

MEMO# 18941

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GAO ISSUES SECOND REPORT REGARDING MUTUAL FUND TRADING ABUSES

©2005 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [18941] June 15, 2005 TO: BOARD OF GOVERNORS No. 29-05 CHIEF COMPLIANCE OFFICER COMMITTEE No. 48-05 COMPLIANCE MEMBERS No. 5-05 PRIMARY CONTACTS - MEMBER COMPLEX No. 26-05 SEC RULES MEMBERS No. 79-05 SMALL FUNDS MEMBERS No. 57-05 RE: GAO ISSUES SECOND REPORT REGARDING MUTUAL FUND TRADING ABUSES The U.S. Government Accountability Office has issued another report to Congressional requesters regarding the mutual fund trading abuses.* The report, which assesses the Securities and Exchange Commission's efforts to impose penalties on violators, (i) discusses the SEC's civil penalties in settled mutual fund market timing and late trading cases; (ii) provides information on related criminal enforcement actions; (iii) evaluates the SEC's criminal referral procedures; and (iv) evaluates the SEC's employee exit procedures. Report Overview The report found that since September 2003, the SEC has brought 14 enforcement actions against investment advisers and 10 enforcement actions against broker-dealer, brokerage- advisory, and financial services firms for mutual fund trading abuses. The penalties the SEC obtained in the market timing and late trading cases are among the highest in the agency's history, ranging from \$2 million to \$140 million, with an average 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. The SEC's penalties in the investment adviser cases also are generally consistent with penalties obtained in cases involving similarly egregious corporate misconduct. In addition, the SEC brought enforcement actions against 24 individuals, many of them high-ranking company executives. The SEC obtained penalties as high as \$30 million * See Mutual Fund Trading Abuses: SEC Consistently Applied Procedures in Setting Penalties, but Could Strengthen Certain Internal Controls, GAO Report to Congressional Requesters (May 2005). In April, the GAO issued a report identifying reasons why the SEC did not detect the trading abuses at an earlier stage. See Mutual Fund Trading Abuses: Lessons Can be Learned from SEC Not Having Detected Violations at an Earlier Stage, GAO Report to the Committee on the Judiciary, House of Representatives (April 2005). For a summary of that report, see Memorandum to Board of Governors No. 17-05, Chief Compliance Officer Committee No. 35-05, Compliance Advisory Committee No. 31-05, Primary Contacts - Member Complex No. 16-05, SEC Rules Members No. 53-05, and Small Funds Members No. 36- 05, dated April 27, 2005 [18801]. 2 against investment adviser executives (among the highest penalties obtained in individual cases) and barred some individuals from their industry for life. The report also found that in determining appropriate

penalties to recommend to the Commission in the investment adviser cases, SEC staff consistently applied criteria that the agency has established. These criteria require the SEC to consider such things as the egregiousness of the conduct, the amount of harm caused, the degree of cooperation, and the penalties obtained in similar cases. The SEC may also consider litigation risks in determining appropriate penalties. Moreover, the SEC has coordinated penalties and disgorgement with state authorities in many of its market timing and late trading cases, although some states obtained additional monetary sanctions. The report notes that state and federal criminal prosecutors told the GAO that, while they have recently investigated market timing conduct, they have generally not pursued criminal prosecution in those cases because market timing is not illegal. On the other hand, they have brought criminal charges in cases involving late trading violations because the practice is a clear violation of the federal securities laws. According to the report, SEC staff said that because 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. The report found, however, that the SEC's capacity to effectively manage its overall criminal referral process to be limited by inadequate recordkeeping. For instance, the 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. The report notes that a 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, which maintain records on referrals. The report also notes that documentation of referrals might serve as an additional internal indicator of the effectiveness of the SEC's referral process and would also be important for congressional oversight of law enforcement efforts in the securities industry. The report found that although the SEC provides training and guidance to staff on federal laws regarding employment with regulated entities and requires former staff to notify the 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, the report notes that other financial regulators obtain information on where departing staff will be employed to assess the potential for violations of employment restrictions. The report states that, in the absence of such information, the SEC's capacity to ensure compliance with conflict-of-interest laws related to postemployment opportunities is limited. Recommendations To strengthen the SEC's management procedures and better ensure that agency responsibilities are being met, the report recommends that the SEC Chairman ensure that the agency take the following two actions: 3 • Document referrals to criminal authorities for potential criminal prosecutions and the reasons for such referrals; and • Request that departing employees identify 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. Jane G. Heinrichs Assistant Counsel