Highlights of GAO-05-385, a report to congressional requesters

MUTUAL FUND TRADING ABUSES

SEC Consistently Applied Procedures in Setting Penalties, but Could Strengthen Certain Internal Controls

Why GAO Did This Study

The Securities and Exchange Commission (SEC) and other regulators have recently identified two significant types of trading abuses—market timing and late trading—in the mutual fund industry. The more widespread abuse was market timing, which involved situations where investment advisers (firms that may manage mutual funds) entered into undisclosed arrangements with favored customers who were permitted to trade frequently in contravention of stated trading limits. These arrangements harmed long-term mutual fund shareholders by increasing transaction costs and lowering fund returns. Late trading, a significant but less widespread abuse, occurs when investors place trades after the mutual fund has calculated the price of its shares, usually at the 4:00 p.m. Eastern Time close of financial markets, but receive that day's fund share price. Investors who late trade have an opportunity to profit, which is not available to other investors. To assess SEC's efforts to impose penalties on violators, this report (1) discusses SEC's civil penalties in settled trading abuse cases, (2) provides information on related criminal enforcement actions, and (3) evaluates SEC's criminal referral procedures.

What GAO Recommends

GAO recommends that SEC document referrals to criminal law enforcement authorities. SEC agrees with this recommendation.

www.gao.gov/cgi-bin/getrpt?GAO-05-385.

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

Since September 2003, SEC has brought 14 enforcement actions against investment advisers and 10 enforcement actions against other firms for mutual fund trading abuses. Penalties obtained in settlements with investment advisers are among the agency's highest—ranging from $2 million to $140 million and averaging $56 million. In contrast, penalties obtained in settlements for securities law violations prior to 2003 were typically under $20 million. SEC's penalties in the investment adviser cases are also generally consistent with penalties it has obtained from firms involved in similarly egregious corporate misconduct. Further, SEC brought enforcement actions against 24 individuals associated with the investment advisers, many of them high-ranking, and obtained penalties as high as $30 million as well as life-time industry bars for some persons. In reviewing a sample of investment adviser cases, GAO found that SEC followed a consistent process for determining penalties and that it coordinated penalties and other sanctions with interested states.

State and federal criminal prosecutors told us that while they have recently investigated market timing conduct, they have generally not pursued criminal prosecution in those cases. They have, however, brought criminal charges in cases involving late trading violations. These officials said that the criminal prosecution of market timing is complicated by the fact that market timing conduct itself is not illegal. Although SEC instituted administrative proceedings in the investment adviser cases discussed above by alleging that the undisclosed market timing conduct involved constituted securities fraud, both federal and state criminal prosecutors told us they reviewed cases involving such market timing conduct and generally concluded that it did not warrant criminal fraud prosecutions. In contrast, criminal charges have been brought against at least 12 individuals for alleged late trading violations. Federal criminal prosecutors said that criminal prosecution of late trading is fairly straightforward because federal securities laws prohibit the practice.

SEC officials said that as state and federal criminal prosecutors were already aware of and generally evaluated the mutual fund trading abuse cases for potential criminal violations on their own initiative, they did not need to make specific criminal referrals to bring these cases to their attention. However, during the course of its review, GAO found that SEC's capacity to effectively manage its overall criminal referral process may be limited by inadequate recordkeeping. In particular, SEC does not require staff to document whether a referral was made or why. According to federal internal control standards, appropriate documentation of agency actions helps ensure that management directives are carried out. Without such documentation, SEC cannot readily determine whether staff make appropriate referrals. Such information is also important as an agency performance indicator and for congressional oversight purposes.