United States Government Accountability Office

GAO

Report to Congressional Requesters

May 2005

MUTUAL FUND TRADING ABUSES

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

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Accountability * Integrity * Reliability

GAO-05-385

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GAO Accountability·Integrity·Reliability

Highlights

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

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.

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Abbreviations

1940 Act	Investment Company Act of 1940
Advisers Act	Investment Advisers Act of 1940
ALJ	Administrative law judge
CEO	Chief Executive Officer
CFTC	Commodity Futures Trading Commission
DOJ	Department of Justice
Enforcement	Division of Enforcement
NYSOAG	New York State Office of the Attorney General
OCC	Office of the Comptroller of the Currency
OCIE	Office of Compliance Inspections and Examinations
penalties	civil money penalties
Remedies Act	The Securities Enforcement Remedies and Penny Stock Reform Act of 1990
SEC	Securities and Exchange Commission
SOX	Sarbanes-Oxley Act of 2002
USAO	U.S. Attorney's Office

United States Government Accountability Office
Washington, DC 20548

May 16, 2005

The Honorable F. James Sensenbrenner, Jr.
Chairman
The Honorable John Conyers, Jr.
Ranking Minority Member
Committee on the Judiciary
House of Representatives

Trading abuses allowing privileged mutual fund investors to profit at the expense of other fund shareholders were recently uncovered among some of the most well-known companies in the mutual fund industry. The Securities and Exchange Commission (SEC), an independent agency headed by a five-member Commission, is charged with oversight of the mutual fund industry and has the authority to bring civil enforcement actions against individuals and mutual fund companies that violate federal securities laws.[1] SEC carries out enforcement activities through its Division of Enforcement (Enforcement).[2] Swift and effective enforcement by SEC of federal securities laws is essential to punish violators and help deter future misconduct in the mutual fund industry. In accomplishing its mission, SEC can coordinate enforcement actions with state authorities that may also have responsibility to bring civil actions. Further, it can make referrals to the Department of Justice (DOJ) and state criminal enforcement authorities to help ensure that potential violations of federal and state criminal statutes are identified and prosecuted. In carrying out its work, SEC has a responsibility to ensure that its enforcement staff and examiners are free of any real or apparent conflicts of interest that could raise questions about their ability to detect violations of and enforce securities laws.

[1]For purposes of this report, “mutual fund companies” generally refer to mutual fund companies and their related investment advisers and service providers, such as transfer agents, unless otherwise specified. As described in this report, many mutual fund companies have no employees, although they typically have boards of directors, and rely on investment advisers to perform key functions such as providing management and administrative services.

[2]Enforcement investigates possible violations of securities laws, recommends Commission action when appropriate (either in a federal court or before an administrative law judge), and negotiates settlements on behalf of the Commission.

Since the New York State Office of the Attorney General (NYSOAG) made public its discovery of mutual fund trading abuses in September 2003, that office, SEC, the NASD, which regulates broker-dealers that may offer mutual funds to their customers, and certain other state regulators have pursued enforcement actions for two principal types of mutual fund violations—market timing and late trading.[3]

Market timing typically involves the frequent buying and selling of mutual fund shares by sophisticated investors, such as hedge funds, that seek opportunities to make profits on the differences in prices between overseas and U.S. markets.[4] As frequent trading can harm mutual fund shareholders through lowered fund returns and increased transaction costs, many mutual fund companies have disclosed limits in their fund prospectuses on the number of trades individual customers may place per year. Although market timing is not itself illegal, it can constitute illegal conduct if, for example, investment advisers (firms that may manage mutual fund companies) enter into undisclosed agreements with favored customers permitting them to trade frequently and in contravention of the fund prospectuses—as certain investment advisers did prior to September 2003. Another type of violation commonly referred to as late trading was significant but less widespread than market timing violations. Unlike market timing, late trading is illegal. It 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.[5] Investors who are

[3]NYSOAG uncovered the abuses in the summer of 2003 after following up on a tip provided by a securities industry insider. We recently issued a report identifying reasons why SEC did not detect these trading abuses prior to September 2003. 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).

[4]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 which is excluded from the definition of investment company under the Investment Company Act of 1940. Hedge funds are also characterized by their fee structure, which compensates the adviser based upon a percentage of the hedge fund's capital gains and capital appreciation. Pursuant to a new rule recently adopted by SEC, advisers of certain hedge funds are required to register with SEC under the Investment Advisers Act of 1940. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 *Fed. Reg*. 72054 (2004) (to be codified in various sections of 17 C.F.R. Parts 275 and 279).

[5]Under SEC rules, mutual fund companies 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.

permitted to late trade can profit on the 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 mutual fund company personnel, late trading violations have typically occurred at intermediaries, such as broker-dealers, before these institutions submit their daily aggregate orders to mutual fund companies for final settlement.

Because of your interest in ensuring the effective enforcement of federal securities laws and effective federal-state coordination, you asked that we assess a range of issues associated with SEC's market timing and late trading enforcement actions. Specifically, our report

- compares the severity of civil money penalties (penalties) obtained in the mutual fund cases with penalties obtained in the past and with similarly egregious cases, reviews SEC's penalty-setting process in these cases, and discusses SEC's coordination with state authorities in pursuing civil enforcement actions;[6]

- provides information on state and federal criminal enforcement actions for market timing and late trading violations;

- assesses SEC's management procedures for making referrals to DOJ and state authorities for potential criminal prosecution; and

- evaluates SEC's procedures for ensuring compliance with federal laws and regulations that govern employees' ability to negotiate and take positions with regulated entities, such as mutual fund companies.

To respond to the first objective, we obtained copies from SEC of enforcement actions and settlement orders related to the mutual fund trading abuses and cases of comparable egregiousness. We also obtained information from SEC, the Commodity and Futures Trading Commission (CFTC), the Office of the Comptroller of the Currency (OCC), and NASD on the criteria and processes they use to determine penalties and data on the highest penalties they have obtained in settlement. The data we obtained from SEC allowed us to compare the penalties obtained in the mutual fund trading abuse cases to the penalties obtained in past cases. To determine the consistency of SEC's penalty-setting process in the mutual fund trading abuse cases, we reviewed a selection of 11 out of the 14

[6]For purposes of this report, the term "penalties" refers to "civil money penalties" authorized by applicable law.

enforcement actions SEC brought against investment advisers charged with market timing abuses. We also obtained information from states that coordinated settlement negotiations with SEC in bringing their own enforcement actions against several of the same investment advisers involved in SEC's 14 settled enforcement actions. To respond to the second objective, we interviewed SEC staff and NYSOAG, Wisconsin Attorney General's Office, and DOJ officials and obtained copies of criminal complaints related to late trading and market timing. To respond to the third objective, we obtained information from SEC, CFTC, and NASD on the procedures these agencies follow for making criminal referrals to DOJ and states. To respond to the fourth objective, we reviewed the policies and procedures of SEC, OCC, the Federal Reserve Banks of Chicago and New York, and NASD for promoting staff compliance with federal laws limiting the seeking of employment opportunities and postemployment activities of federal executive employees and, in the case of NASD and the Federal Reserve Banks, codes of ethics that also include seeking employment restrictions for their employees. We performed our work in Boston, Mass.; Chicago, Ill.; Denver, Colo.; New York, N.Y.; Philadelphia, Penn.; and Washington, D.C., between May 2004 and May 2005 in accordance with generally accepted government auditing standards. Appendix I provides a detailed description of our scope and methodology.

Results in Brief

The penalties SEC obtained in the market timing and late trading cases are among the highest in the agency's history and generally consistent with penalties obtained in cases involving similarly egregious corporate misconduct. Additionally, SEC appears to have followed its process for setting penalties consistently in determining penalties in the cases we reviewed. Since September 2003, SEC has brought 14 enforcement actions against investment advisers primarily for market timing abuses and 10 enforcement actions against broker-dealer, brokerage-advisory, and financial services firms that conducted or facilitated improper or illegal trading. Penalties that SEC obtained in settling the 14 enforcement actions with investment advisers range from $2 million to $140 million, with an average penalty of about $56 million. In contrast, SEC penalties in cases for securities law violations issued prior to January 2003 were generally less than $20 million. SEC's penalties in the investment adviser cases also are generally consistent with penalties the agency has obtained in settlements resulting from recent investment banking analyst and corporate accounting fraud cases, which SEC staff identified as involving similarly egregious misconduct.[7] In addition to actions against advisers, SEC brought enforcement actions against 24 individuals, many of them high-ranking company executives. SEC has obtained penalties as high as $30 million against investment adviser executives (among the highest penalties obtained in individual cases) and barred some individuals from their industry for life. In determining appropriate penalties to recommend to the Commission in the investment adviser cases we reviewed, SEC staff consistently applied criteria that the agency has established. These criteria require SEC to consider such things as the egregiousness of the conduct, the amount of harm caused, and the degree of cooperation as well as to compare proposed penalties with penalties obtained in similar cases. SEC staff may also consider litigation risks in determining appropriate penalties. For example, if SEC pursues an overly aggressive penalty, a defendant may be less likely to settle and a judge or other arbitrator may not agree with SEC's analysis and impose a lesser penalty. A range of SEC officials participate in SEC's process for setting appropriate penalties—including the Commissioners—to help ensure that no one individual or small group has disproportionate influence over the final decision. Moreover, SEC has coordinated penalties and disgorgement (which forces firms to forfeit ill-gotten monetary gain) with state authorities in many of its market timing and late trading cases, although some states obtained additional monetary sanctions.

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 conduct and generally concluded that they did not warrant criminal fraud prosecutions. Federal officials did identify one instance of market timing conduct that led to the initiation of criminal proceedings; however, an undisclosed

[7]The investment analyst cases involved several investment firms who allegedly provided securities research that was biased by investment banking interests, while the corporate accounting fraud cases involved publicly traded companies that allegedly used fraudulent accounting techniques to inflate their revenues and thereby drive up stock prices.

market timing arrangement was not central to the criminal allegations. The case involved a broker-dealer's alleged efforts to facilitate and conceal short-term trading by its customers despite warnings from mutual fund companies that such trades would not be accepted. In contrast, NYSOAG and DOJ have brought at least 12 criminal prosecutions against individuals involving late trading violations. For example, NYSOAG charged a former executive and senior trader of a prominent hedge fund with conducting late trading on behalf of the fund through certain registered broker-dealers. This individual pled guilty in the New York State Supreme Court. According to DOJ officials, criminal prosecution of late trading is fairly straightforward because the practice is a clear violation of federal securities laws.

SEC staff said that as state and federal criminal prosecutors were already aware of and generally evaluated the mutual fund trading abuse cases for potential criminal violations on their own initiative, they did not need to make specific criminal referrals to bring these cases to their attention. However, in the course of our review we found that SEC's capacity to effectively manage its overall criminal referral process may be limited by inadequate recordkeeping. SEC rules provide agency staff with what they characterize as "formal" and "informal" procedures to use when making referrals to appropriate authorities if the facts of a particular investigation indicate potential criminal violations. Formal referral procedures, which according to SEC staff have not been used for over 20 years, require that the Director of Enforcement review cases to be recommended for criminal prosecution in coordination with the Office of the General Counsel and, according to Enforcement staff, that the Commission approve the recommended referrals. Under the informal procedures, SEC regional management staff or their designees are allowed to contact federal or state authorities and apprise them of a particular case. Although SEC procedures provide for informal referrals and such referrals may be efficient, the process as currently implemented does not provide critical management information. In particular, SEC does not require staff to document the reasons for making an informal referral or even whether such a referral has been made. SEC staff told us that such documentation would not aid them in managing the referral process as they already have in place processes to ensure that appropriate referrals are made. However, without such documentation, the Commission cannot readily determine and verify whether staff make appropriate and prompt referrals. This lack of recordkeeping is inconsistent with federal internal control standards, which recommend that documentation be designed to provide evidence that management directives have been carried out, and with the practices of other financial regulators such as CFTC and NASD, which maintain records on referrals. Documentation of referrals might serve as an additional internal indicator of the effectiveness of SEC's referral process and would also be important for congressional oversight of law enforcement efforts in the securities industry.

While SEC provides training and guidance to staff on federal laws and regulations regarding employment with regulated entities and requires former staff to notify SEC if they plan to make an appearance before the agency, it does not require departing staff to report where they plan to work. In contrast, OCC and two Federal Reserve Banks obtain information on where departing staff will be employed to assess the potential for violations of employment restrictions. NASD also obtains information on departed employees' subsequent employment with member firms. Officials from three of these agencies said that they also ask for this information to assess whether the quality of the employee's prior regulatory work could have been compromised by a potential conflict of interest with the employee's new place of employment. According to SEC staff, they have not tracked postemployment information because SEC examiners and other staff are highly aware of employment-related restrictions. Further, SEC staff said that since agency examiners have traditionally visited mutual fund companies periodically to conduct examinations, they are less likely to face potential conflicts of interest than bank examiners who may be located full-time at large institutions. However, SEC staff have told us that as part of recently implemented and planned changes to their mutual fund oversight program, they are assigning monitoring teams to the largest and highest-risk mutual fund companies. The teams would have more regular contact with fund management over a potentially longer period of time. In addition, a new SEC rule requiring all mutual fund companies and investment advisers to designate chief compliance officers may increase an existing demand for SEC examiners to fill open positions in the compliance departments at regulated entities.[8] As a result, the potential for employment conflicts of interest might increase.

This report contains recommendations related to improving SEC documentation of informal referrals and the postemployment plans of

[8]On December 17, 2003, SEC adopted compliance rules requiring all investment companies and investment advisers registered with the agency to adopt and implement policies and procedures designed to prevent violations of the federal securities laws and to designate a chief compliance officer to be responsible for administering such policies and procedures. See Compliance Programs of Investment Companies and Investment Advisers, 68 *Fed. Reg.* 74714 (2003) (to be codified at 17 C.F.R. § 270.38(a)-1 and 17 C.F.R. § 275.206(4)-7.

departed staff. SEC provided written comments on a draft of this report that are reprinted in appendix II. SEC agreed with the recommendations and noted that it will take steps to implement them as part of other, ongoing efforts to modify the forms Enforcement staff use to record investigation-related information and to enhance staff awareness of the conflict-of-interest issues associated with seeking employment and postemployment. SEC's comments are discussed in greater detail at the end of this report. SEC also provided technical comments, which have been incorporated as appropriate.

Background

Although typically organized as a corporation, a mutual fund's structure and operation differ from those of a traditional corporation. In a typical corporation, the firm's employees operate and manage the firm, and the corporation's board of directors, elected by the corporation's stockholders, oversees its operations. Mutual funds also have a board of directors that is responsible for overseeing the activities of the fund and negotiating and approving contracts with an adviser and other service providers for necessary services.[9] Unlike a typical corporation, a typical mutual fund has no employees; it is created and operated by another party, the adviser. The adviser is an investment adviser/management company that manages the fund's portfolio according to the objectives and policies described in the fund's prospectus.[10] The adviser contracts with the fund, for a fee, to administer its operations. These fees are typically based on the size of assets under management. In managing the fund's assets, the adviser owes a fiduciary duty to the investors in the mutual funds to act for the benefit of the investors and not use the fund's assets to benefit itself.

Mutual funds are subject to SEC oversight and are regulated primarily under the Investment Company Act of 1940 (1940 Act) and the rules it has adopted under that act. SEC has authority under this act to promulgate rules to address a constantly changing financial services industry environment in which mutual funds and other investment companies

[9]Most funds are organized either as corporations governed by a board of directors or as business trusts governed by trustees. When establishing requirements relating to the officials governing a fund, the act uses the term "directors" to refer to such persons, and this report also follows that convention.

[10]In some cases, the adviser may contract with other firms to provide investment advice, becoming a subadviser to those funds.

operate. The advisory firms that manage mutual funds are regulated under the Investment Advisers Act of 1940 (Advisers Act), which requires certain investment advisers to register with SEC and conform to SEC regulations designed to protect investors. In addition to its rulemaking authority, SEC carries out its mutual fund oversight responsibilities through examinations. SEC's Office of Compliance Inspections and Examinations (OCIE) establishes examination policies and procedures and has primary responsibility for conducting mutual fund company examinations.

SEC is vested with the authority to bring civil enforcement actions against individuals and companies that violate provisions of the 1940 Act, the Advisers Act, and other federal securities laws and regulations. While SEC has civil enforcement authority only, it works with various federal and state criminal law enforcement agencies throughout the country to develop and bring criminal cases when the misconduct warrants more severe action. SEC carries out its enforcement activities through Enforcement. Enforcement identifies potential securities laws violations through referrals from SEC examiners or other regulatory organizations such as NASD, tips from securities industry insiders or the public, the press, and its own surveillance of the marketplace. After conducting an investigation, Enforcement staff present their findings to the Commission for its review and approval. The Commission can authorize staff to bring an enforcement action in federal court or through administrative proceedings.

When bringing a civil enforcement action in federal court, SEC files a complaint with a U.S. District Court that describes the misconduct, identifies the laws and rules violated, and identifies the sanction or remedial action that is sought. Administrative proceedings differ from civil enforcement actions brought in federal court in that they are heard by an administrative law judge (ALJ), who is independent of SEC. The ALJ presides over a hearing and considers the evidence presented by Enforcement staff, as well as any evidence submitted by the subject of the proceeding. SEC may also enter into settlements with defendants who choose not to contest the charges against them. In a typical settlement of an administrative proceeding, the defendant neither admits nor denies the violation of the securities laws and agrees to the imposition of sanctions. According to senior Enforcement staff, both SEC and the defendants have an incentive to avoid litigation and seek a settlement, as litigation is costly and time-consuming.

SEC can seek a variety of sanctions against defendants in federal court or as part of administrative proceedings. These include officer and director bars and monetary sanctions, such as disgorgement and penalties. The amount of disgorgement SEC seeks in a particular case is usually determined by the amount of monetary gain, if any, realized from the violative conduct. SEC can use these funds to compensate investors harmed by the misconduct. Penalties, on the other hand, are intended to punish wrongdoing and deter others from engaging in similar misconduct. The Sarbanes-Oxley Act of 2002 (SOX) authorizes federal courts and SEC to establish "fair funds" to compensate victims of securities violations.[11] Section 308(a) of SOX provides that if in an administrative or a civil proceeding involving a violation of federal securities laws an order requiring disgorgement is entered, or if a person agrees in settlement to the payment of disgorgement, any penalty assessed against such person may, together with the disgorgement amount, be deposited into a fair fund and disbursed to victims of the violation pursuant to a distribution plan approved by SEC.

The Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (Remedies Act)[12] amended existing federal securities laws to authorize SEC and federal district courts to impose penalties for securities violations other than insider trading, for which penalties were already authorized.[13] The Remedies Act specifies the maximum penalty that SEC can seek in administrative proceedings from a firm or individual in noninsider trading cases according to a three-tier framework, which allows for increasing penalties based on the presence of fraud and harm to investors (see table 1).[14] For example, if SEC finds that a firm's securities law violations did not involve fraud or cause substantial harm to investors,

[11]Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in various sections of the United States Code). The "fair fund" provision is codified at 15 U.S.C. § 7246(a).

[12]The Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (codified in various sections of Title 15).

[13]Section 2 of the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended at 15 U.S.C. § 78u) authorized the Commission to seek in federal district court civil money penalties of up to three times the profit gained or loss avoided by a person who commits illegal insider trading.

[14]Securities Enforcement Remedies and Penny Stock Reform Act of 1990 §§ 202, 301 and 401, 15 U.S.C. §§ 21B, 80a-9(d) and 80b-3(i). The Federal Civil Penalties Inflation Adjustment Act of 1990, Pub. L. No. 101-410, 104 Stat. 890 (codified at 28 U.S.C. 2461, note) requires each federal agency to adopt rules adjusting the maximum penalties it is authorized by statute to seek for inflation at least once every 4 years. SEC most recently carried out this adjustment in February 2005. See 70 *Fed. Reg.* 7606-08 (2005) (to be codified at 17 C.F.R. § 201.1003 and Table III).

a tier one penalty may be appropriate. In that case, the maximum penalty SEC can seek would be $65,000 per violation. However, if SEC finds that a firm's misconduct involved fraud and caused substantial harm to investors, it can apply the third tier maximum penalty— $650,000 per violation.

Table 1: Statutory Maximums for SEC Penalties in Noninsider Trading Securities Violations, Adjusted for Inflation

Tier	Maximum penalty amount for firm (individual)
1	$65,000 ($6,500) per violation.
2	$325,000 ($65,000) per violation when the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.
3	$650,000 ($130,000) per violation when, in addition to satisfying the requirements of a second tier penalty, the violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons.

Source: Adjustment of Civil Monetary Penalties – 2005, 70 Fed. Reg. 7,606 (2005) (to be codified at 17 C.F.R. § 201.1003 and Table III).

Although the Remedies Act requires that in order to impose a penalty in an administrative proceeding SEC must find that the penalty is in the public interest, the act did not impose criteria that SEC must consider in making this determination. Instead, the Remedies Act provides a nonexclusive list of factors that SEC may consider, such as whether the conduct involved fraud or directly or indirectly resulted in harm to other persons. Enforcement staff told us that over the years SEC has internally developed more extensive criteria based on this guidance, case law, and policy directives from the Commission, which are documented for Enforcement staff in internal division memorandums. These criteria include

- the egregiousness of conduct—whether it involved fraud, and if so, the degree of scienter present;[15]
- the degree of harm to investors resulting from the conduct;
- the extent of the defendant's cooperation;
- whether the defendant derived any economic benefit from the conduct;

[15]Scienter refers to the requisite degree of knowledge that makes a person's actions culpable.

- the duration of the conduct;
- whether the defendant is a recidivist;
- the seniority of individuals that participated in the conduct;
- the need for deterrence;
- the defendant's ability to pay;
- the size of the firm or net worth of the individual; and
- the penalties obtained in cases involving the same or a similar scheme.

When negotiating settlements on behalf of the Commission, SEC Enforcement staff apply these factors to the facts and circumstances of each case when determining what penalty to seek. These criteria are similar to the criteria other financial regulators use in their penalty-setting process, including CFTC, OCC, and NASD.

One key factor for SEC in effectively fulfilling law enforcement objectives such as penalty-setting is the implementation of appropriate internal controls. According to the *Standards for Internal Control in the Federal Government*, internal controls (also called management controls) comprise the plans, methods, and procedures used to meet missions, goals, and objectives and, in doing so, support performance-based management.[16] They are a major part of managing an organization. Among other things, they should promote the effectiveness and efficiency of operations, including the use of the entity's resources, and the agency's compliance with applicable laws and regulations. They should also be designed to provide reasonable assurance that the objectives of the agency are being achieved.

[16]GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999), which was prepared to fulfill our statutory requirement under the Federal Managers' Financial Integrity Act, provides an overall framework for establishing and maintaining internal controls and for identifying and addressing major performance and management challenges and areas at greatest risk of fraud, waste, abuse, and mismanagement.

SEC Consistently Applied Penalty-Setting Procedures in Mutual Fund Cases and Coordinated Most Monetary Sanctions with States

SEC has responded to the widespread trading abuses in the mutual fund industry by bringing 14 enforcement actions against investment advisers and 10 enforcement actions against broker-dealer, brokerage-advisory, and financial services firms that conducted or facilitated the illicit trading. Penalties SEC has obtained in settlements with these firms have included some of the highest in the agency's history and are consistent with other penalties obtained in cases of similarly egregious and pervasive misconduct. Further, SEC has held individuals, many of them high-ranking, responsible for their role in the misconduct and also obtained historically high penalties in settlements with several of them. In reviewing a selection of 11 out of the 14 enforcement actions SEC brought against investment advisers and their associated individuals, we found that SEC consistently applied its penalty-setting process and that this process contained various levels of review to help ensure that no one individual or group of individuals had disproportionate influence on penalty decisions. Additionally, SEC coordinated penalties and disgorgements (which force firms to give up ill-gotten gains) with interested states in the majority of cases, although some states obtained additional monetary sanctions.

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

Since NYSOAG announced its discovery of the trading abuses in the mutual fund industry in September 2003, SEC has brought 14 enforcement actions against investment advisers primarily for market timing abuses and 10 enforcement actions against broker-dealer, brokerage-advisory, and financial services firms for market timing abuses and late trading. SEC has entered into settlements in all 14 investment adviser cases and obtained penalties ranging from $2 million to $140 million (see fig. 1). These penalties are among the highest SEC has ever obtained for securities laws violations. Before January 2003, penalties SEC obtained in settlement were generally under $20 million. In contrast, 11 of the 14 penalties obtained in the investment adviser cases are over $20 million, with 8 penalties at $50 million or more. Pursuant to the fair fund provision of SOX, SEC plans to use the penalties and disgorgement moneys, a total of about $800 million and $1 billion, respectively, to provide restitution to harmed investors.[17] In addition to settling with investment advisers, as of February 28, 2005, SEC has settled with two broker-dealers, two insurance companies, and one brokerage-advisory firm, with penalties totaling $17.5 million.

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

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

Investment adviser case[a]	Penalty	Disgorgement	Total
Banc of America Capital Management, LLC[b]	$125,000	$250,000	$375,000
Invesco Funds Group, Inc.	140,000	235,000	375,000
Alliance Capital Management, LP	100,000	150,000	250,000
Massachusetts Financial Services, Co.	50,000	175,000	225,000
Columbia Management Advisors, Inc.	70,000	70,000	140,000
Janus Capital Management, LLC	50,000	50,000	100,000
Pilgrim Baxter & Associates, Ltd.	50,000	40,000	90,000
Strong Capital Management, Inc.	40,000	40,000	80,000
Putnam Investment Management, LLC	50,000	5,000	55,000
Banc One Investment Advisors, Corporation	40,000	10,000	50,000
PIMCO Advisors Fund Management, LLC	40,000	10,000	50,000
Franklin Advisers, Inc.	20,000	30,000	50,000
RS Investment Management, LP	13,500	11,500	25,000
Fremont Investment Advisors, Inc.[c]	2,000	2,146	4,146
	790,500	**1,078,646**	**1,869,146**

Source: SEC.

[a]The entities named in this column are investment advisers associated with these cases. In some cases, SEC simultaneously charged other entities, such as an associated investment adviser, distributor, or broker-dealer for their roles in the market timing abuses. The penalties and disgorgements shown for each case are the totals obtained in settlement from all the entities associated with the case.

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

[c]Fremont Investment Advisors, Inc., settled charges involving both abusive market timing and late trading.

The penalties SEC obtained in the 14 investment adviser cases are also consistent with penalties obtained in settled enforcement actions in two types of cases that senior Enforcement staff identified as being as egregious as the mutual fund trading abuses—the recent corporate accounting fraud and investment banking conflict-of-interest cases. The recent, large corporate accounting frauds surfaced in late 2000 and concerned publicly traded companies that allegedly used fraudulent accounting techniques to inflate their revenues and drive up stock prices. The investment banking analyst cases involved several investment firms that settled enforcement actions brought by SEC in 2003 for allegedly producing securities research that was biased by investment banking interests. Table 2 compares the range of penalties and average penalties SEC obtained from settlements of enforcement actions brought against firms for mutual fund trading abuses, corporate accounting fraud, and investment banking conflicts of interest. Although particular penalties reflect the facts and circumstances of each case, table 2 shows that the average penalties among the three types of cases have generally been consistent (when excluding the record $2.25 billion penalty obtained in a corporate accounting fraud case), particularly when compared with the lower penalties obtained in past years. In a public speech, the Director of Enforcement said that the comparatively large penalties in these cases represented an effort to increase accountability and enhance deterrence in the wake of such extreme misconduct in the securities industry and noted that such penalties create powerful incentives for firms to institute preventative programs and procedures. Others, however, including two members of the Commission, have questioned the appropriateness of these relatively large penalties, particularly for public companies, arguing that the cost of penalties are borne by shareholders who are frequently also the victims of the corporate malfeasance.

Table 2: Average Penalties in SEC Settlements with Investment Advisers, Public Companies, and Investment Firms

Case type	Number of settled enforcement actions	Range of penalties	Average penalty
Investment adviser	14	$2—$125 million	$56 million
Public company	11	$3—$250 million, $2.2 billion	$61.5 million[a]
Investment firm	12	$5—$150 million	$43 million

Source: SEC.

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

Further, the penalties SEC has obtained in the mutual fund and other recent scandals are generally higher than those obtained in settlement by NASD and other federal financial regulators. For example, NASD has also brought nine enforcement actions against broker-dealers for market timing and late trading abuses and obtained penalties ranging from $100,000 to $1 million. Similarly, CFTC and OCC have obtained consistently lower penalties in settlement. For example, as of December 2004, the highest penalties OCC and CFTC obtained were for $25 million and $35 million, respectively.

In addition to bringing enforcement actions against firms, SEC has held individuals responsible for their roles in the trading abuses. As of February 28, 2005, SEC had brought enforcement actions against 24 individuals and settled with 18, obtaining penalties and industry bars in all cases and disgorgement from some (see table 3). Almost all of these settled enforcement actions involved high-level executives, including eight chief executive officers (CEO), chairmen, and presidents. Penalties SEC obtained in these settlements ranged from $40,000 to $30 million. The penalties obtained from 3 individuals are among the four highest in SEC's history—one for $30 million (the highest) and two for $20 million. SEC also obtained a combined $150 million in disgorgement from these three individuals.[18] In addition, as part of its settlements, SEC permanently barred 5 individuals, including the 3 mentioned above, from association with investment advisers, investment companies, and in some cases other regulated entities, and barred the remaining 13 for various periods from their industries.

Table 3: Penalties SEC Obtained in Settlement from Individuals Charged in Investment Adviser Cases

Individuals charged, by investment adviser case[a]	Penalty
Strong Capital Management, Inc.	
• Founder and former chairman[b]	$30 million
• Former executive vice president[b]	375,000
• Former director of compliance[b]	50,000
Pilgrim Baxter & Associates, Ltd.	
• Former president[b]	20 million
• Former chief executive officer (CEO)[b]	20 million
Invesco Funds Group, Inc.	
• Former CEO	500,000
• Chief investment officer	150,000
• National sales manager	150,000
• Assistant vice president of sales	40,000
Massachusetts Financial Services, Co.	
• Former president	250,000
• Former CEO	250,000
RS Investment Management, LP	
• CEO	150,000
• Chief financial officer	150,000

[18]SEC obtained an additional $529,000 in disgorgement from five other individuals.

Individuals charged, by investment adviser case[a]	Penalty
Columbia Management Advisors, Inc.	
• Former portfolio manager	$100,000
• Former chief operating officer	100,000
• Former national sales manager	50,000
Banc One Investment Advisors, Corporation	
• Former CEO of related fund	100,000
Fremont Investment Advisers, Inc.	
• Former CEO	100,000
Total	**$72,515,000**

Source: SEC.

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

[b]SEC permanently barred this individual from association with certain regulated entities, including investment advisers and investment companies.

SEC Consistently Weighed Penalty Determinations Using Established Criteria and Procedures among the Investment Adviser Cases We Reviewed

In reviewing 11 of the 14 settled enforcement actions related to the investment adviser cases, we found that SEC followed a similar penalty-setting process in each of them. SEC regional staff in the six offices that were part of our review generally began their penalty analysis by determining the amount of money earned by the firms and individuals from the abusive market timing and the economic harm such trading caused to investors. For example, as a measure of monetary gain, staff determined the fees the firms earned on the assets market timers invested short-term for market timing purposes.[19] As a measure of harm to fund investors, staff determined the amount of dilution to fund shares that occurred as a result of this improper trading, using the same methodology for each case.[20] SEC's Office of Economic Analysis, which determined this methodology, assisted staff with these analyses. Staff assessments of monetary gain and harm caused were also used to help them determine appropriate disgorgement.

After establishing the economic benefit and harm caused, staff generally then determined the monetary range within which they could seek a

[19]SEC also found that in some instances market timers invested assets long-term in return for market timing privileges, which also generated fees for the investment adviser.

[20]The frequent trading of mutual fund shares lowers, or dilutes, the value of fund shares held by long-term fund investors. According to experts, this dilution is approximately equal to the profits market timers earn as a result of their short-term trading of the fund shares.

penalty by calculating the maximum penalty that applied to their particular case. According to SEC staff at several regional offices, the penalty statutes did not limit them from seeking penalties they thought appropriate, largely because the statutes leave it up to SEC to define the term “violation.”[21] Staff did not necessarily seek the statutory maximum in these cases because they considered SEC criteria for assessing the relative egregiousness of the misconduct and in some cases concluded that it warranted a lesser penalty, and also because they considered the risk that the case would be litigated instead of settled. For example, in one case where staff could have argued a statutory maximum of $1 billion based on the hundreds of improper trades found, staff said they could not have made a convincing argument for such a high penalty based on the relatively small amount of economic harm and level of scienter involved (scienter refers to the requisite degree of knowledge that makes a person’s actions culpable). These staff told us that even if they disregarded SEC criteria and sought the maximum it was very unlikely that they would have achieved an amount close to it. The staff said that the firm involved would never have settled and it was unlikely that the judge or ALJ assigned to the case would have found staff’s underlying rationale for the penalty recommendation credible. As judges and ALJs make independent determinations of the facts when determining whether a penalty or other sanctions are warranted, staff said that they may decide on a lesser penalty than what staff recommended. For that reason, staff said that while the penalty statutes provide a baseline for their analysis, they seek penalties in settlement that reflect the facts and circumstances of the case and the penalties obtained in similar cases.

To determine a penalty appropriate to the facts and circumstances of each case, SEC staff used the criteria discussed earlier to establish the egregiousness of the case relative to that of other market timing and late trading cases—considering, for example, the level of scienter involved, the amount of harm caused and benefit gained, the level of cooperation, and the seniority of the individuals involved. We found that staff sought penalties that reflected these differences. Barring the presence of aggravating or mitigating factors, conduct perceived as more egregious received relatively greater penalties. For example, the highest penalty that SEC obtained from an individual in the market timing and late trading

[21] For example, they said that they could count each type of misconduct as one violation or count each instance of misconduct (such as each improper market timing trade) as a separate violation.

cases was from the former founder and chairman of an investment adviser who SEC found to have market timed the funds he managed for his own personal gain. Regional staff said that this individual's $30 million penalty was merited because as the most senior official in the firm, he was duty-bound to protect the interests of all fund investors and should have set an example in proper ethical conduct for the rest of the firm's employees. Instead, SEC found that he continued his market timing activities even after compliance officials at the firm detected his improper trading and counseled him to cease. Further, this was the second time he had been the subject of an SEC enforcement action—in 1994, SEC charged him with improper personal trading in the fund's portfolio securities. Finally, they said he cooperated very little in the investigation.

In some cases we found that where SEC perceived a high level of egregiousness, the presence of other factors mitigated a more severe penalty determination, such as the degree of cooperation or the firm's ability to pay. For example, staff required firms that argued they could not pay the penalty initially sought to provide documentation of any financial constraints and the financial consequences of paying the higher penalty.

Regional staff regularly consulted with senior Enforcement staff in preparing their penalty recommendations. Enforcement's Office of the Chief Counsel is responsible for reviewing all sanction recommendations, including penalties, for consistency with penalties recommended in analogous cases. This office reviewed all of the penalty and other sanctions recommended in the 11 cases we reviewed. Additionally, staff shared information about penalty-setting in the market timing and late trading settlements with a range of agency officials outside of Enforcement. Once staff had negotiated with the defendant the amount of the disgorgement and penalties and the application of other sanctions they believed were appropriate for a case and obtained a formal offer of settlement from the defendant, staff prepared a memorandum for the Commission describing the settlement offer and their rationale for recommending that the Commission accept it. For example, the memorandums explained how the disgorgement figure related to any calculations of economic benefit or harm and discussed the factors most relevant to the penalty analysis. Before sending the memorandum to the Commission for review and approval, other interested SEC divisions and offices, such as Investment Management, Corporation Finance, and the Office of the General Counsel, first reviewed it. Enforcement staff said that by asking staff from other areas of SEC to review their sanction recommendations, they help ensure that no one individual or small group has a disproportionate influence over the penalty recommended to the

Commission and that the penalty reflects the Commission's policy goals. The Commission either approved the settlement terms outlined in the memorandum or advised Enforcement as to any adjustments they wanted made, which staff then renegotiated with the defendants.

SEC Coordinated Penalties and Disgorgement with States in the Majority of Settlements with Investment Advisers, but Some States Obtained Additional Sanctions

SEC coordinated penalties and disgorgements with interested states in many of the settled enforcement actions related to late trading and market timing. For example, in 11 cases, three states (New York, Colorado, and New Hampshire) coordinated their settlement negotiations with SEC, agreeing to seek the same disgorgement and penalty amounts and requiring in their individual settlement orders that the payments be remitted to and administered by SEC pursuant to the related SEC settlement order. As a result of this collaboration, the penalty moneys collected in these cases can be used to compensate harmed investors, under the fair fund provision of SOX. In one case, a state required a separate, duplicative payment from one firm of disgorgement and penalties, but SEC noted in its own settlement order that it had considered this fact when seeking penalties against the subject firm.

While in most cases states agreed to the same penalty and disgorgement as SEC and to have the payments made directly to SEC, some states, most notably New York, obtained additional monetary sanctions. In addition to disgorgement and penalties, NYSOAG ordered most of the investment advisers with whom it settled to reduce the fees that they charge mutual fund investors over the next 5 years. The value of these reductions totaled about $925 million and in some cases more than doubled the value of the disgorgement and penalties SEC obtained in an individual case. According to NYSOAG, these investment advisers did not just allow improper market timing and late trading, but they had also charged mutual fund investors significantly more in fees than institutional investors for similar services. NYSOAG said that the SEC settlements focusing on disgorgement and penalties for trading abuses did not compensate investors who were overcharged and that the fee reductions it obtained provided this needed restitution.

In conjunction with the settlement order related to one investment adviser case, the Commission issued a public statement on its position regarding fee reductions. The Commission stated that it did not seek fee reductions with this investment adviser because this sanction did not serve its law enforcement objectives. First, the Commission said that there were no allegations that the fees charged by the adviser in question were illegally high. Fee reductions would provide compensation to investors who were not harmed by the market timing abuses SEC set forth in the settlement order. Second, they said that mandatory fee discounts would require that customers do business with the firms to receive the benefits of the fee reductions (meaning that prior customers that received allegedly illegal prices but already redeemed their shares would not benefit). For those reasons, the Commission said that their efforts focused on addressing the market timing abuses by providing full compensation to investors harmed by this activity and a significant up-front penalty.

In addition to NYSOAG, Colorado and New Hampshire also obtained additional monetary sanctions in its settlements in three investment adviser cases. Colorado required the firms involved in two cases to pay $1 million and $1.5 million, respectively, to reimburse its costs and for consumer and investor education and future enforcement activities within that state. New Hampshire required the firm involved in another case to pay $1 million for investor education and protection purposes and an additional $100,000 to defray the costs of the investigation.

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

After NYSOAG announced its discovery of mutual fund trading abuses in September 2003, officials from that office, DOJ, and SEC told us that they met to discuss potential criminal violations in cases involving these abuses and clarify subsequent investigative responsibilities and coordination. Other state officials told us they also reviewed cases involving mutual fund trading abuses for criminal potential. These officials said that the criminal prosecution of market timing is complicated by the fact that market timing conduct itself is not illegal. DOJ officials told us that they have brought criminal charges in cases where late trading occurred, primarily because late trading is a clear violation of federal securities laws and authorities can readily prosecute cases once evidence of late trading is established.

Several Factors Have Complicated Criminal Prosecution of Market Timing Cases

Officials from DOJ, NYSOAG, and the Wisconsin Attorney General's Office told us that they have declined to bring criminal charges for market timing conduct, largely because market timing itself is not illegal. In instituting administrative proceedings in the 14 investment adviser cases discussed above, SEC alleged that the undisclosed market timing conduct involved constituted securities fraud, conduct expressly prohibited under federal securities laws. According to DOJ officials, although state and federal criminal prosecutors can also seek criminal sanctions for securities fraud, such prosecutions may be more difficult to prove than civil actions. DOJ officials told us that criminal prosecutors must be able to prove beyond a reasonable doubt that the defendant committed fraud, whereas civil authorities generally need only show that a preponderance of the evidence indicated a fraudulent action. According to DOJ and NYSOAG officials, for a variety of reasons their review of cases involving market timing arrangements concluded that they did not warrant criminal fraud prosecutions.[22] For example, in commenting on one case involving an investment adviser's undisclosed market timing arrangement, the Wisconsin Attorney General stated that the risk in trying to convince a jury beyond a reasonable doubt that the particular behavior was criminal motivated his office and other state prosecutors to instead pursue a civil enforcement action.

According to a recent law journal article, the ambiguous nature of some funds' prospectus language may have further weakened the ability of federal and state prosecutors to bring criminal charges against investment advisers that allowed favored investors to market time.[23] The article stated that it is often unclear whether and to what extent a fund prohibits market timing. For example, many mutual funds merely "discouraged" market timing to the extent that it caused "harm" to the funds. According to the article, such language is subject to various interpretations as to what constitutes discouraging and what constitutes harm to fund performance. Further, it stated that even prospectus disclosures that allow a specific number of exchanges can be ambiguous because the term "exchange" is subject to various interpretations. Such ambiguities may hamper criminal

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

[23]Roberto M. Braceras, "Late Trading and Market Timing," *Securities & Commodities Regulation*, vol. 37, no. 7 (2004).

prosecutors' efforts to prove that the market timing arrangements constituted a willful intent to defraud.[24]

As of March 31, 2005, federal prosecutors have brought one criminal case involving abusive market timing. However, this case involved a broker-dealer's alleged efforts to facilitate and conceal short-term trading by its customers despite warnings from mutual fund companies that such trades would not be accepted, as opposed to allegations of undisclosed arrangements between a mutual fund company and favored customers. In that case federal prosecutors filed a criminal complaint alleging securities fraud and conspiracy charges against three top executives at this firm. The complaint alleges that these individuals devised and executed a number of deceptive practices to circumvent market timing restrictions placed on their firm by mutual funds companies. These deceptive practices allegedly included creating and using multiple account numbers for the same client and executing trades through multiple clearing firms. As of March 31, 2005, these individuals were awaiting trial.

Most Criminal Cases Brought Have Been Based on Late Trading Charges

NYSOAG and DOJ have brought at least 12 criminal prosecutions against individuals for charges that include late trading. The individuals charged included high-level executives, traders, and other employees of three broker-dealers, two banking-related organizations, and one hedge fund who allegedly either conducted or facilitated late trading for others in mutual fund shares. In one case, NYSOAG charged a former executive and senior trader of a prominent hedge fund with conducting late trading on behalf of that firm through certain registered broker-dealers in violation of

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

New York's state securities fraud statute.[25] This individual pleaded guilty in the New York State Supreme Court. In another case brought by DOJ, prosecutors charged several broker-dealers with conducting late trading for their clients. According to DOJ officials, criminal prosecution of late trading is fairly straightforward because the practice is a clear violation of federal securities laws.[26]

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

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

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

[26]The practice of placing an order after the calculation of net asset value, but receiving the previously calculated net asset value is a violation of SEC Rule 270.22c-1, the SEC's forward pricing rule. Rule 270.22c-1 requires funds, their principal underwriters, dealers, and other intermediaries authorized to consummate transactions in fund shares to assign the net asset value that is calculated after the receipt of any purchase or redemption order.

SEC Prefers Informal Procedures for Making Criminal Referrals

SEC rules set forth what SEC staff characterize as "formal" and "informal" procedures for making referrals for criminal prosecution. Under what SEC staff described as the formal referral procedures, the Director of Enforcement reviews cases to be recommended for criminal prosecution in coordination with the Office of the General Counsel, and, according to senior Enforcement staff, seeks Commission authorization for the recommended referral. Senior Enforcement staff told us that SEC has not used the formal procedures in over 20 years because the Commission has given the ability for making informal criminal referrals to Enforcement staff. According to these staff, the Commission found that it was approving all formal staff requests to make criminal referrals, so it was more efficient to give SEC staff the authority to make the referrals themselves. Under these more informal procedures, staff at the assistant director level or higher have delegated authority to communicate with other agencies regarding cases of mutual interest, including referring cases for criminal prosecution.[27]

According to senior Enforcement staff and regional staff, if staff attorneys uncover what they believe might be criminal violations, they inform their assistant director and other management officials about such findings. Staff at the assistant director or associate director level decide whether the staff's findings merit a criminal referral, and if so, call the local U.S. Attorney's Office or other criminal authority to see whether they have an interest in the case.[28] According to SEC staff, if the criminal authority is interested in the case they send a letter requesting formal access to SEC's investigative files for that case. These staff said that the primary benefit of the informal referral process is that it allows for an efficient flow of information between agencies. For example, SEC staff can tip off DOJ about potential criminal cases and DOJ officials also can call SEC and make informal referrals of cases for potential civil prosecution.

[27] See 17 C.F.R. § 203.2, which authorizes Enforcement staff at the assistant director level to communicate, or to authorize attorneys to communicate, information gleaned from SEC investigations or examinations to law enforcement authorities.

[28] Several regional assistant and associate directors told us that when deciding whether to refer a case to DOJ they consider factors such as the severity and seriousness of the conduct, whether the case is outside SEC's jurisdiction (for example, obstruction of evidence is outside of SEC's jurisdiction), and whether individuals involved have previous records of illegal conduct.

While Potentially Efficient, Informal Procedures Do Not Provide Critical Management Information on the Referral Process

Although SEC's informal procedures may make the communication of criminal violations to DOJ efficient and enable an effective cooperative relationship between the agencies, they do not include requirements for the documentation of these referrals. Currently, Enforcement staff do not document what cases have been referred, to whom, or why. Senior Enforcement staff told us that the documentation of criminal referrals was unnecessary for several reasons. First, they said that such documentation would not aid them in managing the referral process, as they already have processes to ensure that cases with criminal potential are appropriately referred. For example, in addition to the day-to-day monitoring of cases at the associate director level, which results in informal referrals to criminal authorities, the Director or Deputy Director of Enforcement conducts quarterly reviews of SEC's case inventory to ensure, among other things, that referrals are being made. Further, they said that Commission members as a matter of course question staff about their cooperation with criminal authorities when staff request approval for an enforcement action. Second, they said that since the wave of high profile corporate accounting scandals that began in 2000, DOJ has had unprecedented interest in pursuing securities fraud cases. According to SEC staff, senior DOJ officials discuss cases of mutual interest with SEC staff in regular joint meetings and as part of federal regulatory and law enforcement working groups of which both SEC and DOJ are members.[29] SEC staff cited the recent cooperation between criminal law enforcement and SEC in the mutual fund cases as a good example of how well these processes work in alerting criminal prosecutors to appropriate cases. Further, they said that as each local U.S. Attorney's Office (USAO) sets its own prosecutorial priorities, the most effective way for SEC staff to learn what each USAO considers a useful referral is through strong, informal relationships.

While such informal relationships between SEC and criminal law enforcement authorities might be essential to their effective cooperation, appropriate documentation of decision-making is an important management tool. According to federal internal control standards previously discussed, policies and procedures, including appropriate documentation, helps ensure that management directives are carried out. Internal control procedures include a wide range of diverse activities such as authorizations, verifications, and the creation and maintenance of

[29]SEC is a member of the Corporate Fraud Task Force, Bank Fraud Working Group, and the Commodities Fraud Working Group.

related records that provide evidence that these activities were executed. Without such documentation, the Commission cannot readily determine and verify whether staff make appropriate and prompt referrals. Also, the Commission does not have an institutional record of the types of cases that are referred over the years. Such information is essential for appropriate management and oversight of the referral process. For example, although Enforcement staff told us that the director's quarterly review of cases involves a discussion of cooperative law enforcement activities, they said that it does not include a written report on criminal referrals made. Instead, the director must informally poll his staff if he wants to develop a list of such referrals, which introduces the likelihood of reporting error. Similarly, in conducting our work, SEC was unable to tell us what cases had been referred to criminal law enforcement without contacting staff assigned to the case or directing us to do the same. Further, we found that other financial regulators such as NASD and CFTC record their criminal referrals to manage their referral processes. Documentation of referrals might also serve as an additional internal indicator of the effectiveness of SEC's referral process.

In addition to aiding SEC management, information about the number, type, and reasons for SEC criminal referrals could also serve as an important tool for congressional oversight. Although SEC does not have jurisdiction over DOJ and other criminal law enforcement authorities and is not responsible for their decision to act or not upon a referral, the maintenance of evidence of SEC referrals could serve as verification that criminal authorities were made aware of appropriate cases. For example, senior Enforcement staff told us that prior to the corporate accounting fraud scandals, DOJ was not as interested as it is now in pursuing securities fraud. In an environment where changing priorities can influence the types of cases criminal law enforcement agencies pursue, the documentation of referrals would provide some assurance that SEC is consistently considering cases for potential criminal prosecution.

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

SEC provides training and guidance to its staff on federal laws and regulations regarding employment with regulated entities and also requires former staff to notify SEC if they plan to make an appearance before the agency. However, SEC does not require departing staff to report where they plan to work as do other financial regulators. According to SEC staff, they have not tracked postemployment information because SEC examiners and other staff are highly aware of employment-related restrictions. SEC staff also said that since agency examiners have traditionally visited mutual fund companies periodically to conduct examinations, they are less likely to face potential conflicts of interest than bank examiners who may be located full-time at large institutions. Nonetheless, SEC staff have told us that as part of recently implemented and planned changes to SEC's mutual fund oversight program they are assigning monitoring teams to the largest and highest-risk mutual fund companies. The teams would have more regular contact with fund management over a potentially longer period of time. In addition, a new SEC rule requiring all mutual fund firms to designate a chief compliance officer may increase an existing demand for SEC examiners to fill open positions in the compliance departments at regulated entities. As a result, the potential for employment conflicts of interest might increase.

SEC Offers Ethics Training and Counseling Services to Employees on Federal Employment Restrictions but Does Not Ask Where Employees Plan to Work

Federal laws place restrictions on the postfederal employment of executive branch employees. Specifically, these laws generally prohibit federal executive branch employees from participating personally and substantially in a particular matter that a person or organization with whom the employee is negotiating prospective employment has a financial interest.[30] For example, a senior staff member of SEC's Ethics Office told us that as a result of this law, SEC examiners and enforcement staff cannot negotiate employment with a firm that is the subject of an ongoing examination or enforcement action in which they have direct involvement, although they are not prohibited from obtaining employment with such firms after the completion of the examination or enforcement action in which they had such involvement. However, federal law prohibits former federal executive branch employees from "switching sides" and representing their new employer before any federal court or agency concerning any matter in which the employees were personally and

[30] 18 U.S.C § 208(a). Section 208(b) sets forth circumstances under which exceptions to the prohibition may be granted.

substantially involved during the time of their federal employment.[31] According to the SEC ethics staff, if a former SEC examiner accepted employment with a firm that the examiner had previously examined, the examiner would be permanently barred from communicating with SEC regarding the examination in which he or she had participated. In addition, former senior employees are prohibited for a period of 1 year following federal employment from communicating with or appearing before their former federal employer on behalf of anyone with the intent to influence agency action. This "cooling-off" period is 2 years concerning any matter that was pending under a former employee's official responsibility during the 1-year period prior to termination of federal employment.[32] Violation of either the "seeking employment" or postfederal employment activity restrictions can result in civil and criminal sanctions.

The SEC Ethics Office provides annual ethics training and offers ethics counseling to SEC examiners, Enforcement staff, and other employees to explain these and other conflict-of-interest laws and how to avoid violating them. Further, under SEC rules, former SEC staff are required to file a notice with SEC within 10 days after being employed or retained as the representative of any person outside of the government in any matter in which an appearance before, or communication with, SEC or its employees is contemplated.[33] This notice must include a description of the contemplated representation, an affirmative statement that the former employee did not have either personal and substantial responsibility or official responsibility for the matter that is the subject of the representation while employed by SEC, and the name of the SEC division or office in which the former employee had been employed. Senior Ethics Office staff said that upon receiving these notices they verify with the former division or office that the contemplated representation does not involve a matter that the person had responsibility for during his or her employment with SEC.

While these notices provide SEC with information on some employees' postemployment activities and allow SEC to monitor compliance with postfederal employment activity restrictions, they do not provide SEC

[31] 18 U.S.C. § 207(a).

[32] 18 U.S.C. § 207(b).

[33] 17 C.F.R. § 200.735-8(b)(1). This rule applies to all former SEC staff for 2 years after leaving the agency.

with information on the postemployment plans of all of its departing staff at the time they announce their intention to leave the agency. SEC currently does not require departing staff to report where they plan to work, a procedure required by other financial regulators to better ensure that seeking employment restrictions have not been violated. For example, OCC and the Federal Reserve Banks of New York and Chicago obtain information from departing staff, or at least examination staff in the case of the Federal Reserve Banks, on where they are going to work.[34] NASD also tracks information on departing staff's subsequent employment with member firms, although they do not ask staff directly for it.[35] Officials from three of these agencies said that they also ask for this information to assess whether the quality of the employee's prior regulatory work could have been compromised by a potential conflict of interest with the employee's new place of employment. For example, when departing examiners, enforcement attorneys, and other professional staff go to work for a bank with whom they have recently been involved in a regulatory matter, OCC requires a review of their related work products, as does the Federal Reserve Bank of New York for departing examiners.[36] Similarly, NASD requires staff to conduct a reexamination of a member firm if that firm hires an employee who was involved in a recent examination of that firm or a review of the related examination workpapers if the employee was a former supervisor, assistant/associate director, or attorney who

[34]The Federal Reserve Banks of Chicago and New York have codes of ethics that contain seeking employment restrictions.

[35]According to NASD, every month NASD staff generate a list of employees who have left the agency and submit this list to NASD's Central Registration Depository (CRD), which is an electronic database that contains information on the employees of member firms. If the CRD identifies people from the list that are working at a member firm, NASD determines whether these individuals were involved in an examination of that firm within the last 12 months of their employment with NASD. NASD also has a code of ethics that prohibits NASD employees from acting in any NASD matter with whom the employee is seeking employment.

[36]Some senior bank examiners are prohibited by law from going to work directly for a bank they were recently involved in examining. Section 6303(b) of the Intelligence Reform and Terrorism Prevention Act of 2004 amended Section 10 of the Federal Deposit Insurance Act to prohibit former bank examiners from going to work for any depository institution if, during their last year as an employee of a federal banking regulator, they served more than 2 months as senior bank examiner of that depository institution. This prohibition is in effect for a period of one year after the termination of their employment with the federal banking regulator. See Federal Deposit Insurance Act § 10(k), to be codified at 12 U.S.C. § 1820(k).

reviewed or worked on the examination. SEC currently does not require similar workpaper reviews or reexaminations.[37]

Changes to SEC Examination Program and Potential Increased Private Sector Demand for Examiners Could Increase Conflicts of Interest and Need for Postemployment Tracking

According to senior staff from SEC's Office of Compliance Inspections and Examinations (OCIE), which administers SEC's nationwide examination program for investment companies and other regulated entities, postemployment tracking has not been viewed as essential because SEC examiners face fewer potential conflicts of interest than bank examiners. Senior OCIE staff told us that unlike bank examiners, SEC examiners typically participate in multiple examinations in the course of the year. Banking regulators, on the other hand, often have examiners stationed permanently on site at the largest financial institutions.[38] OCIE staff said that because SEC examiners do not have prolonged contact with management at regulated entities, there is little opportunity for them to develop the type of relationships that could lead to conflicts of interest.

However, recently implemented and planned changes to SEC's mutual fund oversight program might increase the potential for employment conflicts of interest. As part of these changes (which we review in a forthcoming report), OCIE is creating monitoring teams of two or three examiners to be assigned to review the operations and activities of the largest and highest-risk mutual fund companies on an ongoing basis, as opposed to conducting periodic routine examinations. We note that SEC's planned approach for large mutual fund companies is intended to be similar to the bank regulators' approach to bank supervision at large financial institutions, in which teams are assigned full-time to monitor the largest institutions. Such an approach would increase the contact SEC examiners have with fund management and potential for conflicts of interest.

Further, SEC's new rule requiring all mutual fund firms to designate a chief compliance officer may increase an existing demand for SEC examiners and other staff to fill open positions at the compliance departments of regulated entities. SEC examiners told us that departing

[37]Procedures such as asking departing staff where they are going to work and reviewing their related work products when appropriate can help provide reasonable assurance, not absolute assurance, that conflicts of interests are avoided.

[38]According to one banking regulator, examiners of smaller banks typically spend a few weeks on site while conducting their examinations.

SEC examiners commonly obtained employment in the compliance departments of regulated entities. Further, these examiners and securities industry officials told us that having former SEC staff at these firms was very beneficial because SEC staff have expertise in compliance issues and are compliance-oriented. One securities industry official said former SEC examiners and other staff are a natural source of expertise for firms that were involved in the recent mutual fund trading abuses and that want to correct their problems. While the compliance departments at regulated entities may benefit by hiring experienced SEC staff, an increase in the employment potential of examiners and other staff at these firms could also increase the potential for conflicts of interest.

Conclusions

After the mutual fund trading abuses were uncovered in September 2003, SEC acted swiftly to bring enforcement actions against prominent firms and individuals involved in the misconduct and obtained some of its highest penalties in history from them in settlements. SEC has also consistently applied its procedures for establishing such penalties. However, we identified weaknesses in SEC's internal controls that may limit its capacity to effectively manage its criminal referral process. Currently, SEC does not require staff to document that a referral has been made to a federal or state criminal investigative authority or the reasons for such referrals. According to federal internal control standards, such documentation is important for verifying that management directives have been carried out. Without such documentation, SEC's ability to measure the performance of its criminal referral process and to help ensure effective congressional oversight of that process is limited.

We also found that SEC has not established controls that could help ensure the independence of staff from the fund industry as they carry out SEC's critical oversight work. Although SEC provides ethics training to its employees regarding seeking employment and postemployment conflict-of-interest laws, the agency does not require departing staff to provide information on their future employment plans. In the absence of such information, SEC's capacity to ensure compliance with conflict-of-interest laws related to postemployment opportunities is limited. Further, SEC does not have procedures in place requiring review of departing employees' workpapers should a potential conflict of interest be discovered. SEC's recently implemented and planned changes to its mutual fund examination program that will likely involve greater contact between examiners and company officials as well as the potential that agency staff will seek to become compliance officers underscore the need for the agency to ensure compliance with these critical conflict of interest laws.

Recommendations

To strengthen SEC's management procedures and better ensure that agency responsibilities are being met, the SEC Chairman should ensure that the agency take the following two actions:

- document informal referrals to criminal authorities for potential criminal prosecutions and the reasons for such referrals; and
- request that departing employees provide the name of their next employer as part of exit procedures and establish procedures to review the departing employees' related work products if a potential conflict of interest is determined to exist.

Agency Comments and Our Evaluation

SEC provided written comments on a draft of this report, which are reprinted in appendix II. SEC also provided technical comments, which were incorporated into the final report, as appropriate. SEC agreed with our recommendations. SEC indicated that it is in the process of converting its investigation opening form to a web-based application, which will provide for documentation of informal referrals to criminal authorities. SEC also noted steps it is taking to avoid conflicts of interests that could affect the implementation of SEC programs and activities, which include establishing a formal ethics component to exit procedures. As part of this process, SEC will ask departing staff to provide information about the identity of their next employer, and, to the extent a potential conflict is identified, will investigate as appropriate.

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 SEC and interested congressional committees. We will also 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 Wesley M. Phillips, Assistant Director, or me at (202) 512-8678. GAO staff who made major contributions to this report are listed in appendix III.

Richard J. Hillman
Director, Financial Markets and
Community Investment

Appendix I: Scope and Methodology

The objectives of our report were to (1) compare the severity of civil money penalties (penalties) obtained in the mutual fund cases with penalties obtained in the past and with similarly egregious cases, review the Securities and Exchange Commission's (SEC) penalty-setting process in these cases, and discuss SEC's coordination with state securities regulators in civil enforcement actions; (2) provide information on state and federal criminal enforcement actions regarding market timing and late trading violations; (3) assess SEC's management procedures for making referrals to the Department of Justice (DOJ) and state authorities for potential criminal prosecution; and (4) evaluate SEC's procedures for ensuring compliance with federal laws and regulations that govern employees' ability to negotiate and take positions with regulated entities, such as mutual fund companies.

To compare the severity of penalties obtained in the mutual fund cases with penalties obtained in the past and with similarly egregious cases, review SEC's penalty-setting process in these cases, and discuss SEC's coordination with state securities regulators in civil enforcement actions, we obtained copies of SEC enforcement actions and settlement orders related to market timing and late trading cases and compared them to corporate accounting fraud and investment banking analyst cases, which SEC staff identified as similar to the mutual fund cases in the egregiousness and pervasiveness of misconduct. We obtained these documents from SEC's Web site and SEC staff reviewed the list of cases we compiled for accuracy. We then calculated and compared the average penalties obtained in these three types of cases. We also obtained data from SEC on the 30 highest penalties obtained from entities in settlement, according to their records, and similar data for individuals. This data allowed us to compare the penalties obtained in the mutual fund trading abuse cases to the penalties obtained in past cases. In addition, we obtained information from SEC, the Commodity and Futures Trading Commission (CFTC), the Office of the Comptroller of the Currency (OCC), and the NASD on the criteria and processes they use to determine penalties and data from CFTC and OCC on their highest settlements and from NASD on its mutual fund trading abuse settlements. Then, to determine whether SEC used its criteria and processes consistently when evaluating what penalties to seek in the late trading and market timing cases, we reviewed documentation pertaining to a selection of 11 out of 14 enforcement actions SEC brought against investment advisers charged with market timing abuses. These 11 cases were distributed among six regional SEC offices. We interviewed regional examiners and attorneys assigned to each case and reviewed the related investigative record. For example, we reviewed enforcement actions and settlement orders, staff analyses of economic harm caused and benefit gained, memorandums from the Division of Enforcement to the Commission, and SEC examinations for each of these investment advisers and their associated fund companies dating back several years. The mutual fund companies we chose to review were among the 100 largest mutual fund companies nationwide, as measured by the size of customer assets under management as of August 1, 2003. We also interviewed two legal scholars and economists who have conducted recent research on SEC penalties or mutual fund trading abuses to obtain additional views on SEC's penalty-setting process. In addition, we interviewed securities regulators or law enforcement officials from three states that coordinated settlement negotiations with SEC in bringing their own enforcement actions against investment advisers involved in 11 of the 14 SEC enforcement actions mentioned above and obtained copies of the related enforcement actions and settlement orders from their Web sites. These regulatory or law enforcement entities were the New York State Office of the Attorney General (NYSOAG), the Colorado Attorney General's Office, and the New Hampshire Bureau of Securities Regulation.

To provide information on state and federal criminal enforcement actions regarding market timing and late trading violations, we interviewed staff from SEC, NYSOAG, the Wisconsin Attorney General's Office, and DOJ and obtained copies of late trading and market timing-related criminal complaints from the Web sites of the relevant federal or state criminal authorities.

To assess SEC's management procedures for making referrals to DOJ and state authorities for potential criminal prosecution, we reviewed SEC rules governing these referrals and interviewed staff from SEC, DOJ, and NYSOAG. We also interviewed officials from NASD and CFTC on their referral procedures and obtained copies of relevant rules and policies. We evaluated SEC's referral procedures using *Standards for Internal Controls in the Federal Government*.[1]

To evaluate SEC's procedures for ensuring compliance with federal laws and regulations that govern employees' ability to negotiate and take positions with regulated entities, such as mutual fund companies, we reviewed applicable laws and regulations, interviewed staff from and

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

reviewed the policies and procedures of SEC, OCC, the Federal Reserve Banks of Chicago and New York, and NASD for promoting staff compliance with federal laws limiting the seeking of employment opportunities and postemployment activities of federal executive employees and, in the case of the Federal Reserve Banks and NASD, codes of ethics that also include seeking employment restrictions.

We performed our work in Boston, Mass.; Chicago, Ill.; Denver, Colo.; New York, N.Y.; Philadelphia, Penn.; and Washington, D.C., between May 2004 and May 2005 in accordance with generally accepted government auditing standards. SEC provided written comments on a draft of this report, which are reprinted in appendix II. Our evaluation of these comments is presented in the agency comments section.

Appendix II: Comments from the Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
450 Fifth Street, N.W.
Washington, D.C. 20549

DIVISION OF
ENFORCEMENT

April 28, 2005

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

Re: Mutual Fund Trading Abuses

Thank you for the opportunity to review and comment on the draft report primarily concerning the Securities and Exchange Commission's ("Commission") penalties in settled mutual fund market timing and late trading cases. The report discusses how well the Commission's Division of Enforcement adhered to policy in setting the penalties. In addition, it makes recommendations regarding criminal referrals and procedures regarding employees' compliance with laws related to new employment.

I appreciate the collegiality with which your staff worked to prepare the report and discussed the report's findings and recommendations with my staff. As the report points out, the Division of Enforcement has consistently applied Commission policy in setting penalties.

Furthermore, we agree with your findings and recommendations, and have already decided to implement them. Our specific comments are as follows:

I. Documenting Informal Criminal Referrals

The draft report found that the Commission's procedures for making informal criminal prosecution referrals do not require documentation of the referral. The draft report recommends that we document informal criminal referrals, including the types of cases referred, and the reasons for such referrals. We agree with this finding and recommendation. We are in the process of converting our investigation opening form to a web-based application, which will provide for documentation of informal referrals to criminal authorities. By modifying the form, we will record the types of matters that are informally referred to criminal authorities and provide the reasons for the referral.

Mr. Richard J. Hillman
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II. Employee Exit Procedures

The draft report also recommends that the agency head should ensure that the agency "requests that departing employees provide the name of their next employer as part of exit procedures and, if a potential conflict of interest is determined to exist, establish procedures to review the departing employee's related work products, as appropriate." The Commission is committed to avoiding even the appearance that conflicts of interest could affect the implementation of Commission programs and activities. To that end, the Commission is undertaking the following actions: increasing the number of ethics liaison officers who are employed in the exam program; increasing the amount of training related to seeking employment and post-employment issues with a particular emphasis on training current employees about the potential issues regarding former employees; and establishing a formal ethics component to exit procedures. As part of this exit process employees will be asked to provide information about the identity of their next employer. Should a potential conflict be identified, the Commission will investigate, as appropriate.

We appreciate the care that is evident in the draft report and its recommendations. If we can be of any further assistance, please contact me at (202) 942-4500 or Joan McKown at 942-4530.

Yours truly,

Stephen M. Cutler
Director

Appendix III: Major Contributors to this Report

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Acknowledgments

In addition to those named above, Fred Jimenez, Stefanie Jonkman, Marc Molino, Omyra Ramsingh, Barbara Roesmann, Rachel Seid, David Tarosky, and Anita Zagraniczny made key contributions to this report.

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