

**MEMO# 6811**

March 30, 1995

## **RECOMMENDATIONS FOR IMPROVING MUTUAL FUND INSPECTIONS**

1 See Memorandum to SEC Rules Members No. 22-95, dated March 29, 1995. March 30, 1995 TO: COMPLIANCE COMMITTEE No. 17-95 SEC RULES COMMITTEE No. 49-95 RE: RECOMMENDATIONS FOR IMPROVING MUTUAL FUND INSPECTIONS

SEC

Chairman Levitt recently announced that the SEC has consolidated its investment company, investment adviser and broker-dealer inspection and examination programs into a newly-formed Office of Compliance Inspections and Examinations (OCIE).<sup>1</sup> Therefore, all SEC examinations will be conducted by one office, while rulemaking, interpretations and other non-examination functions will remain with the Divisions of Investment Management and Market Regulation. The OCIE will coordinate the examination efforts of the SEC's regional and district offices. Chairman Levitt has appointed Lori Richards, formerly Executive Assistant to the Chairman, as Director of the Office. The creation of this new office provides us with an opportunity to offer suggestions on how to improve the SEC's inspection of mutual funds. We are interested in your suggestions for improving the inspection process generally and, specifically, on the preliminary suggestions set forth below, which are based upon past comments of members. Preliminary Suggestions for Improving SEC Inspections

1. Coordination with IM - It is important that the OCIE coordinate closely with the Division of Investment Management. This will ensure that, among other things, the OCIE's positions are consistent with IM's. One way this could be accomplished would be to designate a staff person to act as a liaison between the two offices.
2. Provide Advance Notice - Fund complexes should be provided with advance notice of routine inspections. This would enable funds to compile the materials that will be examined ahead of time and make other necessary preparations, which would help to increase the efficiency of inspections. In addition, examiners seem to select two or three "hot" areas (e.g., use of derivatives, personal investing by portfolio managers) on which they devote most of their time. It would be helpful to the industry if those areas were identified ahead of time. This would allow funds to be better prepared on these matters and would be more efficient for examiners. For example, funds would be able to assemble relevant data and materials prior to an inspection, which might be voluminous and time-consuming to collect.
3. Improve Inspection Personnel - The SEC should hire more knowledgeable and competent senior personnel in the regional offices and steps should be taken to improve the continuity at the senior level (which perhaps could be achieved by paying higher salaries). In addition, supervisors or other senior personnel should participate more in the actual inspections. Moreover, junior examiners should be better trained. Consideration should be given to improving the caliber of junior examiners by paying higher salaries. Another suggestion would be to permit and encourage IM staff attorneys to work in the OCIE or the regional offices for a specified period (e.g., six months). This would produce a dual benefit in that

the examiners would have direct access to a staff attorney when legal issues arose and the staff attorney would gain practical experience by directly participating in inspections and dealing with inspection-related issues. 4. Provide Continuous Examiner Training - OCIE should hold training seminars on a frequent basis and keep the regional offices informed of current staff positions and other significant developments. Members of the industry (e.g., lawyers, accountants, portfolio managers, transfer agents) should participate in the SEC's training seminars for examiners. In addition, the OCIE should hold periodic meetings of senior staff in the regional offices to discuss, among other things, issues that have come up in their individual offices and how they were resolved. Such meetings would promote consistency among the regional offices. 5. Inspection Manual - To improve the efficiency of inspections and ensure consistency among the regional offices, the OCIE should update the inspection manual that is currently being used. It also would be helpful if the manual were made available to the industry. 6. Change the Philosophy of the Regional Offices - Inspections should be more helpful and less confrontational. Instead of the regional offices encouraging examiners to bring enforcement cases, which seems to be the current practice, they should promote the importance of the inspection function and stress that it is an integral component of mutual fund regulation and investor protection. Examiners need to understand that they are performing their job adequately even if they never bring an enforcement case. 7. Improve Communication with Funds - The examiners should communicate more with the funds, preferably through an exit interview but at least before a deficiency letter is issued. This would allow funds to clear up any problems or confusion that exists because of a misunderstanding by the examiner of a fund's operations or policies. In addition, at the end of an inspection or maybe after any open issues are resolved, examiners should solicit feedback from fund groups about the inspection process, including any problems they encountered or positive experiences they had. This information should then be provided to the OCIE and used to improve future inspections. 8. Examiners Should Be Better Prepared - More work should be done by the examiners in advance to prepare for an inspection (e.g., the examiner should review fund prospectuses and become generally familiar with no-action letters and exemptive orders granted to the fund before starting an inspection). Advance preparation would better familiarize examiners with the complex and increase efficiency. \* \* \* Please provide me with your suggestions for improving mutual fund inspections, including your views on the suggestions set forth above, by April 12, 1995. My direct number is 202/326-5824 and the fax number is 202/326-5827. Amy B. R. Lancellotta Associate Counsel