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SEC Adjusted Its Oversight in Response to Rapid Industry Growth

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The Honorable Paul S. Sarbanes
Ranking Minority Member
Committee on Banking, Housing, and
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This report discusses our self-initiated review of the Securities and Exchange Commission's (SEC) regulation and oversight of investment companies. We initiated this review because rapid growth in open-end investment companies, commonly known as mutual funds, had the potential to outstrip SEC's ability to properly oversee the industry.[1] In our September 1995 report on bank mutual funds, we noted that SEC had obtained additional staff to oversee mutual funds, but that continued industry expansion could create new challenges for SEC in meeting its oversight responsibilities.[2] Our objective for this review was to determine how SEC has responded to this rapid industry growth in carrying out its mutual fund oversight through inspections, disclosure review, and other regulatory activities. We are sending this report to you because it pertains to matters under your jurisdiction.

Results in Brief

SEC has increased its inspection staffing and adjusted the focus of its inspections in response to the rapid growth in the mutual fund industry. Since fiscal year 1990, SEC has more than doubled the number of its staff available to do mutual fund inspections. SEC used the increased staff to

[1]The term "open-end" refers to the fact that shareholders may redeem shares issued by the mutual fund on any day on which the fund is open for business. Other types of investment companies include closed-end funds, unit investment trusts, separate accounts of insurance companies issuing variable annuities, and business development companies. The distinguishing feature between closed-end and open-end funds is that closed-end fund shares are not redeemable. Instead, closed-end fund shares are generally traded on one of the major stock exchanges or in the over-the-counter market. As used in this report, the term "mutual funds" refers to open-end investment companies.

[2]Bank Mutual Funds: Sales Practices and Regulatory Issues (GAO/GGD-95-210, Sept. 27, 1995).

expand the scope of its inspections to focus primarily on the activities of families of funds, called fund complexes, that may present high risks to investors. It also expanded its coverage of investment advisers, and SEC inspectors spent more time on each mutual fund inspection. As a result, the number of mutual fund inspections completed each year has remained relatively constant. SEC still met its current goal of inspecting fund complexes at least once every 5 years, and most had been inspected more than once since fiscal year 1992. As inspections became more comprehensive, the number of deficiencies that inspectors found increased each year, but few deficiencies were considered serious enough to be referred for potential enforcement action. SEC reported that the mutual fund industry had generally been free of major scandal for the last 2 decades.

SEC selectively reviews mutual funds' disclosure documents. A large part of the growth in the mutual fund industry has been in adding new funds to already existing fund complexes. As a result, although each new mutual fund must submit disclosure documents, these documents often contain disclosures that are very similar to those of other funds within the same complex. SEC officials told us that, by selectively reviewing these documents, they have been able to review all new or materially different disclosures, despite an almost 8-percent increase in the number of documents that SEC has received since fiscal year 1994 and despite a relatively constant staffing level in this function over the same period.

SEC's other regulatory activities relating to mutual funds include (1) granting exemptions from various provisions in mutual fund laws and regulations, (2) developing and modifying rules to implement these provisions, and (3) providing the industry, Congress, and other government agencies with SEC interpretations of mutual fund laws and regulations. These activities have allowed the mutual fund industry to change dramatically in size and scope without substantially amending existing laws. SEC staff devoted to these regulatory activities increased nearly 45 percent from fiscal years 1990 to 1993. However, by 1996, this staffing had declined 14 percent from its peak in 1993. Nonetheless, SEC reduced its backlog of pending applications for exemptions in 1996. SEC officials said that the National Securities Market Improvement Act of 1996 (P.L. 104-290) will increase their rulemaking workload by about 30 percent through 1997, and that this increased workload may delay progress on other rulemaking initiatives.

Background

Lower returns on alternative investments and a rapidly rising stock market have contributed to mutual funds becoming an increasingly popular and important investment vehicle. Assets managed by mutual funds have more than tripled since the end of fiscal year 1990 from about $1 trillion to nearly $3.2 trillion by June 1996, exceeding insured commercial bank deposits, which totaled about $2.6 trillion in June 1996. As of April 1996, an estimated 63 million individuals, making up about 37 million households, owned mutual funds. At that time, these fund-owning households represented 37 percent of all U.S. households, which was up from 31 percent in mid-1994. Much of this growth in mutual fund ownership has been attributed to investors buying mutual funds to save for retirement.

SEC regulates and supervises the operations of all mutual funds under four federal securities laws: the Investment Company Act of 1940 (Investment Company Act), the Investment Advisers Act of 1940 (Investment Advisers Act), the Securities Act of 1933 (1933 Act), and the Securities Exchange Act of 1934 (1934 Act). Of these four acts, only the Investment Company Act was written specifically to regulate the formation and operation of mutual funds. The Investment Company Act requires mutual funds to register with SEC and subjects their activities to SEC regulation. The act also imposes detailed requirements on the operation and structure of mutual funds.[3] The core objectives of the act are to (1) ensure that investors receive adequate, accurate information about the mutual fund; (2) protect the physical integrity of the fund's assets; (3) prohibit abusive forms of self-dealing; (4) prevent the issuance of securities that have inequitable or discriminatory provisions; and (5) ensure the fair valuation of investor purchases and redemptions.

The other three acts regulate mutual fund activity in various ways. The Investment Advisers Act requires mutual funds' advisers to register with SEC; imposes reporting requirements on those registered investment advisers; and prohibits the advisers from engaging in fraudulent, deceptive, or manipulative practices.[4] The 1933 Act requires that mutual fund shares offered to the public be registered with SEC. In addition, SEC has adopted rules under this act and the Investment Company Act that require extensive disclosures in a mutual fund's prospectus. The 1933 Act

[3]The Investment Company Act's requirements include rules on the composition and election of boards of directors, disclosure of investment objectives and policies, and approval of investment advisory and underwriting contracts. The act also imposes limitations on transactions with affiliates, defines permissible capital structures and custodial arrangements, requires reports to shareholders, and requires maintenance of records.

[4]Banks are exempt from the registration requirements of the Investment Advisers Act when their employees directly sell mutual funds.

also regulates mutual fund advertising. The 1934 Act, among other things, regulates how mutual funds are sold. This act requires that persons distributing mutual fund shares or executing purchase or sale transactions in mutual fund shares be registered with SEC as securities broker-dealers.[5]

Broker-dealers who sell mutual funds are regulated and examined by both SEC and the National Association of Securities Dealers (NASD). NASD, which is subject to SEC's oversight, was established pursuant to the 1934 Act as a self-regulatory organization for brokerage firms, including those firms that engage in mutual fund distribution. SEC and NASD regulate broker-dealers by periodically examining broker-dealer operations on-site and investigating customer complaints. NASD has also established specific rules of conduct for its members that, among other things, provide standards for advertising and sales literature, including filing requirements, review procedures, approval and recordkeeping obligations, and general standards. In addition, NASD tests individuals to certify their qualifications as registered representatives[6] and has primary responsibility for regulating advertising and sales literature used to solicit and sell mutual funds to investors.

On October 11, 1996, the National Securities Market Improvement Act of 1996 (1996 Act) was signed into law. This legislation represented the most significant overhaul of the securities regulatory structure in decades. Among other things, the 1996 Act divided responsibility for regulation of the financial markets between the federal and state governments. The 1996 Act amended the Investment Company Act to promote more efficient management of mutual funds, protect investors, and provide more effective and less burdensome regulation. The amendments, in effect, made the regulation of mutual fund disclosures and advertising the exclusive province of the federal government by preempting state securities registration, merit review, and prospectus disclosure requirements for investment companies. In connection with investment company offerings, states (1) can continue to require companies to file, with the state, documents they file with SEC and can charge fees for such filings; and (2) will retain jurisdiction over fraud and deceit and unlawful broker-dealer conduct under applicable state law. The 1996 Act also

[5]Broker-dealers combine the functions of brokers and dealers. Brokers are agents who handle public orders to buy and sell securities. Dealers are principals who buy and sell stocks and bonds for their own accounts and at their own risk.

[6]A registered representative is a person who is associated with a broker-dealer and who must acquire a background in the securities business and pass relevant qualifications examinations that are administered for the industry by NASD. The broker-dealer must register with SEC and be a member of a self-regulatory organization, such as NASD or a stock exchange.

amended the Investment Advisers Act, including provisions that divided responsibility for regulation of investment advisers between the states and SEC.

SEC's oversight focuses on protecting mutual fund investors by minimizing the risk to investors from fraud, mismanagement, conflicts of interest, and misleading or incomplete disclosure. SEC oversees mutual funds primarily through (1) performing on-site inspections of mutual funds' compliance with federal securities laws; (2) reviewing disclosure documents that mutual funds are required to file with SEC; and (3) engaging in other regulatory activities, such as rulemaking, responding to requests for exemptions from applicable federal securities laws, and providing interpretations of those laws. In addition, although not discussed in this report, SEC's enforcement program is responsible for investigating and prosecuting violations of securities laws related to mutual funds.

In the early 1990s, SEC considered its oversight of the investment management industry, including mutual funds, to be severely understaffed. SEC attributed its staffing shortage to the explosive growth in the industry since 1983; the industry's use of increasingly complex products, such as derivatives, which may be difficult both to value and trade during falling markets;[7] and the use of more complex organizational structures. Believing that inadequate staffing threatened its ability to protect investors, SEC reallocated positions from its other regulatory programs to investment management oversight and obtained additional positions through congressional appropriations. Of SEC's six major regulatory programs, its investment management program was the second smallest in fiscal year 1990, comprising about 12 percent of SEC's total authorized positions.[8] By fiscal year 1996, the investment management program had become SEC's second largest regulatory program, comprising almost 20 percent of SEC's total authorized positions.

Objective, Scope, and Methodology

Our objective was to determine how SEC has responded to the rapid growth in mutual funds in carrying out three parts of its mutual fund oversight—inspections, review of disclosure documents, and other regulatory activities. To determine the requirements for SEC's oversight, we

[7]Derivatives are financial products whose value is determined from an underlying reference rate, index, or asset. The underlying includes stocks, bonds, commodities, interest rates, foreign currency exchange rates, and indexes that reflect the collective value of various financial products.

[8]In addition to Investment Management Regulation, SEC's five other major regulatory programs are the following: Prevention and Suppression of Fraud, Full Disclosure, Supervision and Regulation of Securities Markets, Program Direction, and Legal and Economic Services.

reviewed applicable securities laws; SEC rules and regulations implementing these laws; and relevant testimony, commentary, and studies, including a 1992 SEC study on the regulation of investment companies.[9]

To determine how SEC carries out these responsibilities, we (1) reviewed agency documents that described SEC's mutual fund oversight activities, including relevant mission statements, policies and procedures, training materials, staffing data, budget estimates, and annual reports, and (2) interviewed SEC officials. We also reviewed workload and performance data for these oversight activities, including the number and results of inspections completed during fiscal years 1992 through 1996, the number and type of disclosure documents SEC received and reviewed during fiscal years 1994 through 1996, and the number of applications for exemptions and requests for no-action and interpretive letters that SEC processed during fiscal years 1994 through 1996. We were unable to include and compare data for all disclosure documents from previous fiscal years because of changes in how SEC counted the filings received.

To determine how frequently SEC has inspected mutual funds, we compared the inspections completed between fiscal years 1992 and 1996 with a list of fund complexes SEC prepared for its field offices to use in scheduling their fiscal year 1996 inspections. We judgmentally selected for this analysis 5 of the 10 SEC field offices that inspect investment companies. We selected the four field offices—New York, Chicago, Boston, and Philadelphia—that are responsible for inspecting the largest number of mutual funds, and one field office—Fort Worth—that is responsible for inspecting a smaller number of mutual funds. To obtain more information on how SEC conducts and documents mutual fund inspections, we interviewed SEC officials from the New York, Boston, and Philadelphia field offices and reviewed selected inspection reports and workpaper files at those locations.

We did our work between March 1996 and March 1997 at SEC in Washington, D.C., and at SEC field offices in New York, Boston, and Philadelphia. We did our work in accordance with generally accepted government auditing standards. SEC officials provided written comments on a draft of this report, which are reprinted in appendix I. Our evaluation of these comments is presented on page 29.

[9]Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management, United States Securities and Exchange Commission, May 1992.

Increased Staffing Benefited the SEC Inspection Program

Periodic, on-site inspections are the cornerstone of SEC's oversight of mutual funds. Increasing its inspection staff during the 1990s allowed SEC to broaden its inspection objectives. Although SEC frequently changed its objectives, it met its goal of inspecting fund complexes at least once every 5 years, and most of the complexes were inspected about once every 3 years. Despite SEC's increase in staffing, the total number of yearly investment company inspections did not increase because SEC used the staffing increase to expand its coverage of investment advisers and because inspectors spent more time on each investment company inspection. The total number of deficiencies that inspectors found increased each year. The inspectors referred an average of about 5 percent of these deficiencies to SEC's Division of Enforcement for potential enforcement action.

On-Site Inspections Are the Cornerstone of SEC Oversight

SEC's inspections are meant to enhance investor protection because they provide a direct check of mutual funds' compliance with the securities laws, including the accuracy of disclosures made to investors. Rather than inspecting individual mutual funds, SEC's inspections primarily focus on fund complexes, which are generally groups of mutual funds—sometimes called fund families—that are associated with common advisers or underwriters. In most cases, investors can, with a telephone call, switch between individual funds within the same fund complex and change their investment strategies. Fund complexes can be large. For example, as of June 1996, the Fidelity fund complex, which was the largest complex, consisted of over 200 funds and more than $400 billion in assets.

The growth in the number of fund complexes has not been as great as the growth in the number of individual mutual funds because many existing fund complexes have expanded their complement of individual funds to attract and serve diverse market segments. According to data provided by SEC, between December 1991 and June 1996, the number of individual mutual funds grew by about 75 percent, from 3,427 funds to 5,996 funds. In comparison, the number of fund complexes grew by 40 percent, from 578 complexes in December 1991 to 812 complexes in June 1996.[10] As of June 1996, the 50 largest fund complexes accounted for about 74 percent of total complex assets.

Before May 1995, SEC's Division of Investment Management (Division of IM) was responsible for conducting and coordinating inspections of mutual

[10]SEC includes open-end funds, closed-end funds, separate accounts of insurance companies, or some combination of these in its definition of fund complexes. SEC also considers single or stand-alone funds to be fund complexes. According to SEC, only a small number of stand-alone funds remain.

funds as well as disclosure reviews and regulation. In an effort to enhance its overall inspection efforts and promote a more effective use of its inspection resources, SEC created the Office of Compliance Inspections and Examinations (OCIE), which began operating on May 1, 1995, to consolidate its inspection programs for entities over which it had regulatory authority. These entities include investment companies, investment advisers, broker-dealers, and self-regulatory organizations.[11]

OCIE conducts inspections to (1) evaluate mutual funds' compliance with securities laws and regulations, (2) determine if funds are operating in accordance with disclosures made to investors, and (3) assess the effectiveness of funds' internal control systems. Inspections of mutual funds and their related investment advisers are carried out primarily by staff in 10 of SEC's 11 field offices.[12] If a mutual fund's principal investment adviser is located outside of the United States, responsibility for inspecting that fund is assigned to headquarters, rather than a field office. Although OCIE provides detailed inspection manuals and general guidance on selecting mutual funds for inspection, the SEC field offices have primary responsibility for selecting which mutual funds to inspect in accordance with those guidelines.

The separation of the inspection function from the Division of IM has caused the Investment Company Institute (ICI), the national trade association of the mutual fund industry, some concern about the potential for inconsistent oversight of mutual funds. ICI officials told us that separating the staff members who write and interpret the law from those who inspect companies for compliance with the law creates the potential for differences in how the laws are interpreted and applied. SEC officials agreed that this potential exists but told us that staff members in the Division of IM and OCIE have worked well together since the oversight functions were separated, and that both units have made an effort to maintain ongoing communication. However, the SEC officials also said that the current good working relationship between the two units is largely because the staff members in OCIE who oversee mutual fund inspections are essentially the same people who were responsible for doing these inspections in the Division of IM before OCIE's creation. SEC officials said they intend for these two units to work well together regardless of who the individuals are in each unit. However, according to some SEC officials, as personnel changes occur in the future—in either the Division of IM or

[11]Responsibility for inspecting these entities previously was divided between SEC's Division of Market Regulation and Division of IM.

[12]One SEC field office does not have investment company inspection staff.

OCIE—maintaining good communications and consistent oversight of mutual funds may become more difficult.

SEC generally does two types of inspections: routine and for cause. Routine inspections result primarily from the passage of time, but they are done more frequently if (1) the inspection staff believes that a fund or its agents are engaged in risky activities or (2) the fund has a history of significant problems. Inspection staff do for-cause inspections when, for example, specific facts come to their attention that suggest something may be wrong at a fund. Most inspections are routine. Inspections either can be announced in advance or can be done on a surprise basis. According to SEC, the first inspection of a fund and its service agents usually is done on a surprise basis. Generally, for-cause inspections are also done on a surprise basis or with short notice. However, for most SEC inspections, inspectors notify the fund several weeks in advance of the starting date for on-site work.

Before going on-site to the offices of the fund complex, inspectors are to obtain and review information from the complex about its structure and operations and prepare an inspection plan. When they arrive on-site, inspectors typically will meet with senior management and do a walk-through of the offices. The inspectors will then begin reviewing documents and interviewing other fund personnel as necessary. During the on-site inspection, inspectors are to look for patterns of activity and evidence that (1) the fund complex and its agents are conducting their activities in compliance with the securities laws, (2) potential conflicts of interest are being identified and resolved to the benefit of shareholders, (3) operations are being conducted consistent with disclosures made to shareholders, and (4) internal control systems seem to be effective. Inspectors are usually on-site for 1 or 2 weeks, but they could be on-site for up to 2 months when inspecting very large fund complexes. Inspectors also usually review the activities of mutual funds' advisers concurrent with their inspection of the fund complex. After inspectors complete on-site work, they generally spend additional time in the SEC field offices preparing the inspection report and completing any follow-up work.

SEC inspectors also collect compliance-related data and investigate particular industry-related issues. For example, early in fiscal year 1995, SEC was interested in obtaining information on the types of controls that were in place to address personal trading by fund personnel. At that time, SEC directed the inspection staff to obtain information on the content of funds' codes of ethics during their inspections. The Investment Company

Act permits fund personnel to engage in personal trading in securities that are held or are to be bought by a fund, as long as the investment activities are not fraudulent, manipulative, or abusive. However, conflicts of interest between fund personnel and shareholders can arise, for example, whenever fund personnel with access to information about securities and potential fund transactions buy and sell securities for their personal accounts. To address conflicts of interest, the act requires mutual funds—as well as their investment advisers and principal underwriters—to adopt a code of ethics designed to prevent abusive personal trading. SEC found that most funds inspected appeared to have the controls necessary to identify abusive trading practices by fund personnel after the trading occurred.

More recently, SEC directed its inspection staff to do inspections that target "soft-dollar" payments among investment companies, investment advisers, and broker-dealers. A provision in the 1934 Act allows advisers to receive soft-dollar payments for directing transactions to a specific broker for execution. These payments are typically in the form of investment research services. SEC officials told us that they were examining whether advisers are using the soft-dollar payments for expenses that are unrelated to research, such as salaries. Such uses of soft-dollar payments would constitute a conflict of interest that, if not disclosed, would violate the Investment Advisers Act.

Increases in Inspection Staffing Allowed SEC to Broaden Its Inspection Objectives

SEC allocated most of the increase in its investment management industry oversight staffing during fiscal years 1990 through 1996 to doing investment company and investment adviser inspections. During this period, SEC frequently changed the objectives of its investment company inspection program in an effort to more efficiently use these resources. Although many of these changes were in response to industry growth, SEC broadened its inspection objectives in fiscal year 1995 primarily because of the increase it had attained in inspection staffing.

As shown in table 1, SEC's inspection staff years grew by 154 percent during fiscal year 1990 through fiscal year 1996, with about 53 percent of that growth occurring during fiscal year 1993 through fiscal year 1996.

Table 1: SEC Inspection Staff Years, Fiscal Years 1990-96

Fiscal year	Number of staff years
1990	114
1991	137
1992	148
1993	189
1994	216
1995	262
1996	290
Percentage change, 1990-96	154%
Percentage change, 1993-96	53%

Source: SEC.

SEC devoted more staff to its inspection program to increase both the scope and frequency of mutual fund inspections. SEC reported that its inspections of mutual funds are particularly important because SEC, rather than a self-regulatory organization, is responsible for providing first-line oversight of the investment management industry. An OCIE official told us that SEC's inspection program now has enough staff for examining existing investment companies.

With the availability of additional inspection staff, SEC changed its inspection objectives during the 1990s. During fiscal years 1991 through 1993, SEC's inspection objective was to attain the greatest dollar coverage with the limited number of inspection staff years available. With this in mind, SEC directed its inspection staff to concentrate on inspecting the 100 largest fund complexes and all money market funds. SEC also directed its inspection staff to inspect small and medium-sized fund complexes, if time was available after this objective was achieved. SEC reported that the inspections completed during these fiscal years were limited in scope, focusing mainly on whether fund activities were consistent with the information disclosed to investors and whether funds accurately valued their shares. SEC also reported that some activities, such as fund marketing and shareholder services, were rarely scrutinized.

SEC revised its inspection objectives for fiscal year 1994 because a large number of small and medium-sized fund complexes had never been examined and others had not been examined for several years. Because of the focus during fiscal years 1991 through 1993 on inspecting large fund complexes and all money market funds, inspectors had only been able to

inspect about 200 small and medium-sized fund complexes. SEC estimated that about 350 fund complexes had not been inspected since 1990, and that many, especially those fund complexes connected with banks, had been formed after 1990 and had never been inspected. Consequently, for its fiscal year 1994 inspection program, SEC headquarters directed the field offices to inspect all small and medium-sized fund complexes that had not been inspected since 1990 and all new fund complexes formed during that year. Again, except for fund complexes that had never been inspected, inspections were to be limited in scope, with an emphasis on portfolio management activities.

Reflecting the increase in inspection staffing as well as the significantly increased use of mutual funds by American investors, SEC broadened its inspection objectives for fiscal year 1995. Inspection staff were to begin doing comprehensive inspections of all fund complexes. These comprehensive inspections were to include all fund activities and cover all funds in a complex, not just certain types of funds as had been the case before 1995. In addition, inspection staff were to inspect the 50 largest complexes on a 2-year cycle and inspect all other complexes on a 4-year cycle.

Responding to suggestions from field office staff members, SEC revised its inspection objectives for fiscal year 1996. Specifically, instead of reviewing the activities of all funds within a complex on a set schedule, SEC officials decided that a more efficient use of inspection staff would be to focus on those activities and complexes that presented higher risks to investors. Using the following criteria, SEC field offices were to select for inspection those fund complexes with (1) a history of compliance problems, (2) a sudden increase in the number of investor complaints, (3) an appearance on one of the Division of IM's "watch lists,"[13] (4) a report of processing problems, and (5) length of time since last inspected. While the field offices were given discretion in selecting fund complexes for inspection, SEC instructed them to examine all fund complexes at least once every 5 years. An SEC official told us that a 5-year inspection cycle was chosen on the basis of feedback from field office staff members and experience with varying inspection cycles over the years. Together, these factors indicated that a maximum of 5 years between inspections allowed for the most cost-effective use of SEC's inspection staff. The official also said that 5 years is the most time allowed between inspections but that if inspectors

[13]The Division of IM develops several watch lists for particular types of funds on the basis of characteristics that may indicate the need for additional scrutiny by the Division of IM and OCIE.

considered a fund complex to present a greater risk of having problems, it would be inspected more frequently.

SEC did not change its inspection program objectives for fiscal year 1997. However, SEC deferred routine inspections through the end of March 1997, while the field offices focused exclusively on doing the fieldwork for the soft-dollar study. An SEC official told us that for-cause inspections took precedence over the soft-dollar study during this period. The official said that although using the inspection staff to do the soft-dollar study would likely result in fewer inspections being completed during fiscal year 1997, this would not prevent SEC from meeting its overall goal of inspecting fund complexes at least once every 5 years.

Despite Changing Objectives, SEC Inspected Most Fund Complexes

As SEC changed its objectives between the ends of fiscal years 1990 and 1996, its field offices changed their inspection plans to meet these objectives. Instead of focusing on the results of these changing annual objectives, we determined the extent to which SEC inspected the total number of fund complexes existing during this period.

To assess SEC's inspection coverage, we analyzed data on completed inspections for 5 of the 10 SEC field offices responsible for inspecting fund complexes.[14] These 5 field offices, which included the 4 offices with the largest number of complexes to inspect, were responsible for inspecting 547 of the 757 fund complexes (about 72 percent) in SEC's database as of the beginning of fiscal year 1996.[15]

As indicated in table 2, our analysis showed that between the beginning of fiscal year 1992 and the end of fiscal year 1996, these 5 field offices completed inspections of 493 of the 519 fund complexes (about 95 percent) for which they were responsible.[16] Table 2 also displays the last year in which these 493 fund complexes had been inspected. For example, of the 168 fund complexes that the New York field office was responsible for inspecting, 4 were last inspected in fiscal year 1992. The data show that the 5 field offices last inspected 408 of the 519 fund complexes (about 79 percent) between the beginning of fiscal year 1994 and the end of fiscal year 1996.

[14]Completed inspections included both limited scope and comprehensive inspections.

[15]Of the 547 fund complexes, 460 (about 84 percent) included mutual funds. Some of these fund complexes were first established after fiscal year 1992.

[16]We eliminated 6 fund complexes determined to be inactive and another 22 complexes that were not inspected by these field offices because they were the responsibility of another field office.

Table 2: Inspections of Fund Complexes by Year Last Inspected for Five SEC Field Offices, Fiscal Years 1992-96

Field office	Fund complexes at end of fiscal year 1996	Last fiscal year fund complexes were inspected					Total fund complexes inspected
		1992	1993	1994	1995	1996	
Boston	82	0	19	16	25	18	**78**
Chicago	159	0	14	36	43	57	**150**
Fort Worth	30	0	8	3	10	8	**29**
New York	168	4	26	44	63	23	**160**
Philadelphia	80	3	11	23	22	17	**76**
Total	**519**	**7**	**78**	**122**	**163**	**123**	**493**
Percentage	•	1%	15%	24%	31%	24%	**95%**

Note: Although some fund complexes were inspected more than once during these 5 fiscal years, the data shown for each fiscal year reflect only the last year they were inspected. Therefore, the total shown for the number of fund complexes inspected is not the total number of inspections completed by these five field offices during these fiscal years.

Source: GAO analysis.

We also found that the five field offices, on average, inspected fund complexes more frequently than every 5 years. For example, these offices inspected about 52 percent of the 519 fund complexes for which they were responsible more than once since the start of fiscal year 1992 and inspected each of the top 50 complexes about 3 times.

Number of Investment Company Inspections Has Not Increased

The increase in the number of SEC inspectors has not led to an increase in the number of investment company inspections completed each year. This total remained relatively constant, with the inspection staff averaging about 320 inspections a year since fiscal year 1992.[17] According to an SEC official, the number of investment company inspections has not increased because SEC has used the increase in inspection staffing to expand its coverage of investment advisers. Also, inspectors spent more time on each investment company inspection due to (1) a need to train newly hired inspectors, (2) a change in how inspectors approached mutual fund inspections, and (3) a change in how inspectors inspected fund administrators.

Generally, inspectors are to be cross-trained to inspect both investment companies and investment advisers. Of the 10 field offices that do

[17]The total number of inspections completed each year includes, in addition to fund complexes, inspections of administrators, business development companies, sponsors of unit investment trusts, and insurance company sponsors of variable insurance products. Of the 1,613 inspections completed from the end of fiscal year 1992 to the end of fiscal year 1996, 120 were inspections of these entities.

investment company and investment adviser inspections, an SEC official said that only 2 field offices do not extensively cross-train their inspectors to do both types of inspections. Because the same pool of inspectors inspect both investment companies and investment advisers, there is an ongoing trade-off in the number of investment company and investment adviser inspections completed. Therefore, although the number of investment company inspections done each year since fiscal year 1992 has remained relatively constant, averaging about 320 a year (see table 3), the number of investment adviser inspections completed has increased from 614 in fiscal year 1992 to 1,446 in fiscal year 1996. The 1996 Act transfers to the states regulatory responsibility for investment advisers that manage less than $25 million in assets, and SEC expects the number of investment adviser inspections completed in fiscal year 1997 to decrease partly because of the transition. SEC has projected that it will increase investment adviser inspections 13 percent in fiscal year 1998.

Since fiscal year 1992, the average time SEC inspectors spent on each investment company inspection more than doubled, from about 164 hours in fiscal year 1992 to about 376 hours in fiscal year 1996. An SEC official attributed the increase in inspection time primarily to the use of senior inspectors to provide on-the-job training for the large number of new inspectors that were hired beginning in fiscal year 1994. The official said that it took longer to complete inspections because the new inspectors were inexperienced and were still being trained during fiscal years 1995 and 1996. During fiscal year 1997, SEC expects senior inspectors to continue devoting considerable time to on-the-job training of the 38 new inspectors hired during 1996. SEC reported that, by the end of fiscal year 1997, all inspectors hired since fiscal year 1994 will have received classroom and on-the-job training and are expected to be able to function as fully qualified investment company and investment adviser examiners. Although all new inspectors are to be fully trained, SEC is not planning to increase the number of fund complexes inspected beyond 320 during fiscal year 1998. At that level, fund complexes would be inspected at an average frequency of once every 3.1 years. SEC reported that this inspection frequency, combined with more frequent inspections of fund complexes that present above average risk factors, provides adequate inspection oversight of mutual funds. An SEC official said that inspecting fund complexes any more frequently would not be an efficient use of inspection staff.

Another reason for the increase in time spent on each inspection was a change in SEC's approach to mutual fund inspections. Before fiscal year

1994, SEC primarily did limited-scope inspections of the 100 largest fund complexes and all money market mutual funds. In fiscal year 1995, SEC directed its inspectors to do comprehensive inspections of all fund types. SEC reported that these inspections required more time to complete because inspectors were to review all activities of funds in the complex. In fiscal years 1996 and 1997, SEC directed its inspectors to use a risk-based approach to doing inspections. These inspections required inspectors to focus on fund activities that presented higher risks to investors. As a result, each inspection is customized, to some extent, according to the types of activities of each fund complex. Areas in which these risk-based inspections may focus include portfolio management, such as brokerage commissions and principal trades; sales practices; internal controls; classification, diversification, and appropriateness of investments; and personal securities transactions, including funds' code of ethics.

SEC inspections of fund administrators also contributed to the increase in inspection time. Administrators perform many of a fund's key functions such as keeping the fund's books and records, filing the necessary reports with SEC, helping the fund establish and maintain compliance procedures and internal controls, and calculating the fund's net asset value.[18] Some administrators perform these functions for several fund complexes, which different SEC field offices may be responsible for inspecting. Before fiscal year 1995, inspectors assessed the adequacy and appropriateness of services that administrators provided to funds as a part of their inspection of the fund complex. As a result, inspections of administrators usually focused on only a limited number of funds and did not always consider all of the key functions. In fiscal year 1995, SEC began conducting more comprehensive inspections of administrators that served more than one fund complex. The inspections were to provide an adequate test of all administrator systems used in serving multiple mutual funds. These inspections involved larger inspection teams and, on average, took more time to perform than an inspection of a fund complex. For example, during fiscal years 1995 and 1996, inspectors spent an average of nearly 750 hours on each of the 28 inspections of administrators that served more than one fund complex.

[18]Net asset value is the daily share price of a mutual fund. It is based on the market value of assets held by the fund, less liabilities, divided by the number of outstanding fund shares.

More Deficiencies Were Found, but Few Were Referred for Enforcement Action

During fiscal years 1993 through 1996, the number of deficiencies that SEC inspectors found increased steadily. In fiscal year 1993, inspectors found 1,281 deficiencies; in fiscal year 1996, the inspectors found 4,713 deficiencies. To some extent, this increase reflects the changes in the scope of SEC's inspections from primarily doing annual, limited scope inspections of the 100 largest fund complexes and all money market funds to inspecting complexes on the basis of the risks they pose as well as the length of time since last inspected. Another reason for the increase in the number of deficiencies was a change in SEC's system for reporting deficiencies after fiscal year 1993. Specifically, instead of reporting each deficiency identified at a fund complex as one violation, inspectors were to begin reporting any systemic deficiencies as having been found in each individual fund within the complex. For example, if a systemic pricing problem was identified at a fund complex that had six funds, the inspector would report that six deficiencies, not one, had been identified.

When inspectors find that a fund complex has failed to comply with the securities laws, the deficiency may relate to any of a broad range of issues, from recordkeeping to misrepresentations or other sales practice abuses. According to SEC, if the deficiencies found are serious, such as when investor funds or securities are at risk, the inspectors may refer the matter to the Division of Enforcement, which would decide whether to pursue an investigation and possible enforcement action. If deficiencies are not referred to the Division of Enforcement, SEC sends a letter to the fund complex identifying all the deficiencies inspectors found and requiring that they be corrected. SEC requests that the fund complex respond to the deficiency letter within 30 days by informing SEC of what the complex has done or plans to do to correct the problems identified. If no deficiencies are found, no further action is taken.

SEC reported in 1994 that the mutual fund industry had generally been free of major scandal for the last 2 decades.[19] As shown in table 3, during fiscal years 1992 through 1996, SEC referred deficiencies to the Division of Enforcement in about 5 percent of the investment company inspections. SEC addressed the majority of these deficiencies by sending deficiency letters to the fund complexes.

[19] Personal Investment Activities of Investment Company Personnel, Report of the Division of IM, SEC, Sept. 1994.

Table 3: Disposition of Investment Company Inspections, Fiscal Years 1992-96

Disposition	Number (percentage) of inspections, by fiscal year					
	1992	**1993**	**1994**	**1995**	**1996**	**Total for 1992-96**
Deficiency letters	235 (74)	240 (73)	244 (78)	261 (75)	254 (82)	**1,234 (77)**
Enforcement referrals	14 (4)	8 (2)	21 (7)	23 (7)	14 (5)	**80 (5)**
No action	65 (21)	74 (23)	37 (12)	53 (15)	37 (12)	**266 (17)**
Other	2 (1)	6 (2)	11 (4)	11 (3)	3 (1)	**33 (2)**
Total	**316 (100)**	**328 (100)**	**313 (100)**	**348 (100)**	**308 (100)**	**1,613 (100)**

Note 1: In addition to dispositions of fund complex inspections, investment company inspections also include inspections of administrators, business development companies, sponsors of unit investment trusts, and insurance company sponsors of variable insurance products. Of the 1,613 inspections completed between fiscal years 1992 and 1996, 120 were inspections of these entities.

Note 2: Percent totals may not add to 100 due to rounding.

Source: SEC.

Among the reasons SEC officials cited for inspections not producing more enforcement referrals were that (1) the Investment Company Act imposes detailed, substantive requirements on the structure and operations of mutual funds; (2) frequent inspections by SEC inspectors instill discipline in funds' operations; (3) the industry generally supports strong regulation and strict compliance with the securities laws; (4) a self-regulatory organization, NASD, separately reviews funds' sales literature; and (5) market conditions have generally been favorable as the industry has grown. An SEC official also said that because violations of the Investment Company Act typically do not involve fraud or investor losses, these violations generally are not remedied through enforcement actions. However, the official noted that, although many of the violations were "technical," they are still violations of the act that need to be remedied, especially before the violations become a major problem that could cause investor losses.

SEC Selectively Reviewed Disclosure Documents

SEC's responsibility for ensuring that mutual funds comply with applicable disclosure requirements has become particularly important because of the increasing number of mutual fund investors. Many of these investors may be investing for the first time and may not be sophisticated in legal or financial matters. SEC's disclosure review staffing level has remained relatively constant during fiscal years 1990 through 1996. However, despite receiving an increased number of documents to review since 1994, SEC officials said that by selectively reviewing mutual funds' disclosure documents, staff members have been able to review all new or materially different disclosures.

SEC's disclosure review process is intended to ensure that (1) disclosure documents filed by mutual funds are complete, (2) all proposed activities are legal, and (3) information contained in the filings is not misleading to investors. Disclosure documents filed by mutual funds include initial registration statements, amendments to registration statements, proxy statements, and periodic reports. Initial registration statements have three parts: (1) a prospectus, which must be provided to every fund investor and includes information about a fund's investment objectives and policies, investment risks, and all fees and expenses; (2) a statement of additional information, which contains more detailed information on all aspects of the fund and must be provided upon request to fund investors; and (3) other information required to be in the registration statement, including copies of a fund's contracts with its various service providers. Amendments to registration statements are filed whenever important information in a mutual fund's original, effective registration statement has changed. Mutual funds are also required to annually file amendments updating their financial information. Most of the disclosure documents that SEC receives are amendments. Proxy statements are to be filed when a mutual fund is considering an event that requires shareholder approval before taking action, such as changing its investment policies and objectives or merging with another fund. Periodic reports primarily contain statistical data about a mutual fund, such as the fund's assets, expenses, portfolio turnover, and type of investments.

All disclosure documents filed by mutual funds are subject to review and comment by staff in SEC's Division of IM. However, to focus on those filings that are most in need of review, Division of IM staff members selectively review the disclosure documents SEC receives. In fiscal year 1996, SEC received a total of about 30,000 disclosure documents from all types of investment companies, including mutual funds, which was an almost 8-percent increase since fiscal year 1994. SEC officials told us that

completely reviewing all of these documents is not necessary because many of them contain repetitive information. The officials also said that a complete review would be an inefficient use of SEC's limited resources. Instead, SEC's disclosure review process is intended to ensure that SEC's review focuses on new information in disclosure documents as well as filings that contain material changes.[20]

SEC procedures specify that routine filings, presenting no novel questions of law, need not be targeted for review. For example, many initial registration statements filed by mutual funds that are members of the same fund complex are similar to previous filings by other funds in the complex. That is, even though certain funds in a complex may have different investment objectives and techniques, their prospectuses often contain similar disclosure information regarding other aspects of the funds' operations, such as procedures for share purchase and redemption and the descriptions of the investment adviser, underwriters, transfer agent, and officers and directors. In these instances, the funds' initial registration statements often include disclosures from previous filings that had already been subject to SEC review and comment. Because SEC considers that reviewing these disclosures again would be redundant, it focuses its review on more substantive information in the filing by identifying what information is new. SEC officials said that fund counsel generally initiate requests for selective review and indicate to SEC which parts of the filing have already been reviewed. SEC's disclosure review staff can also identify situations in which a selective review can be done and are to alert fund counsel to that option.

SEC also selectively reviews amendments to registration statements so that only material changes routinely undergo staff review. Similar to initial registration statements, many matters in an amendment may already have been considered by staff members in processing other filings by that fund. To focus SEC's disclosure review on significant changes, mutual fund counsel represent to SEC whether changes contained in an amendment are considered material. Amendments that contain only nonmaterial changes may become automatically effective without SEC review.[21] Examples of nonmaterial changes include bringing a fund's financial statements up-to-date, changing the fund's phone numbers, and increasing the number

[20]Material changes include disclosures that are significantly different from those disclosures previously made by the investment company in its most recent filing of the same kind.

[21]Rule 485(b) [17 CFR230.485] permits amendments filed by registered mutual funds that contain enumerated routine or nonmaterial changes to become automatically effective on the date the amendments are filed with SEC or on a later date, designated by the fund, that does not exceed 30 days after the date on which the amendment was filed.

or amount of securities proposed to be offered. According to SEC officials, most amendments filed by registered mutual funds contain nonmaterial changes and, therefore, are not routinely reviewed. In contrast, they said that amendments containing material changes are routinely reviewed with a focus on the disclosures that have changed.

Proxy statements and periodic reports also undergo a targeted review by SEC. Specifically, proxy statements covering nonroutine matters, such as a merger, are targeted for review; although more routine proxies, such as the standard approval of a mutual fund's auditors, are not. Of the periodic reports received, SEC only reviews the attachment to the second of two semiannual reports that most mutual funds file every year. The attachment is the fund auditor's report on the mutual fund's internal controls.

Table 4 shows SEC's coverage of investment company disclosure documents for fiscal years 1994 through 1996.[22] During this period, SEC devoted an average of 44 staff years to reviewing these documents. Although the total percentage of disclosure documents reviewed over these years averaged about 31 percent, the breakdown of documents reviewed indicates that SEC dedicated its disclosure staff to reviewing those documents most likely to have new or materially different information. For example, the data show that SEC reviewed a high percentage of initial registration and proxy statements each year, reflecting the greater possibility that these filings would contain new or materially different information. Furthermore, SEC reviewed at least 93 percent of the initial registration statements filed by mutual funds for each of these years. In contrast, SEC reported that its staff members reviewed between 12 and 15 percent of the amendments SEC received each year, reflecting the high number of these filings that would contain nonmaterial changes.

[22]We were unable to include and compare data for all disclosure documents from previous fiscal years because of changes in how SEC counted the filings received.

Table 4: SEC Coverage of Investment Company Disclosure Documents, Fiscal Years 1994-96

Disclosure document	Number and percentage of disclosure documents reviewed, by fiscal year		
	1994	1995	1996
Initial registration statements			
Filed	2,570	2,321	2,410
Reviewed[a]	1,605	1,570	1,800
Percentage reviewed	62%	68%	75%
Initial mutual fund registration statements			
Filed	1,040	819	811
Reviewed	960	755	761
Percentage reviewed	93%	93%	94%
Amendments			
Filed	16,388	15,258	16,864
Reviewed	2,008	1,859	2,494
Percentage reviewed	12%	12%	15%
Proxy statements			
Filed	624	711	750
Reviewed	579	595	669
Percentage reviewed	93%	84%	89%
Periodic reports			
Filed	8,300	9,500	10,000
Reviewed	4,150	4,750	5,000
Percentage reviewed	50%	50%	50%
Total disclosure documents[b]			
Filed	27,882	28,060	30,024
Reviewed	8,342	8,774	9,963
Percentage reviewed	30%	31%	33%

[a]The number of initial registration statements reviewed includes those submitted by open-end (mutual funds), closed-end, and unit investment trust portfolios.

[b]The total number of disclosure documents filed and reviewed includes the initial registration statements, amendments, proxy statements, and periodic reports. The number of initial mutual fund registration statements filed and reviewed is included as a subset of the initial registration statements.

Source: SEC.

SEC officials told us that, because they already review the most important disclosures, additional staffing would not necessarily be used to increase the number of filings reviewed each year. Instead, the officials said they could use more resources to help them in related disclosure activities,

such as helping mutual funds improve and simplify prospectus language and performing long-range strategic planning. However, SEC officials also said that a current rulemaking project could substantially affect, at least for the short term, SEC's ability to maintain adequate review coverage of disclosure documents. Specifically, the proposed rule would substantially revise the registration form and prospectus requirements for mutual funds. During the initial implementation period of the proposed rule, SEC does not plan to use its selective review procedures for initial registration statements or amendments because it would need to ensure that mutual funds are complying with the new disclosure requirements.[23]

SEC's Other Regulatory Activities Enabled the Industry to Evolve Without Major Legislative Changes

SEC's Division of IM is also responsible for other regulatory activities, which include responding to requests for exemptions from the requirements of the Investment Company Act, rulemaking, and providing interpretations of applicable laws and rules through issuing interpretive and "no-action" letters.[24] According to SEC officials, these activities are a primary way of allowing the industry to grow and change while continuing to protect investors. During fiscal years 1990 through 1993, staff years for these regulatory activities grew by nearly 45 percent. However, from the end of fiscal year 1993 to the end of fiscal year 1996, staffing decreased by almost 14 percent. SEC officials said that this staffing decrease occurred largely because staff members often pursue opportunities created by rapid growth in the investment management industry. They also said that additional staff could help them keep pace with industry developments and be more proactive in identifying and reacting to industry changes.

Exemptive Orders Enable SEC to Adapt Its Regulation to Industry Changes

The Investment Company Act and the Investment Advisers Act allow SEC to issue orders granting exemptions from one or more provisions of these acts, or from rules issued by SEC under these acts. Congress gave SEC this authority to prevent the acts from being unduly restrictive. To grant an exemption, SEC must find that the exemption is necessary or appropriate in the public interest, is consistent with investor protection, and is fairly intended by the policy and provisions of the act. The exemptive order permits the applicant to engage in the activity described in the application that would otherwise be prohibited by the act. Exemptive orders apply

[23]The selective review procedures would still be applicable in some instances. For example, after SEC reviews a fund's revised registration form, all funds within the same complex can request a selective review of subsequent filings using the revised form.

[24]A no-action letter is a request from investment companies and investment advisers that SEC staff react to a particular set of circumstances or facts as outlined in the letter by indicating whether the Division of IM would recommend taking an enforcement action if those circumstances were to occur.

only to the applicant. However, if the exemption appears to have general applicability, such as when a number of similar requests for exemptive relief are made, SEC may decide to adopt a rule granting exemptions to all funds that can meet the conditions.

According to SEC officials, SEC's authority to grant exemptions from various provisions of the Investment Company Act and the Investment Advisers Act has enabled it to adapt its regulation of investment companies so that SEC is both receptive to new innovations and able to keep pace with the general evolution of the investment management industry. For example, in the 1970s, SEC first allowed trading of money market mutual funds through exemptive orders. These funds used specialized pricing methods that were not contemplated by the Investment Company Act. Also, SEC recently adopted a rule, following the issuance of numerous exemptive orders, that allows mutual funds to sell multiple classes of shares with different fee structures. In the 57 years since the Investment Company Act was enacted, it has been amended significantly only twice—in 1970 and again in 1996.

In a 1992 study of investment company regulation,[25] SEC reported that many responses to its 1990 request for comments on reforming investment company regulation contained complaints that the process for obtaining an exemptive order took too long. In 1995, SEC's Office of Inspector General (OIG) studied the exemptive order process, giving particular attention to its timeliness. The OIG found that, although the process was essentially sound, many outside attorneys were still dissatisfied with how long SEC took to process exemptive applications when novel or complex issues were involved. The OIG made several recommendations to improve the process, including a recommendation that, for applications with these types of issues, the Division of IM modify its guideline requiring initial comments on all applications within 45 days.[26]

Although the Division of IM's response to the OIG's report agreed to adopt most of the recommendations, it did not agree that changing this existing 45-day guideline for novel or complex applications would shorten the amount of time spent reviewing those applications. The Division's response explained that these applications generally take longer to review

[25]Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management, United States Securities and Exchange Commission, May 1992.

[26]To prevent a disproportionate amount of staff time from being spent on routine applications, in part to increase production as well as process applications within the 45-day time frame, the OIG suggested that the Division of IM either provide a different timetable for complex applications or set appropriate due dates for complex, individual applications.

because of the potential effect significant changes to policy may have on the industry and investors. Nonetheless, in its response, the Division agreed to monitor the progress of complex applications more closely and continue to strive to meet its 45-day initial comment period for all applications.

According to SEC data on all exemptive applications processed during fiscal years 1994 through 1996, SEC processed about 10 percent more applications in fiscal year 1996 than it processed in the preceding 2 fiscal years. Although SEC reduced its backlog of pending applications during fiscal year 1996, at the end of that fiscal year, the number of applications not acted on within 45 days had more than doubled from the end of fiscal year 1995. According to an SEC official, the latter increase was due to a loss of staff near the end of fiscal year 1996.

SEC Shapes Mutual Fund Regulation Through Rulemaking

SEC issues rules and regulations that implement the provisions of the securities laws. Through rulemaking, SEC develops rules relating to (1) the disclosure requirements that are applicable to investment companies and investment advisers and (2) the Investment Company Act and the Investment Advisers Act. Rulemaking involves constantly reviewing how well the various rules that SEC has adopted are working. SEC often consults with industry representatives and others affected by the various rules and reviews their suggestions to modify rules. For example, an SEC official told us that, in its efforts to develop rule changes regarding fund disclosure requirements, SEC (1) sponsored focus groups with fund investors, (2) reviewed industry-sponsored surveys on investors' views of fund disclosures, and (3) encouraged comments from individual investors on ways to improve mutual funds' risk disclosure in April 1995. Of about 3,700 comment letters SEC received, about 3,600 were from individuals.

When SEC rulemaking staff find that a particular rule does not appear to be achieving its objective or is burdensome in relation to its benefits, the staff members are to present the problem to SEC Commissioners, who then may consider modifying the rule. SEC gives advance public notice of proposals to adopt new or amended rules and allows time for interested members of the public to comment on the proposals. At the conclusion of the comment period, staff members are to analyze the comments and prepare a summary of their analysis for the Commissioners to consider when determining whether any modifications to existing rules are warranted. Proposals approved by the Commissioners take effect as final rules, usually within a specific time after publication in the Federal Register.

In addition, if SEC receives several very similar requests for an exemption from a particular provision, it may consider promulgating a rule to codify the exemption. To determine if an exemptive rule is needed, the rulemaking staff are to consider whether the exemption should also be applicable to other entities. As previously discussed, money market funds were first allowed to trade through a series of exemptive orders beginning in the 1970s. These orders were later codified into a rule. According to SEC, the exemptions granted and the subsequent rulemaking were critical to the evolution and success of money market funds.

In recent years, much of the Division of IM's disclosure-oriented rulemaking has focused on improving mutual fund prospectuses. For example, two major rule proposals focused on making prospectuses more understandable to investors. The first rule proposal would update and streamline the full prospectus that mutual funds are required to provide investors. It also would improve the risk disclosures required to be made in the prospectus. The second rule proposal would allow investors to purchase shares of mutual funds solely on the basis of information contained in a summary prospectus called a "fund profile."[27] The fund profile provides a summary of the essential information about a mutual fund by addressing nine items in a question-and-answer format. On March 10, 1997, SEC published these proposed rules in the Federal Register.

A number of rulemaking efforts regarding the Investment Company Act and the Investment Advisers Act were under way in the Division of IM at the time of our review. Many of these efforts were mandated by various provisions in the 1996 Act. For example, the 1996 Act initially required SEC to issue rules by April 9, 1997, that (1) separate the regulation of investment advisers between the states and SEC based on asset size and (2) exempt certain private investment companies from SEC regulation. Congress subsequently amended the 1996 Act to provide a 90-day extension of the April 9 deadline for separating investment adviser regulation. However, the rule exempting certain private investment companies from SEC regulation was effective April 9.

[27]The fund profile is a summary of the long-form prospectus. SEC intended that the fund profile provide investors an easy-to-read summary of essential information about the fund, including the fund's investment objectives, risks, and fees. Although investors can buy shares after reading only the fund profile, the profile must disclose that investors have the option to request a full prospectus before making an investment decision. Funds are required to provide investors the full prospectus when the funds confirm investors' purchases. SEC has had a pilot program that permitted funds to use a fund profile since July 31, 1995.

The 1996 Act also gave SEC additional authority in several areas that will require other rulemaking. For example, the 1996 Act (1) gave SEC additional rulemaking authority to define certain fund names as materially deceptive or misleading, (2) expanded SEC's authority to require funds to keep books and records, and (3) allowed SEC to require investment companies to file information more frequently than quarterly to keep information in investment companies' registration statements current. According to an SEC official, several of SEC's ongoing rulemaking efforts, such as proposed rules on personal trading, the use of foreign custodians, and limits on purchasing securities from an affiliated underwriter, have been delayed because SEC's first priority is to complete the implementing rules for the 1996 Act. On March 10, 1997, SEC published its proposed rule on fund names in the Federal Register.

SEC officials told us that SEC's rulemaking function has been affected in the past by high staff turnover and, as a result, SEC has had more inexperienced staff in the rulemaking area than it desired. In addition, the Director of the Division of IM estimated that the 1996 Act is likely to increase the division's workload by about 30 percent in 1997.

SEC Provides Informal Views and Interpretations of Securities Laws

Through issuing no-action and interpretive letters, SEC staff members in the Division of IM provide investment companies, investment advisers, Congress, and other government agencies with their informal views and interpretations about how the federal securities laws apply to proposed transactions that appear to raise compliance issues. These letters, which are available to the public, represent the views of SEC officials who are responsible for administering the laws on a daily basis. SEC officials told us that the letters are an effective method of providing information about how the securities laws are likely to be interpreted and applied.

SEC issues no-action letters in response to requests for its staff members' views on whether they would recommend enforcement action if the particular facts and circumstances outlined in the request were to occur. No-action letters do not make rulings on whether the particular circumstances are legal or illegal—the letters only state whether the Division of IM staff would or would not recommend an enforcement action to the Commission under those specific circumstances. Consequently, unlike exemptive orders, no-action letters do not shield the requester from any liability that may otherwise result if the circumstances outlined in the request were to occur. In addition, SEC has reported that positions in

no-action letters are subject to reconsideration and should not be regarded as precedents binding SEC.

An SEC official told us that no-action letters promote voluntary compliance with the securities laws because the letters inform not only the requester but others as well about the likely legality of a particular proposed transaction. For example, Division of IM staff provided no-action assurances to a mutual fund that wanted to include in its prospectus performance information relating to another fund that its portfolio manager had previously managed. The staff's no-action assurances were based on specific representations made in the request (1) that during the portfolio manager's tenure in managing the other fund, no other person had played a significant part in achieving that fund's performance and (2) that the performance information would not be presented in the prospectus in a misleading manner, nor would that information impede investors' understanding of required prospectus information.

SEC issues interpretive letters in response to requests for its staffs' views on whether the requester has interpreted and applied a particular statute or rule correctly to a particular set of facts or circumstances. According to an SEC official, interpretive letters differ from no-action letters because, rather than simply stating it would not recommend an enforcement action, the Division of IM agrees that the statute or rule in question permits the proposed transaction. Again, SEC officials view interpretive letters as a means of informing the investment management industry about how the laws are actually being applied.

While the Investment Company Act requires that SEC respond to requests for exemptions, responding to requests for no-action and interpretive letters is a discretionary role that SEC has had in place for several decades. According to SEC data, the Division of IM responded to 2,643 requests for no-action and interpretive advice during fiscal years 1993 through 1996. Although the number of no-action and interpretive responses increased each fiscal year during 1993 through 1995—620, 674, and 747, respectively—the number decreased to 602, or about 19 percent, in fiscal year 1996. SEC reported that this decline was a result of its staff having spent time during fiscal year 1996 providing technical assistance to Congress on a number of provisions of the 1996 Act and other legislation.

Conclusions

SEC has responded to the challenges presented by the growth in the mutual fund industry through increasing its inspection staffing and adjusting the

focus of its oversight activities. The effects of these responses cannot be separated from other factors, such as the requirements of the Investment Company Act, industry support for strict compliance with securities laws, and favorable market conditions, that may have contributed to the industry remaining generally free of major scandal. However, the continued proliferation in the number and type of funds offered, the industry's use of increasingly complex products that may be difficult both to value and to trade during falling markets, and the increased reliance by millions of Americans on mutual funds as a source of retirement income make it imperative that SEC's efforts to protect mutual fund investors against abuse continue to be a priority.

Agency Comments and Our Evaluation

We requested comments on a draft of this report from the Chairman, SEC. In response, the Chairman stated that the contents of our report provide a detailed and accurate description of SEC's program for inspecting and regulating mutual funds. He also expressed concern that, if the industry continues to grow at its current pace, SEC will need additional resources to meet its oversight responsibilities.

We agree that industry growth can influence the resources needed to oversee the industry. However, in determining the extent to which an increase in resources would be the most effective response to rapid industry growth, SEC may also be guided by the results it achieves from the program goals and performance measurements that it is developing pursuant to the Government Performance and Results Act of 1993 (GPRA). In July 1993, Congress passed GPRA to improve the efficiency and effectiveness of federal programs by establishing a system to set goals for program performance and to measure results. GPRA directed all federal agencies, including SEC, to develop by September 1997 long-range strategic goals and the measures they will use to gauge their progress toward achieving these goals. GPRA requires that agencies report annually to the President and to Congress on their performance and progress toward meeting their goals. These annual reports are intended to be used by Congress and SEC to assess what SEC is accomplishing with its mutual fund oversight resources and whether additional resources are needed.

We are sending copies of this report to the SEC Chairman and other interested parties upon request. This report was prepared under the direction of Michael A. Burnett, Assistant Director, Financial Institutions and Markets Issues. Major contributors to this report are listed in

appendix II. Please contact me on (202) 512-8678 if you have any questions concerning this report.

Jean Gleason Stromberg
Director, Financial Institutions and
Markets Issues

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Abbreviations

GPRA	Government Performance and Results Act of 1993
ICI	Investment Company Institute
IM	Investment Management
NASD	National Association of Securities Dealers
OCIE	Office of Compliance Inspections and Examinations
OIG	Office of Inspector General
SEC	Securities and Exchange Commission

Comments From the Securities and Exchange Commission

THE CHAIRMAN

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

May 2, 1997

Jean Gleason Stromberg, Esq.
Director, Financial Institutions
and Markets Issues
General Government Division
U.S. General Accounting Office
Washington, DC 20548

Re: GAO Draft Report
MUTUAL FUNDS: SEC Adjusted Its Oversight in Response to Rapid Industry Growth

Dear Ms. Stromberg:

Thank you for the opportunity to comment on the General Accounting Office's draft report and assessment of the Commission's regulation and oversight of mutual funds. The report provides a detailed and accurate description of the Commission's program for investment company regulation and examination. I commend GAO for effectively presenting the scope of the management and regulatory issues the Commission faces in overseeing the fund industry.

As the report observes, the Commission has redesigned its procedures and reallocated its resources when necessary to meet the regulatory challenges posed by exponential growth and new developments in the mutual fund industry. In this way, the Commission has sought to direct its relatively limited resources so as to best serve investors while accommodating innovation and continued growth in the industry. The Commission is concerned, however, that if industry growth continues at its current pace, the agency will require additional resources to meet increasing demands on its regulatory and examination programs.

Thank you for an excellent job of reporting on Commission activities.

Sincerely,

Arthur Levitt

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