

Testimony Concerning the Securities and Exchange Commission's Examinations of Mutual Funds

**By Lori A. Richards,
Director, Office of Compliance Inspections and Examinations, United States
Securities & Exchange Commission**

Before the U.S. Senate Committee on Banking, Housing and Urban Affairs

March 10, 2004

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee:

Thank you for inviting me to testify today on behalf of the Securities and Exchange Commission concerning our examinations of mutual funds. With more than 95 million Americans invested in mutual funds, representing tens of millions of households, and approximately \$7 trillion in assets, mutual funds are a vital part of this nation's economy. Millions of investors depend on mutual funds for their financial security. As Chairman Donaldson said when he testified before this Committee in November, mutual fund investors have a right to an investment industry that is committed to the highest ethical standards and that places investors' interests first. The Commission's regulatory and enforcement actions, as well as actions by state securities regulators, are intended to prevent and deter market timing and late trading abuses.

The Commission is responsible for examining mutual funds and their investment advisers. There are now some 8,000 funds, managed in over 900 fund complexes, and over 8,000 investment advisers. Until recently, the SEC had approximately 360 staff persons for these examinations. In 2003, budget increases allowed us to increase our staff for fund examinations by a third, to approximately 500 staff. The size of the mutual

fund industry precludes a comprehensive audit of each registrant's operations by examination staff. Our routine examinations, therefore, focus on those areas that, in our view, pose the greatest risk to investors.

Examinations identify compliance problems at individual firms, and also help to identify areas of emerging compliance risk. In recent years, for example, examiners have identified and Commission staff have addressed a number of practices that may harm investors, including, for example, abusive soft dollar arrangements, favoritism in the allocation of investments, misrepresentations and omissions in the sales of fund shares, inaccurate pricing of fund shares, the failure to obtain best execution in portfolio transactions, sales practice abuses in the distribution of different classes of mutual fund shares, and the failure to give customers the discounts generally available on large purchases of fund shares – these discounts are known as “breakpoints.”

Commission examiners, along with enforcement staff, are actively conducting examinations and investigations of a large number of market participants to determine whether they engaged in abusive and undisclosed market timing and late trading in fund shares. The preliminary results from those examinations and investigations were reported by Stephen Cutler, Director the SEC's Division of Enforcement, in his testimony before this committee in November, and the Commission has brought numerous enforcement actions and engaged in an aggressive rulemaking agenda as a result of the misconduct.

Prior to September 2003, however, examination staff did not detect the abusive market timing or late trading arrangements that fund executives had with select traders. We have

been reviewing examination protocols to identify lessons learned from these cases and evaluating ways that our examination oversight can be improved, both to detect abusive market timing specifically, and more generally to timely detect other types of misconduct by fund firms.

My testimony today focuses on the changes we are making to our examination oversight, specifically with respect to market timing, and more broadly with respect to overall examination oversight generally. Our goal is to improve examiners' ability to identify and scrutinize transactions and arrangements that place the interests of fund shareholders at risk. Today, examiners are increasing the frequency and depth of examination reviews for high-risk firms; increasing the use of technology and data; developing new methods to identify new or emerging areas of compliance risk; conducting more targeted “mini-sweep” examinations to identify risk areas sooner; and working more closely with other staff at the Commission to highlight problems detected, and identify possible solutions sooner. Attached to this testimony is a comprehensive report on the Commission’s examinations of investment companies and investment advisers prepared in response to the request made by Chairman Shelby to Chairman Donaldson on November 18, 2003. This report describes the examination program and these initiatives in greater detail, as well as recent enforcement actions brought by the Commission involving mutual funds.

I. Examination Steps to Better Detect Market Timing

Prior to the recent revelation of market timing and late trading abuses, examiners reviewed trading *by* a fund (*i.e.*, the fund’s purchases and sales of securities on behalf of

investors), but did not review trading *in* the fund's own shares. Examiners focused on whether funds were trying to inflate the returns of the fund, or take on undisclosed risk. The concern was that, in attempting to produce strong investment returns to attract and maintain shareholders, fund portfolio managers had an incentive to engage in misconduct in the management of the fund. As a result, examination protocols required that significant attention be focused on portfolio management, order execution, allocation of investment opportunities, pricing and calculation of net asset value, advertising returns, and safeguarding fund assets from theft. Examinations in these areas revealed problems and deficiencies. Because examiners' focus was on the fund itself, and not on trading in the fund's shares, however, examiners did not detect aberrant trading patterns that could be indicative of abusive market timing.

Although market timing in itself is not illegal, many mutual funds said that they discouraged the practice, and fund firms told examiners that the firms had appointed anti-market timing "police" who were responsible for detecting market timing trades and preventing timers from continued trading in their funds. The shocking development, not detected by examiners, was the secret complicity of some fund personnel in allowing select timers to continue to time.

Based on our recent examinations, we have identified ways to better detect market timing. These examinations have shown that daily sales and redemptions data can reveal patterns of trading in a fund's shares that may indicate market timing, and we now have made a review of this data a part of every routine examination.

Additionally, our review of funds' books and records did not reveal the covert arrangements that fund executives had with select shareholders, allowing them to trade frequently in fund shares. These arrangements appear to have been evidenced often only in e-mail communications and not in written agreements, contracts, or other documents. In the past, routine examinations did not include a random review of employees' internal e-mail communications (unless there was cause to believe that particular communications were relevant to the examination). Now, to aid in detecting any misconduct that might not otherwise be reflected in the books and records kept by the firm and shown to examiners, routine examinations include a review of a sample of fund executives' internal e-mail communications. We are now deploying software that will enable us to review large volumes of e-mail traffic, and we have made this a key element of our regular oversight.

Additional new examination steps include a review of personal trading records showing trading in the fund shares by select fund executives (even in advance of new Commission rules that would require that this information be made available), and a review of procedures to ensure that orders are processed to receive the appropriate day's net asset value, including firms' procedures governing order receipt time and order time stamping.

Recent Commission rule proposals that would require better and more specific disclosure of funds' anti-market timing policies and a possible "hard 4 p.m." close for receiving fund orders would aid examiners in detecting abuses of this type in the future. More broadly, the Commission has recently adopted rules to improve compliance by funds and advisers by requiring that they strengthen their own internal compliance programs. The

new rules require that advisers and funds implement and maintain compliance policies and procedures designed to prevent, detect, and correct compliance problems in key areas of their operations. The new rules also require that funds and advisers designate a chief compliance officer to implement those compliance policies and procedures, and, in order to assist the fund board in exercising compliance oversight, to report on compliance matters to the fund's board of directors.

In sum, we are taking aggressive steps to address abusive timing, and to improve our ability to detect this type of misconduct.

II. Other Changes to Fund Examinations

We are implementing other changes to SEC examinations to enhance our ability to detect problems, as well as to anticipate problems before they become widespread. This is the central goal of the Commission's risk assessment initiative.

The challenge for any examination oversight program is to determine how best to use limited resources to oversee a large and diverse industry. More specifically, the challenge is to identify the areas of highest risk to investors, and to probe these areas effectively, while still providing examinations of each industry participant with appropriate frequency. In addition, once emerging trends and problems are identified, we must share our knowledge with other Divisions and Offices so that the Commission can bring all of its resources to bear on efforts to protect investors. We have

implemented or are implementing changes that we believe will better allow us to meet these challenges. These changes are summarized below.

- **New Fund Surveillance Program:** As Chairman Donaldson announced on March 5, he has formed an SEC staff task force that will be drafting the outlines of a new surveillance program for mutual funds. This task force will examine the mutual fund reporting regime - looking at both the frequency of reporting to the Commission and the categories of information to be reported, as well as how new technologies can be used to enhance our oversight responsibilities. The goal of such a surveillance program would be to identify indications of problems, and then target the particular fund or adviser for follow up inquiry by telephone, letter, or on-site visit. Staff will also be able to examine the relevant data -- industry-wide -- to determine if a systemic problem is emerging.
- **Increased Use of Data Analysis:** Examiners have been making increased use of computer technology to facilitate review of large volumes of data. This has significantly enhanced the level of oversight possible in critical areas such as portfolio trading and best execution.
- **Interviews:** Examiners have been making increased use of interviews. More recently, interviews have played a critical role when assessing a firm's control or risk environment.

- **More Frequent Examinations:** With the additional resources added to the examination program in 2003, we are able to increase examination frequency of the largest fund firms, and those fund firms posing the greatest compliance risk (from once every five years, to once every two years). Prior to 1998, examination cycles had been as infrequent as once every 12-24 years.
- **More Targeted “Mini-Sweeps:”** To quickly identify and investigate a particular industry practice, and to help the Commission and staff expeditiously solve or mitigate the compliance risk, we have been conducting more examination sweeps focused on particular issues. Examples of some of the ongoing or recent sweeps or mini-sweeps include: payments by mutual funds for “shelf-space;” use of soft dollars by index funds, valuation and pricing of bond funds; fair value pricing; and practices of investment consultants.
- **Facilitating Immediate Corrective Action:** Recently, we have adopted new policies to enhance the speedy resolution of any problems found, including holding exit interviews with senior management of firms and providing deficiency letters directly to fund boards of directors.
- **Requests for Reports:** Examiners have increased their requests for written reporting by funds and advisers. This allows the staff to monitor compliance in between on-site examinations, obtain information on an expedited basis, and gather information on particular issues across a large number of firms. It also

enables examiners to better manage and prioritize a large number of sweep examinations and focus examinations before the on-site portion of the review.

- **Collaboration with Other Commission staff:** As noted above, we must act promptly on emerging areas of compliance risk. To facilitate such action, examination staff must share exam findings and trends with other Commission staff. Now, a committee composed of examination, enforcement, and regulatory staff reviews all examinations indicating serious problems to ensure that appropriate findings are investigated promptly. In addition, so that any emerging trends are identified and made known promptly, examination findings and trends are shared with other Commission staff on a routine basis. Examiners also seek input from other Commission staff on possible areas of examination scrutiny.
- **“Benchmarking” Examinations:** We are adopting a program to test the assumptions we use in our routine, risk-based examinations. Now, each year, we will conduct comprehensive “wall-to-wall” examinations of a select number of firms to test the assumptions used in our risk-based exams and to benchmark our procedures. These comprehensive reviews should identify weaknesses in our risk-based models and allow us to expand, as needed, our review of risky activities.

III. Other Areas of Examination Scrutiny

As noted above, in addition to market timing, SEC examiners are conducting sweep examinations and mini-sweep examinations designed to identify areas of emerging

compliance risk. In routine examinations, examiners are also focusing on compliance risk areas. Examples of recent and current areas of scrutiny include: allocations of securities among accounts; valuations of portfolio securities; use of soft dollars to pay for fund distribution; whether customers are provided with breakpoint and other discounts on purchases of funds; use of affiliated service providers; performance claims by advisers; anti-money laundering protections; Regulation S-P; and best execution, among other areas.

IV. Conclusion

As outlined above, and described in greater detail in the attached report, we are moving aggressively to implement the lessons learned from recent market timing abuses, and more broadly, to enhance our ability to detect abuses in the fund industry.

I would be happy to answer any questions you may have.

Thank you.