

MEMO# 19181

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GAO REPORT REGARDING SEC'S MUTUAL FUND EXAMINATION PROGRAM

©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. [19181] September 22, 2005 TO: BOARD OF GOVERNORS No. 47-05 CHIEF COMPLIANCE OFFICER COMMITTEE No. 59-05 COMPLIANCE ADVISORY COMMITTEE No. 52-05 PRIMARY CONTACTS - MEMBER COMPLEX No. 41-05 SEC RULES MEMBERS No. 105-05 SMALL FUNDS MEMBERS No. 81-05 RE: GAO REPORT REGARDING SEC'S MUTUAL FUND EXAMINATION PROGRAM The U.S. General Accountability Office has issued a report regarding the Securities and Exchange Commission's new examination procedures for mutual funds at the request of the ranking minority members of the U.S. House of Representatives' Committee on Financial Services and its Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises.¹ The Report: (i) assesses changes the SEC has made to, or is planning for, its mutual fund examination program; (ii) evaluates key aspects of the quality control framework of the SEC's routine mutual fund examinations; and (iii) reviews the adequacy of the SEC's oversight of the NASD and the New York Stock Exchange, particularly with respect to their oversight of mutual fund sales practices. The Report, its recommendations, and the SEC staff's comments thereon are summarized below. Report Overview The Report reviews the examination approach put into place by the SEC following detection of mutual fund trading abuses in 2003. Rather than routinely examining all funds on a regular schedule, the SEC now is conducting targeted examinations focusing on specific risks (e.g., sweep exams), routinely examining funds it perceives to pose the greatest risk of having compliance problems that may harm investors, routinely examining a random sample of lower risk funds, and monitoring larger funds on a continuous basis with dedicated teams of examiners. 1 See SEC's Revised Examination Approach Offers Potential Benefits, but Significant Oversight Challenges Remain, GAO Report to the ranking minority members of the U.S. House of Representatives' Committee on Financial Services and Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (August 2005) ("Report"). 2 While the Report recognizes that the SEC is seeking to focus its limited resources on higher risk funds and activities, it concludes that this approach limits the SEC's capacity: (i) to examine lower risk advisers and funds within a reasonable period of time; (ii) to accurately identify which funds pose higher risk and target them for examination; (iii) and to oversee the hedge fund industry.² According to the Report, the GAO found that the SEC has integrated some quality controls into its routine examinations, but that certain aspects of its framework could be improved. The GAO found deficiencies in certain SEC exam work papers, raising questions about the quality of supervisory review. It also found that the SEC's oversight exams of broker-dealers provide limited information in helping SROs improve their exam quality because the SEC and the SROs use different exam

guidelines and their exams cover different time periods. The GAO also found that the SEC does not have an automated system to track the full scope of work done during its oversight exams and, as a result, the SEC cannot readily determine the extent to which these exams assess mutual fund sales practices. Report Recommendations The Report recommends that the SEC periodically assess the level of resources allocated to the various types of examinations to help ensure that it is effectively using its resources to oversee the mutual fund industry, including broker-dealers that offer mutual funds. It recommends that as part of this assessment, the SEC examine mutual funds that present a low risk profile more frequently than is currently the case, and complete fund risk assessments in a shorter period than it does currently. The Report recommends that the SEC's assessment include a review of its methodology for conducting broker-dealer oversight examinations and whether some portion of the resources currently devoted to these examinations should be used for mutual fund examinations. The Report also recommends that the SEC establish additional policies for improving its controls to ensure examination quality and consistency throughout SEC field offices. The Report specifically suggests that the SEC require: (i) documented, consistent supervisory review of risk scorecards;³ (ii) consistent preparation of written examination plans that document the scope and objectives of routine examinations; and (iii) a review of a sample of completed examinations and work papers to determine whether examinations are conducted according to procedures and done consistently across field offices. Finally, the Report recommends that the SEC electronically track information about the full scope of work performed during broker-dealer oversight examinations, including all major areas reviewed, to determine whether areas are receiving adequate review and to more fully assess the significance of deficiencies and violations found.

SEC Comments on the Report 2 The Report acknowledges that the precise extent of the impact on the SEC's exam workload of overseeing hedge funds advisers is not yet known. 3 The SEC has developed risk scorecards that are used during mutual fund examinations to assess and document a fund's compliance controls in thirteen areas and to determine the amount of additional testing examiners will do. 3 The SEC staff stated that risk-targeted examinations are a reasonable and effective means of quickly addressing risks in the mutual fund industry. They stated that this approach promptly identifies emerging trends and compliance problems, and permits the SEC to compare individual fund firms to their peers. The SEC staff also stated that it is not possible for them to conduct timely, comprehensive routine examinations of every mutual fund and adviser, given the size of the industry and agency resources. In addition, the SEC staff stated that they would fully consider the Report's recommendations regarding improving quality controls for routine fund examinations. Specifically, in 2006, the staff plans to deploy a computer-based document management system, which will convert most, if not all, of the work papers created during examinations into electronic files. These files will be maintained in a consistent manner online for a number of years. In preparation for that deployment, the staff will review how the new technology can enhance the quality of its examination program and will include the GAO's recommendations in that review. The SEC staff also stated that they have formed a working group to explore ways to enhance the value of broker-dealer oversight examinations. Dorothy M. Donohue Associate Counsel