of the work papers created during examinations will be converted into electronic files, and these files will be maintained in a consistent manner online for a number of years. SEC officials said that when the system is fully operational, estimated to be some time in 2006, all work papers created during an examination will be available electronically to OCIE staff. At that point, OCIE liaisons could review electronic examination work papers on a sample basis in conjunction with their review of examination reports. In addition, electronic work papers would eliminate the need to be on-site to review underlying examination documentation and work papers across SEC's examination program.

Importantly, deficiencies we found during our review of risk scorecards highlight the need for OCIE to periodically assess the consistency of examination staff's use of scorecards and other steps being taken during examinations. While the requirement to complete risk scorecards became effective in October 2002, SEC has not yet evaluated, for instance, whether the risk scorecards are being completed according to the guidance provided, whether changes to the design of the scorecards are needed, and whether additional guidance or training is needed. In March 2003, OCIE provided one training course on the scorecards, which was attended by 98 examiners, or about 20 percent of the SEC examiners devoted to fund and adviser examinations. According to SEC officials, two senior OCIE staff visited each field office during the spring and summer of 2003 and provided a full day of training on the scorecards to all examination staff. Nevertheless, the scorecard deficiencies we found during our review may indicate that additional training is needed.

In addition, the scorecards may have design weaknesses that result in inconsistencies across SEC field offices. For example, field office officials stated that scorecards are designed for investment companies organized as mutual funds and do not readily apply to investment companies organized as unit investment trusts.[25] NERO examiners did not complete scorecards for unit investment trusts, but MRO examiners did by modifying the scorecards as needed. Similarly, SEC field office officials stated that while the scorecards are designed to cover a broad range of fund compliance controls, fund controls for detecting and preventing market timing do not fall squarely under any of the 13 areas covered by the scorecards. As a result, staff have used work papers other than the risk scorecards to document their assessment of market timing controls. SEC officials said that the scorecards are models created to assist examiners in assessing fund controls. As such, scorecards are not intended to exist necessarily for every conceivable control and examiners have the flexibility to modify the scorecards as necessary. Moreover, the officials said that some inconsistencies in the preparation of risk scorecards are expected because not all funds and advisers are the same. In that regard, SEC officials told us that the approach taken by MRO staff in modifying a scorecard to fit the circumstances of an examination appears to be consistent with the approach to scorecard use expected by OCIE.

SEC's Oversight Examinations of Broker-Dealers Provide Limited Information on the Adequacy of SRO Oversight

To assess SRO oversight of broker-dealers, including their mutual fund sales practices, SEC conducts examinations of broker-dealers shortly after they have been examined by SROs. However, these SEC broker-dealer examinations, which involve a significant commitment of agency examination resources, provide limited information on the adequacy of SRO oversight and impose duplicative regulatory costs on the securities industry. SEC and SROs' broker-dealer examinations often cover different time periods, and generally employ different sampling methodologies and use different examination guidelines. Consequently, SEC cannot reliably determine whether its examination findings are due to weaknesses in SRO examination procedures or some other factor. Another deficiency we found regarding SEC's SRO oversight of broker-dealer mutual fund sales practices is that the agency does not have automated information on the full scope of areas reviewed during its broker-dealer oversight examinations and, therefore, cannot readily and reliably track useful examination information.

[25]A unit investment trust is an investment company that (1) is organized under a trust indenture, (2) does not have a board of directors, and (3) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities.

SEC Often Cannot Attribute Broker-Dealer Oversight Violations It Finds to Weaknesses in SRO Examination Programs, Because Different Examination Procedures Are Used

SEC performs two types of activities to review the quality of SRO oversight of broker-dealers, including their sales of mutual funds. First, SEC conducts inspections of NASD and NYSE on a 3-year cycle that cover various aspects of their compliance, examination, and enforcement programs. These SRO oversight inspections are designed to determine whether an SRO is (1) adequately assessing risks and targeting its examinations to address those risks, (2) following its examination procedures and documenting its work, and (3) referring cases to enforcement authorities when appropriate. When conducting these inspections, SEC reviews a sample of the SRO's examination reports and work papers to identify problems in examination scope or methods. As a result of these inspections, SEC has identified deficiencies in SRO examinations, including ones related to the SROs' examinations of mutual fund sales practices, and communicated those to the SRO to remedy the problem. Second, SEC conducts broker-dealer oversight examinations, during which it examines some broker-dealers from 6 to 12 months after an SRO examines the firms. The purpose of broker-dealer oversight examinations is to help the SROs improve their examination programs by identifying violations that the SROs did not find and also by assisting them in evaluating improvements in how SRO examiners perform their work. SEC officials told us that a secondary goal of these examinations is to supplement the SROs' enforcement of broker-dealer compliance with federal securities laws and regulations.

SEC's broker-dealer oversight examinations involve a significant commitment of agency resources and expose firms to duplicative examinations and costs. In addition to conducting broker-dealer examinations for the purposes of assessing SRO oversight (including for mutual fund sales practices), SEC conducts cause, special, and surveillance examinations of broker-dealers to directly assess broker-dealer compliance with federal securities laws and regulations, including those related to mutual fund sales. SEC currently has an internal goal of having oversight examinations account for 40 percent of all broker-dealer examinations each year. In 2004, 250, or 34 percent, of its 736 broker-dealer examinations were oversight examinations.[26] Broker-dealers that are subject to similar SEC and SRO examinations that may take place within a 6 to 12 month

[26] As of October 2004, about 40 percent of OCIE's total examination staff of 810 individuals was assigned to broker-dealer, transfer agent, and clearing agency examinations (315 examiners dedicated to broker-dealer, transfer agent, and clearing agency examinations and 495 individuals assigned to mutual fund and investment adviser examinations).

period incur the costs associated with assigning staff to respond to examiner inquiries and to make available relevant records as requested.

Although SEC broker-dealer oversight examinations involve a significant commitment of agency examination resources and impose costs on securities firms, our past work questioned their cost-effectiveness. In a 1991 report, we found that the way SEC conducted oversight examinations of broker-dealers provided limited information to help SROs improve the quality of their broker-dealer examination programs.[27] Specifically, during its oversight examinations of broker-dealers, SEC often found violations not identified by SROs and frequently could not attribute the violations it found to weaknesses in SRO examination programs. Because SEC and SROs used different examination procedures or covered different time periods of broker-dealer activity, SEC examiners often could not determine whether the violations they found resulted from the improper implementation of procedures by SRO examiners or differences between the procedures used or the activity period covered. We previously recommended that SEC directly test SRO examination methods and results. However, based on its efforts to replicate some examinations conducted by SROs, the agency concluded that this was unproductive because it only confirmed findings identified by SROs during their examinations.

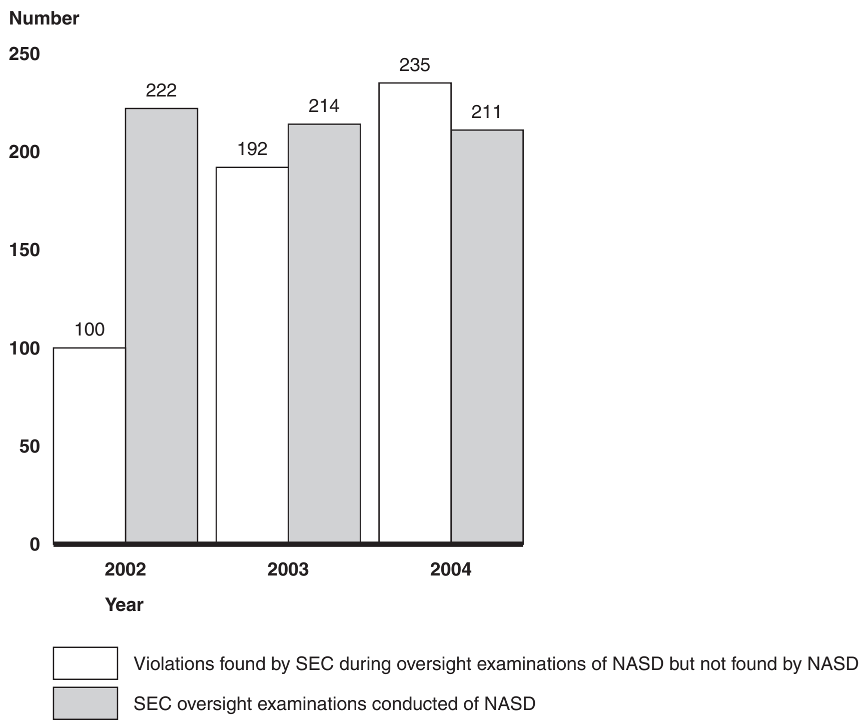
Our current review has shown that despite our 1991 findings, SEC continues to conduct oversight examinations in a similar manner—by using different examination guidelines and time periods. First, SEC continues to review firm activities during the time between the completion of the SRO examination and its own examination. Next, when SEC is reviewing a firm's transactions or customer accounts to identify potential abuses, it generally does not duplicate the sampling technique used by the SRO, but instead selects its own sample of transactions or customer accounts based on its own procedures. Finally, SEC examiners ask different questions to identify potential abuses. For example, although SEC and NASD both direct their examiners to ask questions to assess potential weaknesses in a firm's internal controls to prevent market timing and late trading, their procedures call for examiners to ask about different potential internal control weaknesses.

[27] GAO/GGD-91-52.

According to SEC officials, its examiners do not use the same procedures as SROs because using different procedures allows them to find violations that would not otherwise be found if they just duplicated the SRO procedures. Also, SEC officials stated that SEC has an obligation to review the broker-dealer's activities at the time of the SEC examination to ensure compliance with securities laws at that time. However, as a result, SEC often cannot determine the specific reason why the SRO did not find the violations, limiting its ability to suggest improvements to SRO programs. SEC routinely provides SROs copies of deficiency letters it sends to broker-dealers as a result of oversight examinations. These deficiency letters sometimes include oversight comments that include steps the SRO can take to enhance its program. SRO officials stated they can often identify the reasons why SEC found the violations, but in many cases the reason is due to SEC's use of different procedures, such as different review periods or samples. Consequently, SEC often cannot attribute a violation it finds to a problem with the SRO's examination program. SEC officials said in some cases when SEC identifies a violation, it is able to determine whether the violation was occurring at the time of the original examination and should have been detected by the SRO. For example, in some cases when SEC finds an error in a broker-dealer's net capital calculation, it is able to trace the error to previous calculations and determine whether it existed during the SRO examination. Even in cases when SEC can attribute a violation it found to a weakness in the SRO examination, it does not track this information in its automated examination tracking system and, as a result, cannot use it to identify trends in SRO problems it discovered during oversight examinations. SEC officials stated that they have a staff committee conducting a comprehensive review of oversight examination procedures and plan to add a feature to SEC's examination tracking system to allow it to more systematically track identified weaknesses in SROs' examination programs.

Although SEC's oversight examinations continue to find violations at broker-dealers and, thus, provide investor protection benefits, the violations provide limited information for assessing the quality of the SRO program. This information is particularly important given that the number of violations that SEC has found during its oversight examinations and determined as not found by NASD has increased in recent years. As shown in figure 2, the number of these violations that SEC found but has categorized as not found by NASD more than doubled between fiscal years 2002 and 2004.

Figure 2: Violations Found by SEC during Oversight Examinations of NASD but Not Found by NASD, and SEC Oversight Examinations Conducted of NASD, Fiscal Years 2002-2004



Source: SEC.

Despite this significant increase, SEC officials could not explain why the number of these violations increased but stated that the increase did not necessarily represent a decrease in the quality of NASD's examination program. They said some of the increase is due to a significant increase in the number of rules applicable to broker-dealers. SEC officials told us that SRO officials have noted, and they agree, that the number of these violations, alone, is not always an appropriate measure of the quality of SRO examination programs. Accordingly, SEC officials told us that the agency recently began tracking findings deemed to be significant to allow it to better assess the materiality of an increase in the number of missed violations. If SEC had tested NASD's examination methods or better tracked the reasons why NASD did not find a violation, SEC would have more information to assess the quality of NASD's examination program.

SEC Does Not Track the Full Scope of Work Performed during Its Oversight Examinations

Another deficiency we found regarding SEC's SRO oversight is that the agency cannot readily and reliably track key examination information. In assessing the quality of SEC's oversight of broker-dealer sales of mutual funds, we asked SEC to provide data on which of its broker-dealer oversight examinations in recent years included reviews of mutual fund sales practices. The data would help determine the extent that SEC has reviewed mutual fund sales practices. SEC was not able to provide this information because it does not have automated information on the full scope of areas reviewed during its broker-dealer oversight examinations.

SEC maintains a broad range of automated information about its examinations in its Super Tracking and Reporting System (STARS), including basic information about the firm, SEC staff assigned to conduct the examination, and the deficiencies and violations found during the examination. STARS identifies examinations that reviewed specific areas of special interest to SEC, called "focus areas," as identified by senior SEC staff in headquarters, and new areas are added in part based on the emergence of new abuses. For example, SEC added breakpoints as a focus area in January 2003 and market timing and late trading in 2004.[28] Although focus area designations provide useful information about how often SEC reviews some areas, focus areas do not cover all areas potentially reviewed by SEC during its examinations. Without methodically tracking the full scope of work performed during oversight examinations, SEC lacks information for determining how effective its oversight is in two important areas.

First, because SEC does not know how often it has reviewed particular areas such as mutual fund sales practices during its oversight examinations, it cannot ensure that it has adequately reviewed all areas it considers important. When SEC reviews particular areas, its examiners generally refer to a set of written procedures, known as examination modules that provide information to guide examiners' work. STARS does not include data fields to track whether staff use the module on mutual funds during an examination. Therefore, the extent of coverage of mutual funds is unknown. As a result, SEC officials could not determine how many of the approximately 1,400 broker-dealer oversight examinations conducted between 2000 and 2004 included a review of mutual fund sales

[28]Breakpoints are discounts offered to investors on up-front sales charges on certain mutual fund shares when an investor makes a large purchase.

practices. SEC officials stated that they have a separate database containing examination reports that can be electronically searched to identify relevant examinations containing a search term such as "mutual fund," which would yield an estimate of the number of examinations that reviewed broker-dealer mutual fund sales practices. However, according to an official, not all examinations covering mutual fund sales practices would be captured because some examination reports that included reviews of mutual fund sales practices would not necessarily include any mention of mutual funds, especially if SEC identified no deficiencies or violations in that area.

In contrast to SEC, both NASD and NYSE have systems with capability to track the full scope of examinations including the use of mutual fund and other examination modules. For NASD, some of its offices are able to track which of its broker-dealer examinations were followed by an SEC oversight examination. At 8 of its 15 district offices, which account for 55 percent of its examinations, NASD tracked this information and SEC conducted oversight examinations of approximately 5 percent of the 2,602 NASD examinations conducted between January 1999 and August 2004 that reviewed mutual fund sales practices. The remaining seven offices were not able to track this information because, according to an NASD official, the SEC field office conducting oversight examinations did not always provide a letter informing them that an oversight examination was conducted. With mutual fund sales practices being a regulatory priority, the percentage of SEC examinations reviewing these practices would be a useful measure for ensuring that the agency is addressing this priority.

Second, because SEC does not track the full scope of work performed during its oversight examinations, it is limited in its ability to assess the significance of deficiencies and violations it finds. Because SEC does not know how often it has reviewed a particular area, the data it tracks on the number of deficiencies and violations it finds in a particular area are less meaningful. For example, it would be less significant if SEC found violations in a particular area during 5 out of 100 examinations as opposed to finding violations during 5 out of 5 examinations during which it reviewed the area. Without knowing the full scope of each oversight examination and therefore the number of times a particular area was reviewed, data tracked by SEC on the number of deficiencies and violations it finds are less meaningful.

In addition to conducting broker-dealer oversight examinations to evaluate the adequacy of SRO activities, SEC conducts other types of examinations, including cause and sweep examinations, which are designed to directly assess broker-dealer compliance with the law. SEC tracks the number of firms it targets during its examination sweeps along with the number of violations and deficiencies it finds. SEC officials told us that the agency tracks the number of findings from these examinations as a percentage of the number of firms examined, and that tracking such information helps SEC assess the prevalence of the findings relative to the number of firms. However, without tracking the scope of work performed during its oversight examinations, SEC is unable to make similar assessments about the prevalence of violations and deficiencies identified during those reviews.

Appendix II provides information you requested about (1) how SEC, NASD, and NYSE share information, including written examination guidance, related to their review of mutual fund sales practices and other examination priorities; (2) how SEC distributes and stores examination guidance for use by its broker-dealer examiners; and (3) what training SEC has provided to broker-dealer examiners on mutual funds and other topics and how it tracks and assesses such training.

Conclusions

In the wake of the market timing and late trading abuses, SEC staff implemented significant changes to the agency's mutual fund examination program in the view that doing so would help ensure the earlier detection and correction of violations. These changes—including conducting additional sweep examinations and continuously monitoring large companies—reflect a practical approach designed to focus SEC's limited resources on higher risk funds and activities and have the potential to strengthen SEC's oversight practices in certain regards. Nonetheless, the changes also involve tradeoffs, such as limiting the agency's capacity to review funds perceived to be lower risk and conduct risk assessments of all funds in a timely manner. Moreover, SEC's capacity to effectively monitor the hedge fund industry is open to question, given the tradeoffs that the agency has had to make in overseeing the mutual fund industry. While we recognize that SEC at some point may need to request additional resources from Congress to carryout its mutual fund and other oversight responsibilities, such requests should only occur after the agency has explored and achieved all available efficiencies within its existing resource limitations. Whether SEC's utilization of resources under its revised examination program will provide effective oversight remains to be seen. Future adjustments by SEC to resources devoted to various oversight activities, such as sweep examinations and randomly selected lower risk fund examinations, are likely to occur as the agency gains experience through conducting these oversight activities and changing conditions in the mutual fund industry. However, SEC has had extensive experience with its broker-dealer oversight examinations, and the effectiveness of these examinations for improving the quality of SRO oversight remains unclear. This situation raises concern, particularly in light of the significant level of resources devoted to oversight examinations and the resource challenges faced by SEC's fund and adviser examination program.

We also identified basic weaknesses in SEC's approaches to conducting mutual fund and broker-dealer examinations. For mutual fund examinations, SEC does not require staff to document their examination plans to facilitate supervisory review. Second, SEC has issued work paper standards but lacks guidance on their supervisory review. Moreover, despite the importance of risk scorecards in determining the depth of work done during examinations, SEC has not yet assessed whether they are prepared according to standards since implementing the scorecards in 2002. For broker-dealer examinations, SEC has not developed an automated system to track the full scope of work completed during examinations and therefore lacks useful information about SRO oversight. Without addressing these deficiencies, SEC's capacity to effectively oversee the mutual fund industry and SROs is reduced.

Recommendations for Executive Action

To improve SEC's oversight of mutual funds and SRO oversight of broker-dealers that sell mutual funds, we are making four recommendations to the SEC Chairman. First, we recommend that SEC periodically assess the level of resources allocated to the various types of examinations in light of their regulatory benefits to help ensure that the agency is using its resources efficiently and effectively to oversee the mutual fund industry, including broker-dealers that offer mutual funds. As part of this assessment, SEC should seek to ensure that it allocates sufficient resources to mitigate any regulatory gaps that may currently exist concerning the timely examination of mutual funds perceived to represent lower risk, complete mutual fund risk assessments within a more reasonable period, and fulfill its new oversight responsibilities for the hedge fund industry. Second, in so doing, we recommend that the agency assess its methodology for conducting broker-dealer oversight examinations and whether some portion of the resources currently devoted to these examinations could be better utilized to perform mutual fund examinations.

Third, to strengthen SEC's approach to mutual fund examinations, we recommend that SEC

- establish a policy or procedure for supervisory review of work papers prepared during routine examinations and for documenting such reviews;
- establish a policy or procedure for preparing a written plan for each routine examination, documenting at a minimum the preliminary objectives and scope of the examination; and
- consider reviewing on a sample basis completed routine examinations and work papers to assess the quality and consistency of work within and across the field offices conducting examinations.

Fourth, to assess and improve the effectiveness of SEC's oversight of SRO broker-dealer examination programs, we recommend that the Chairman, SEC, electronically track information about the full scope of work performed during broker-dealer oversight examinations, including all major areas reviewed, to determine whether areas are receiving adequate review and to more fully assess the significance of deficiencies and violations found.

Agency Comments and Our Evaluation

SEC provided written comments on a draft of this report, which are reprinted in appendix III. SEC also provided technical comments that we incorporated into the final report, as appropriate. SEC focused most of its comments on providing further elaboration on the potential benefits of its examination strategy for overseeing mutual funds and investment advisers and on the benefits obtained from its broker-dealer oversight examinations. In addition, SEC briefly commented that it will consider our recommendation directed at improving its quality controls for routine fund examinations and that it has formed a working group to explore ways to enhance the value of its broker-dealer oversight examinations, including their ability to identify the reasons that violations may have been missed by SRO examinations.

First, SEC stated that it is not possible for the agency to conduct timely, comprehensive routine examinations of every mutual fund and adviser, given the size of the industry and agency resources. Further, it expects its risk-targeted examinations to provide an effective means of addressing risks in the securities industry. Specifically, it believes that looking at the same type of risk at a number of different firms is a better approach than examining a single firm in depth. According to SEC, this approach will provide benefits by promptly identifying emerging trends and compliance problems, and individual firms can be compared to their industry peers. The agency believes this approach has already yielded benefits in identifying and addressing significant compliance problems before becoming major crises. In addition, SEC stated that the program it is developing to randomly select a sample of lower risk firms for routine examination will address our concern that such firms may not be given sufficient attention under its revised oversight strategy. According to SEC, this approach will provide a deterrent effect, enable the agency to test assumptions and techniques used throughout its examination program, and allow the agency to draw inferences about compliance in the adviser community, based on statistically valid sampling techniques.

We recognize that SEC's revised examination strategy for mutual funds and advisers offers potential benefits, including focusing its limited resources on firms and activities that are perceived to pose higher risks. Nonetheless, we continue to be concerned about SEC's ability to examine all mutual funds within a reasonable period and accurately assess the relative risk of each fund on a timely basis. Unlike broker-dealers, mutual funds are regulated and examined solely by SEC. Under SEC's current plans to randomly sample 10 percent of the firms perceived to be lower risk for routine examination each year, it is possible that up to a third of the total number of firms would not be selected for examination within a 10-year period. We believe that this is a lengthy time period for firms to conduct business without being examined. Similarly, SEC's inability to conduct examinations of all mutual funds within a reasonable period will limit its capacity to accurately distinguish relatively higher risk funds from lower risk funds and effectively target its limited examination resources on those funds posing the highest risks. Therefore, we continue to believe that, as recommended, SEC should periodically assess the level of resources allocated to its various types of examinations and in so doing ensure that it allocates sufficient resources to mitigate any regulatory gaps that currently exist in the timely examination of funds perceived to represent lower risks and to ensure that it completes mutual fund risk assessments within a more reasonable time period.

Second, SEC stated that its broker-dealer oversight examinations provide quality control over SRO examinations and serve other important goals. For example, SEC stated that oversight examinations allow it to detect violations that otherwise might not be detected, conduct routine examinations of new products or services, and test and validate assumptions and techniques used throughout the broker-dealer examination program. In addition, SEC expressed concern about our suggestion that it should reproduce SRO examinations if its oversight examinations are to provide accurate quality control information. SEC stated that this suggested approach would result in redundancies for broker-dealers being examined and limit the agency's ability to reach conclusions about SRO examination programs. By conducting its examinations as independent compliance reviews, SEC stated that it can assess whether SRO procedures were followed and whether SRO procedures need to be modified or enhanced. The agency stated that through its oversight program it has identified SRO procedures that need to be modified or enhanced and its examiners meet regularly with SRO examiners to review the results of oversight examinations. Finally, SEC commented that it has formed a working group to explore ways to gain additional value from its broker-dealer oversight examinations, such as by better identifying the reasons that a violation may not have been detected by an SRO examination, aiding the SRO in improving its program, and minimizing burden on the firm examined.

We recognize that SEC's oversight examinations serve more than one goal and provide investor protection benefits. While such examinations serve a variety of purposes, one of their primary purposes is to assess the quality of SRO examinations. In fulfilling this purpose, we remain concerned that SEC's approach provides limited ability to identify the reasons why an SRO did not find violations that SEC found and, in turn, provide suggestions for improving SRO examinations. SEC is responsible for overseeing SROs that examine broker-dealers on a regular basis, and it conducts oversight examinations of only a small percentage of the total number of broker-dealers. Thus, it is critical for SEC to ensure that SROs conduct effective examinations. As discussed, SEC has formed a working group to evaluate its oversight examinations. We believe this is a step in the right direction and also provides the agency with the opportunity to evaluate its approach and level of resources devoted to broker-dealer oversight examinations.

Finally, regarding our recommendation that SEC strengthen three aspects of its quality control framework for routine fund examinations, the agency stated it will fully consider the recommendation. Specifically, in 2006, the agency plans to deploy an electronic system for work papers. In preparation for this effort, it plans to review how new technology can be used to improve the quality of examinations and it will consider our recommendation in its review. While SEC did not directly comment on our recommendation that it electronically track information about the full scope of work performed during its broker-dealer oversight examinations, we believe that this would provide SEC important information to determine whether areas are receiving adequate review and the relative significance of violations found in each area.

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 the Chairman of the House Committee on Financial Services; the Chairman of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, House Committee on Financial Services; and the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs. We also will provide copies of the report to SEC, FDIC, the Federal Reserve Board of Governors, NASD, NYSE, and OCC and will 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 me at (202) 512-8678 or hillmanr@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix IV.

Richard J. Hillman
Director, Financial Markets and
Community Investment

Scope and Methodology

To identify and assess the changes SEC has made to or is planning for its mutual fund examination program, we reviewed SEC testimony, speeches, reports, and other documents related to the agency's mutual fund examination program. We also reviewed federal securities laws and regulations applicable to mutual funds and analyzed SEC data on the number, types, and results of its fund and adviser examinations. We also interviewed officials from SEC's Office of Compliance Inspections and Examinations (OCIE), Division of Investment Management, and Office of Risk Assessment and representatives from the Investment Company Institute to obtain information on the significance of planned changes. In addition, we interviewed federal bank regulatory officials from the Federal Deposit Insurance Corporation (FDIC), Board of Governors of the Federal Reserve System, and Office of the Comptroller of the Currency (OCC) and self-regulatory organization (SRO) officials from NASD, the New York Stock Exchange (NYSE), and the National Futures Association (NFA) to discuss their examination programs and supervisory tools.

To assess key aspects of the quality control framework of SEC's routine mutual fund examinations, we reviewed policies, procedures, and other guidance applicable to those examinations. We also reviewed routine fund examinations completed in fiscal year 2004 by SEC's Midwest Regional Office (MRO), Northeast Regional Office (NERO), and Philadelphia District Office (PDO). We selected these field offices because they were the three largest in the number of completed routine fund examinations in fiscal year 2004. The three offices completed 66 routine fund examinations, accounting for about 72 percent of all routine fund examinations completed in fiscal year 2004.[1] Where appropriate, we also reviewed examinations of advisers to the funds we reviewed.[2] We used a standardized data collection instrument to document the methods examiners used to conduct examinations and areas examiners reviewed during examinations. In addition, we interviewed officials from OCIE and three SEC field offices—MRO, NERO, and PDO—about their examination policies and procedures and representatives from a mutual fund company and consulting firm about fund examinations. To gather information and compare SEC examinations with those of other regulators, we interviewed

[1]MRO, NERO, and PDO completed 40, 17, and 9 routine fund examinations, respectively, in fiscal year 2004.

[2]SEC focuses its examinations on fund complexes, or groups of funds that generally share the same adviser. SEC officials told us they examine both the fund complex and affiliated adviser at the same time when both are located at the same site.

officials from FDIC, the Board of Governors of the Federal Reserve System, OCC, NYSE, and NFA about their quality controls and reviewed some of their quality control policies and procedures.

To determine the adequacy of SEC's oversight of NASD and NYSE in protecting shareholders from mutual fund sales practice abuses, we reviewed SEC policies, procedures, and other guidance related to its broker-dealer oversight examinations and inspections and interviewed officials from SEC's OCIE and Boston District Office, NASD, and NYSE. We also reviewed judgmentally selected SEC broker-dealer oversight examinations conducted by SEC's Boston District Office in 2003 and 2004, and reviewed all reports of SRO inspections conducted of NASD and NYSE between 2001 and 2003. To gather information on SEC's automated tracking system, Super Tracking and Reporting System, we interviewed SEC staff responsible for the system in headquarters and received an overview of the system and its capabilities at the Boston District Office. In addition, we reviewed reports generated from the system and training documents for the system. To help assess the extent to which SEC, NASD, and NYSE have shared written guidance, we compared and contrasted the examination modules they used to examine for certain mutual fund sales practice abuses. As part of our assessment of the training received by broker-dealer examiners, we obtained and analyzed SEC's training attendance rosters and list of examiners employed by SEC since 1999.

To ensure that data provided about the number, nature, and results of examinations conducted by SEC, NASD, and NYSE were reliable, we reviewed written materials describing these systems and reviewed the data provided to check for missing or inaccurate entries. We also interviewed agency staff responsible for maintaining the information systems that track such data. We determined that the data were sufficiently reliable for use in this report.

We performed our work in Boston, Massachusetts; Chicago, Illinois; New York, New York; Philadelphia, Pennsylvania; and Washington, D.C. We conducted our work between February 2004 and July 2005 in accordance with generally accepted government auditing standards.

Securities and Exchange Commission's (SEC) Broker-Dealer Examination Guidance and Training

You asked us to provide information about aspects of SEC's oversight of the broker-dealer industry, including (1) how SEC, NASD, and the New York Stock Exchange (NYSE) share information, including written examination guidance, related to their review of mutual fund sales practices and other examination priorities; (2) how SEC distributes and stores examination guidance for use by its broker-dealer examiners; and (3) what training SEC has provided to its broker-dealer examiners on mutual funds and other topics, and how it tracks and assesses such training.

Sharing of Written Mutual Fund Examination Guidance among Regulators

SEC, NASD, and NYSE have developed guidance for examiners to use in assessing compliance by broker-dealers with mutual fund sales practice rules. Each regulator has developed its own examination module, or set of procedures, covering various topics related to mutual fund sales. Moreover, all three regulators recently revised their modules to include procedures to detect market timing and late trading abuses. In addition, the regulators periodically have provided their staff with other written guidance related to mutual fund sales. For example, SEC issued internal memorandums in 1997 and 2001 to inform staff about abuses related to breakpoints[1] and other mutual fund sales practices and provide them with procedures for detecting such abuses.

Through its oversight role, SEC reviews aspects of the self-regulatory organization (SRO) examination modules, including the mutual fund sales practice module. First, SEC officials told us that NYSE and NASD e-mail SEC copies of their examination modules when they make material changes to them. Second, during SEC's on-site inspections of SRO examination programs, staff generally review SRO examination modules in connection with their review of completed SRO broker-dealer examinations and work papers. Third, as part of their broker-dealer oversight examinations, SEC staff generally review the SRO broker-dealer examinations and applicable examination modules before going on-site to conduct examinations of such broker-dealers.

SEC and the SRO officials meet at least semiannually to discuss significant examination findings, customer complaints, trends in the industry, enforcement cases, and examination guidance. SEC officials told us that

[1]Breakpoints are discounts offered to investors on up-front sales charges on certain mutual fund shares when an investor makes a large purchase.

agency staff have met with NASD and NYSE officials semiannually and quarterly, respectively, to discuss, among other things, examination findings and guidance. The officials also said that they hold frequent telephone conversations to coordinate their examination efforts. For example, SEC, NASD, and NYSE staff talked with each other immediately following NASD's discovery of breakpoint abuses in 2002, and established a joint task force to determine the extent of the abuses by conducting examinations of firms designed to identify failures to provide breakpoint discounts. Similarly, SEC, NASD, and NYSE staff talked with each other in their efforts to respond to the late trading and market timing abuses uncovered in 2003. In addition, SEC and SRO staff jointly attended conferences and training that included examination guidance as a topic of discussion. Finally, SEC, NASD, and NYSE have jointly developed a number of examination modules to enforce recent changes in laws and rules applicable to broker-dealers.

Although SEC, NASD, and NYSE coordinate in these ways to oversee broker-dealers, they generally do not provide copies of their written examination materials to each other. That is, SEC typically does not provide copies of its modules or other internal written guidance to the SROs, nor do NASD and NYSE generally provide copies of such guidance to each other. Officials at these agencies shared benefits and drawbacks of providing written copies of examination materials to each other. The regulators agreed that sharing information about their examination approaches and outcomes is overall a positive way to more effectively oversee the broker-dealer industry. They cautioned, however, that certain drawbacks should be considered regarding the sharing of written examination materials. SEC officials said that sharing SEC examination modules could compromise its supervision of the SROs. According to the officials, if SEC shared its modules, the SROs may be less innovative and motivated to improve their methods. They said, for example, that the SROs may view SEC's procedures as the most that they would need to do. NASD officials strongly disagreed with SEC's assertions about the sharing of examination modules, saying they always seek the most effective examination procedures, regardless of those used by SEC; and an NYSE official said that while NYSE understands the SEC's position in this regard, the sharing of SEC's examination module would only enhance NYSE's pre-existing examination procedures related to mutual funds. NASD and NYSE officials said it would be helpful if SEC shared copies of its modules and other guidance it shares with its own examiners. However, SEC and NASD officials said that NASD and NYSE may not want to share their examination modules with each other because of competitive reasons. For example, if one SRO shared its modules with another SRO, it would run the risk that its competitor could be able to adopt similar procedures without the cost of developing them. Finally, NASD officials told us that differences exist between NASD's and NYSE's membership, culture, priorities, and strategies that can lead to differences in examination procedures, and the same is true for financial institutions overseen by the banking regulators.

Distribution and Storage of Broker-Dealer Examination Guidance

SEC's Office of Compliance Inspections and Examinations (OCIE) oversees and directs SEC's broker-dealer examination program, but SEC's 11 field offices conduct the vast majority of the broker-dealer examinations. Among other things, OCIE creates and updates broker-dealer examination modules, or policies and procedures; issues other examination guidance; and reviews broker-dealer examination reports. Currently, when OCIE develops and issues policy changes and examination guidance, it typically distributes such guidance to the field offices by e-mail. In turn, each field office separately stores the guidance on one of its shared computer drives or in some other way to provide its examiners access to the information. Field office examiners generally are responsible for keeping abreast of changes in guidance and reviewing it as needed in performing examinations.

To better ensure that SEC examiners across all field offices have access to current and complete broker-dealer examination guidance, OCIE is developing an internal Web site to serve as a central repository for all broker-dealer examination guidance. According to agency officials, OCIE launched its internal Web site in April 2005 on a pilot basis to select broker-dealer examiners nationwide to obtain their comments about its organization and comprehensiveness. Subsequently, SEC made the Web site available to all examiners in July 2005. According to SEC officials, the Web site will allow broker-dealer examiners to access not only all guidance at one location but also links to databases and numerous other examiner tools.

Broker-Dealer Examiner Training and Tracking

SEC's OCIE has a training branch that provides routine and specialized training to its broker-dealer examiners, with some of the training related to mutual funds. More specifically, OCIE's training branch provides a two-phased training program for broker-dealer examiners that is designed to teach examiners how to handle increasingly complex examination issues. According to an SEC official, the phase-one course is designed for new examiners and includes some training on mutual fund operations and mutual fund sales practices of broker-dealers. OCIE's training branch also offers a range of specialized training delivered in a variety of formats. For example, it offers classroom training sessions and videoconferences taught by senior examiners or vendors, such as NASD, as well as training videos that examiners can view when convenient. An SEC official told us that since 1999 the training branch has offered over 25 training sessions that have included mutual fund topics, such as breakpoints.

In addition, SEC periodically has coordinated its training efforts with SROs, including NASD and NYSE. For example, examiners representing SEC, NASD, NYSE, and other SROs, as well as state regulators have met annually for a 3-day joint regulatory seminar to receive training about emerging and recurring regulatory issues. In 2003 and 2004, the seminars provided training on mutual fund sales practice abuses, including late trading, market timing, and failure to provide breakpoint discounts. Finally, SEC examiners attend or participate in external training, such as industry conferences.

Separate from OCIE's training branch, SEC has a central training center called SEC University that oversees the agency's training programs.[2] SEC University uses an electronic database to track training received by SEC staff. According to SEC officials, the database has a number of weaknesses that limits its usefulness in helping SEC to track and assess the training received by examiners. For example, the database cannot be used to generate reports on which examiners have taken or not taken a particular course. Also, the database is not directly accessible to examiners or their supervisors and, thus, does not allow them to review their training records or enter external training they may have taken. Because of these weaknesses, OCIE's training branch uses training rosters as needed to manually track which examiners have taken particular courses. SEC training staff said that they are requesting that the agency purchase a learning management system that would better enable it, including OCIE, to track and assess all training and other developmental opportunities. According to one of the officials, the initiative is currently tabled and may or may not receive funding this year.

[2]As part of its 2004-2009 Strategic Plan, SEC is implementing SEC University—a comprehensive redesign of the agency's training and orientation programs—to help the agency develop and reinforce a strong operating culture, enhance employee performance, and broaden staff knowledge.

Despite challenges in its ability to track training in an automated way, OCIE takes some steps to evaluate the training needs of its examiners. It gathers and evaluates training participants' reactions to and satisfaction with training programs and uses that information to decide on what training to offer in the future. Training branch staff told us that at the end of each course, they hand out course evaluation forms to participants. These forms include closed-ended questions about the extent to which participants found the course helpful and open-ended questions about what additional training needs they have. The training branch uses the information to improve individual classes and the program as a whole. In addition, training staff attend monthly meetings with management and staff from all field offices, in part, to identify training needs and opportunities, and they also attend yearly meetings with examination program managers to discuss the examiners' training needs.

Comments from the Securities and Exchange Commission

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

OFFICE OF COMPLIANCE
INSPECTIONS AND
EXAMINATIONS

July 7, 2005

Mr. Richard J. Hillman
Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441G Street, N.W.
Washington, D.C. 20548

Re: GAO Report 05-45: "*SEC's Revised Examination Approach Offers Potential Benefits but Significant Oversight Challenges Remain*"

Dear Mr. Hillman:

Thank you for this opportunity to review and comment on a draft of your report regarding the Securities and Exchange Commission's ("SEC") examination oversight of mutual funds. We applaud your finding that our revised examination approach offers potential benefits.

We are committed to utilizing our resources in the most effective manner to identify fraud and compliance violations for the protection of investors. As you note in your report, approximately 495 SEC staff persons are dedicated to examination oversight of mutual funds and investment advisers. Given the size and growth of the industry, it is not possible for the SEC to conduct comprehensive, timely, routine examinations of every registrant. We also believe that routine examinations, standing alone, are not the best mechanism to promptly identify and investigate emerging compliance risks.

As you describe in your report, we have focused our resources on the highest risk activities and firms, and on identifying emerging compliance risks. The SEC has done so by establishing an Office of Risk Assessment for the agency, creating full-time risk assessment positions within the examination program, developing a risk mapping program that includes all examiners, developing a risk-targeted methodology for examinations, expediting internal reporting from examinations, conducting more frequent routine examinations of the highest risk firms, developing monitoring teams to work with the largest firms, developing a surveillance program, and conducting risk-targeted examinations. The last item, risk-targeted examinations, is of particular importance. We would like to describe their value in greater detail.

Risk-targeted examination reviews are a reasonable and effective means of quickly addressing risks in the securities industry. In a risk-targeted review, we conduct roughly contemporaneous examinations of the same risk at a number of different firms. These are

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"horizontal" examinations, in the sense that they look at the same risk across the industry, as compared to a "vertical" examination in which we would look at a single firm from top-to-bottom. This methodology better enables us to:

- promptly investigate emerging compliance risks;
- compare a firm to its industry peers;
- address risks on a consistent basis through consolidated management of the review and the preparation of a single consolidated report at the end, thus avoiding the danger that examiners will take inconsistent positions on the same issues in different examinations; and
- make findings that are amenable to meaningful empirical inferences, such as the incidence of a particular problem in the sample, thus facilitating quick reports to the Commission and the staff, including the Divisions that draft rules and provide guidance to the industry.

The benefits of risk-targeted reviews in promptly identifying emerging trends and compliance problems have already been demonstrated. For example, as a result of coordinated reviews of both mutual funds and the broker-dealers that distribute their shares, we found that fund assets were increasingly being used to pay broker-dealers for "shelf space" with related disclosure weaknesses. The SEC brought several enforcement actions, adopted new rules restricting funds' ability to use brokerage for distribution and is considering improved "point of sale" disclosure to customers. In another example, we recently completed a risk-targeted review of pension plan consultants. We found significant conflicts of interest and inadequate disclosure of those conflicts and released a public report describing what we found. In both of these situations, and in many others that have not yet led to public action, our risk-targeted reviews have enabled us to address significant compliance problems before they became major crises.

In your report, you express concern that as a result of our focus on risk-targeted reviews and more frequent routine examinations of high-risk advisers and funds, we may give insufficient attention to low-risk advisers. We believe your concern is addressed by the program we are developing to use statistical techniques to select lower-risk advisers for full scope examinations. In this program, each year we will randomly select a statistically valid sample of lower-risk advisers for full scope examinations. This methodology will:

- provide compliance deterrence in the adviser community because advisers will not know if they will be selected that year;
- enable us to test the assumptions and assessment techniques used throughout the fund and adviser examination program; and
- enable us to make inferences about the overall state of compliance in the adviser community, based on the statistically valid sampling techniques.

From year-to-year, we expect that the mix of risk-targeted reviews, statistically selected examinations of low-risk firms, and routine full scope examinations of higher risk firms will change in response to changes in the regulated community. We expect this three-

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pronged approach to enable us to provide effective oversight of the fund and adviser community without the significant increases in staff that would be necessary if we were to restore a fixed cycle of fund and adviser examinations.

You express concern about the value of our oversight examinations of broker-dealers. Oversight examinations have a valuable role to play in achieving our mission. First, you should note that while oversight examinations provide quality control over the examinations performed by the self-regulatory organizations ("SROs"), they also address other important goals as well. Oversight examinations allow us to detect violations that might not otherwise be detected, to conduct routine reviews of new products and services that have not yet been identified as posing a significant compliance risk, to conduct surveillance type-oversight, and to test and validate the assumptions and assessment techniques used throughout the broker-dealer examination program. All of these are important elements of our program.

It is important to note that oversight examinations have revealed significant violations at broker-dealers that likely would not otherwise have been detected. In fact, in the last two and two-thirds fiscal years, 95.6% of our oversight examinations have revealed violations by the broker-dealers examined, and 19.4% revealed violations of sufficient gravity that they warranted referral to the enforcement staff of the SEC (7.9%) or to an SRO (11.5%). SEC oversight exams have revealed extremely serious problems, such as a ponzi scheme, that were not discovered in repeated SRO examinations. Finally, since April 1, 2004, we have been tracking how many of our examinations have had "significant" findings. Since that date, 37.5% of our oversight examinations have had significant findings, including market manipulation, excessive markups and markdowns, possible insider trading, unregistered distribution of securities, best execution, anti-money laundering violations, net capital violations, and other significant problems.

Second, you suggest that if our oversight examinations are to provide accurate quality control information, they should seek to reproduce the SRO examinations they review. We are concerned about this approach. If we were to reproduce an SRO examination, there would be substantial redundancies for the broker-dealer being examined, and our conclusions would be limited to whether the SRO examination followed the SRO's stated procedures. On the other hand, by conducting oversight examinations as *independent* compliance reviews, we obtain a results-oriented view of the SRO's examination program. We can assess not just whether the SRO's procedures were followed, but more importantly, whether the SRO's procedures need to be modified or enhanced. In recent years, through our oversight program, we have identified a number of SRO examination procedures that needed improvement, including sampling techniques and examiner training.

Our oversight examinations also provide the SROs with feedback on specific examinations. Commission examiners regularly meet with SRO examiners to review the results of oversight examinations, including any problems or shortfalls they detected in individual examinations. These meetings range from formal, fully documented meetings

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at the larger offices, to informal discussions at the smaller offices. In all cases, however, the SROs are informed of the problems we have detected.

Third, as you correctly suggest in your report, an important element in any examination program is to seek out risks and problems that the regulator does not otherwise suspect. We expect that our statistically-selected examinations will perform that function for funds and advisers, and oversight examinations perform that function for broker-dealers. Our continued vigilance in oversight examinations provides an important element of investor protection, particularly at firms and in areas where we may not expect to find problems.

As you note in your report, we have formed a working group to explore ways to gain additional value from oversight examinations, including by better identifying the reasons that a violation may not have been detected by an SRO examination, to better aid the SRO in improving its program, and to minimize the burden on the firm examined.

Finally, you recommend several changes to our internal administrative processes. We will fully consider your recommendations. Specifically, we expect to deploy an enhanced electronic system for workpapers in 2006. In preparation for that deployment, we expect to review how the new technology can be used to its maximum potential to enhance the overall quality of our examination program. We will include your recommendations in that review.

Thank you again for this opportunity to review and comment on your draft report. If we can be of any further assistance, please contact me at (202) 551-6200.

Sincerely,

Lori A. Richards
Director

GAO Contact and Staff Acknowledgments

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