

PN-ACC-010

**Workshop: AMFI Mutual Fund  
Compliance Workshop  
"Meeting our Professional Responsibilities"**

**US Agency for International Development  
Contract #386-0531-C-00-5010-00  
Project #386-0531-3-30069**

**December 4-5, 1997**

**Price Waterhouse LLP  
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## *Price Waterhouse LLP*



December 18, 1997

Mr. A. P. Kurian  
Chairman, Association of Mutual Funds in India ("AMFI")  
Apple Asset Management Ltd.  
38/39, Rajgir Chambers, 4<sup>th</sup> Floor  
Shahid Bhagat Singh Road  
Fort, Bombay - 400 023

Dear Mr. Kurian:

**Subject: Results of the AMFI Mutual Fund Compliance Workshop  
"Meeting our Professional Responsibilities" December 4-5, 1997**

At the request of the Association of Mutual Funds in India ("AMFI"), Price Waterhouse LLP (PW) presented a workshop on *Mutual Fund Compliance – "Meeting Our Professional Responsibilities,"* on December 4-5, 1997. This workshop was designed and delivered under the USAID-sponsored Financial Institutions Reform and Expansion (FIRE) project to provide a broad compliance framework for issues related to mutual funds in India. To that end, CEOs, managing directors, COOs and compliance officers from asset management companies (AMCs) were invited to participate in the workshop. The workshop's further purpose was to facilitate the implementation of the AMFI Compliance Manual and to ensure industry compliance with the Securities Exchange Board of India's 1996 Mutual Fund Regulations.

In total, 53 representatives of 26 AMCs, including 14 CEOs / MDs, attended the workshop's opening ceremonies and keynote address, and participated in a moderated case discussion highlighting key compliance issues. The balance of the workshop was attended by 34 professionals, mostly serving as the compliance officers of their respective AMCs.

The workshop was delivered by a host of industry consultants and practitioners. Among the presenters and panelists from the local industry were:

- Mr. K. N. Vaidyanathan, Morgan Stanley Growth Fund
- Mr. S.V. Prasad, JM Mutual Fund
- Mr. L. Vedanarayanan, JM Mutual Fund
- Mr. P.C. Singh, Morgan Stanley Growth Fund
- Mr. P. Ghosh, PW India
- Mr. Ajai Kaul, Alliance Mutual Fund

December 18, 1997

Mr. A. P. Kurian

Chairman, Association of Mutual Funds in India ("AMFI")

Page 2



- Mr. S. Haribhakti, Haribhakti & Co.

Also serving as presenters were Ms. Anjali Kamat of Price Waterhouse - New York's Regulatory Compliance Practice and PW FIRE Project consultants Lewis Mendelson, R.N.K. Prasad, Sandhya Bhate, and Mariann Kurtz. The workshop also benefited by the participation of Mr. Pratip Kar of SEBI who represented the interests of the regulator.

Feedback from workshop participants (both formal and informal) was very positive. Nearly all participants were satisfied with the workshop and all found it relevant to their work. Results of written evaluations completed by the participants including recommendations for potential, future workshops are included in the enclosed report. If you have any questions, please do not hesitate to contact me at (022) 496-3599. Thank you.

Sincerely yours,

W. DENNIS GRUBB

PRINCIPAL CONSULTANT CAPITAL MARKETS

## TABLE OF CONTENTS

1. RESULTS FROM THE AMFI MUTUAL FUND COMPLIANCE WORKSHOP .....	1
1.1 Workshop Participants .....	1
1.2 Workshop Content and Materials .....	1
1.3 Trainers .....	1
1.4 Evaluation Results .....	2
1.5 Recommendations for future training programs .....	2
1.5.1 Provide workshops to areas of compliance/ regulations that are vague or require further clarification .....	3
1.5.2 Create working groups of compliance officers and SEBI officers .....	3
1.5.3 Provide training to trustees .....	3
1.5.4 Provide and package materials to facilitate onward training within AMCs .....	3
Appendix A: Attendees	
Appendix B: Agenda and Course Materials	
Appendix C: Results of the Participants Evaluations	

## 1. RESULTS FROM THE AMFI MUTUAL FUND COMPLIANCE WORKSHOP

### “Meeting our Professional Responsibilities”

The Price Waterhouse FIRE Project in conjunction with AMFI sponsored a two-day training workshop on Mutual Fund Compliance entitled “Meeting our Professional Responsibilities.” The workshop was delivered on December 4<sup>th</sup> and 5<sup>th</sup> at the Taj Mahal Hotel in Mumbai.

The overarching objective of the workshop was to provide a broad compliance framework for issues related to mutual funds in India. Specific objectives of the workshop were to promote and facilitate the implementation of the AMFI Compliance Manual, ensuring industry compliance with SEBI’s Mutual Fund Regulations of 1996.

#### 1.1 Workshop Participants

The workshop was organized in two parts, the first provided an overview of compliance and its importance to industry growth, and the second focused in greater detail on the role of the compliance officer and specific compliance issues. Given the two-part structure of the workshop, chief executive officers, managing directors, chief operating officers, and compliance officers from asset management companies were invited to participate. In total, 53 representatives from 26 AMCs, including 14 CEOs / MDs, attended the workshop’s opening ceremonies and keynote address, and participated in a moderated case discussion highlighting key compliance issues. The balance of the workshop was attended by 34 professionals, mostly serving as the compliance officers of their respective AMCs (please see Appendix A for a list of participants).

#### 1.2 Workshop Content and Materials

The workshop was implemented through a variety of training methodologies including presentations by industry leaders and consultants, panel discussions by industry practitioners, and a moderated case study was used to highlight and facilitate debate around key compliance issues. The main topics of the workshop included:

- Compliance as the Foundation to Industry Growth
- Case Study on Critical Compliance Issues
- The Role of the Compliance Officer
- Investment Management and Compliance Issues
- Scheme Launch and Investor Services
- Preparing for an Inspection

Each participant received a binder of course materials which were also displayed on screen during formal presentations. These materials along with summary points of speeches or panelists’ remarks are enclosed in Appendix B to this report. In addition, each participant received a copy of the AMFI Compliance Manual and the AMFI Code of Ethics.

#### 1.3 Trainers

The workshop was delivered by a host of industry consultants and practitioners. Opening remarks were given by Mr. Dennis Grubb and Mr. Lew Mendelson of the PW FIRE Project and Mr. A. P. Kurian, Chairman of AMFI. Mr. Pratip Karr of SEBI delivered the keynote address. Among the presenters and panelists from the local industry were:

5

- Mr. K. N. Vaidyanathan, Morgan Stanley Growth Fund
- Mr. S.V. Prasad, JM Mutual Fund
- Mr. L. Vedanarayanan, JM Mutual Fund
- Mr. P.C. Singh, Morgan Stanley Growth Fund
- Mr. P. Ghosh, PW India
- Mr. Ajai Kaul, Alliance Mutual Fund
- Mr. S. Haribhakti, Haribhakti & Co.

Also serving as presenters were Ms. Anjali Kamat of Price Waterhouse - New York's Regulatory Compliance Practice and PW FIRE Project consultants R.N.K. Prasad, Sandhya Bhate, and Mariann Kurtz.

#### 1.4 Evaluations Results

Each participant who completed both days of the workshop was asked to complete an evaluation at the conclusion of the workshop. Thirty-three responses were received and the results have been tabulated and summarized in Appendix C. Overall, the participants were satisfied (96%) with the workshop and all (100%) found the objectives of the workshop to be relevant to their roles and responsibilities.

Several participants also commented on how the workshop helped them understand the importance of the compliance function and gain a deeper knowledge as to the role and responsibilities of the compliance officer. "Compliance as a serious business is a new trend and helps us to think more clearly and schedule accordingly," wrote one participant. Others stated, "It [the workshop] will help me to develop my role and responsibility in the organization and improve the system." "It definitely has helped us to make a better team of compliance and not just sign off all documents without proper evidence of documentation."

Topics which were noted as most helpful to participants include the Role of the Compliance Officer, Scheme Launch and Investor Services, and Compliance as the Foundation for Industry Growth. Topics deemed least effective in assisting participants in understanding the subject matter also include Scheme Launch and Investor Services and Investment Management. This result (the same session being noted as most helpful and least effective at the same time) illustrates that there is a wide range of experience and knowledge among the compliance officers. The respondents further echoed this finding by requesting additional training workshops with time allowed for detailed discussions of key compliance topics and more access to SEBI officers in order to discuss areas of regulation which remain ambiguous.

#### 1.5 Recommendations for future training programs

As noted above, participants made a strong call for additional training programs. Their recommendations for additional programs may be summarized in four categories:

- Provide workshops to address areas of compliance/regulations that are vague or require further clarification.
- Create working groups of compliance officers and SEBI officers
- Provide training to trustees
- Provide and package materials to facilitate onward training within AMCs

1.5.1 Provide workshops to address areas of compliance/regulations that are vague or require further clarification.

One of the participants said it best, "Compliance as a serious business is a new trend. . ." Compliance officers as well as AMC managers are still internalizing the SEBI regulations and need both SEBI support and access to clarifications, rulings, etc. to best ensure compliance. To that end, participants are looking to SEBI and AMFI to structure and provide additional training programs. In order to be most responsive to this need, AMFI should poll AMC managers and compliance officers to determine which topics or areas of regulation in particular should be addressed. Further insights into common problem areas related to compliance may be found in the results from the FIRE Project sponsored Workshop on Mutual Fund Inspections delivered for SEBI inspection staff and external chartered accountants serving as inspectors.

#### 1.5.2. Create working groups of compliance officers and SEBI officers

Noting the valuable contribution made by Mr. Pratip Kar during the past workshop, participants have asked for more participation and partnership with SEBI in future workshops. Participants have suggested the formation of working groups to dissect, discuss and analyze practical compliance problems. Further it is hoped that through such working groups better understanding of regulations may be accomplished which will result in standardized procedures and ultimately better compliance. Participants also liked the case discussion and requested additional case studies to be included in future workshops as fodder for the working groups.

#### 1.5.3. Provide training to trustees

Participants of the workshop quickly noted the need for trustees to take a more active role in oversight and compliance issues. Unfortunately, participants noted that the relationship between compliance officers and trustees is often a weak or little used link. They also reported that the role of the compliance officer often is not fully understood and therefore afforded limited power and scope within the AMC. To address these concerns, participants have made two suggestions:

- a) AMFI should draft a letter clarifying and standardizing the basic roles and responsibilities of the compliance officer. This letter should be shared with all officers of the AMC and the Trustees.
- b) A separate training workshop should be prepared for trustees and include a discussion of compliance. FIRE Project consultants currently are discussing such a workshop with officers of AMFI and SEBI. A useful way to facilitate discussion of compliance issues and procedures would be to invite a presentation by a representative panel of AMC officers and compliance officers during the workshop.

#### 1.5.4. Provide and package materials to facilitate onward training within AMCs

Participants of the workshop were anxious to share training materials and hold discussions with their colleagues. To facilitate onward training within AMCs, AMFI should formalize its training outreach programs and provide materials in both hard and soft copies to workshop participants. To the extent available, the FIRE Project will provide electronic versions of presentation materials to AMFI for further distribution. A further step in this process would be to identify a team of trainers within the industry who may be called upon to train others. Using a train-the-trainer approach, the FIRE Project could potentially make available a series of additional seminars which could then be replicated by local trainers.

**Appendix A:**

**Attendees of the AMFI Mutual Fund  
Compliance Workshop**

**December 4 - 5, 1997**

**Mumbai, India**

**Workshop on Mutual Fund Compliance**  
**December 4 - 5, 1997**

**Participant List**

<b>Sr. No.</b>	<b>Name of the AMC</b>	<b>Participant</b>
1	20th Century Asset Mgmt. Corp. Ltd.	Mr. Anup Somani
2	20th Century Asset Mgmt. Corp. Ltd.	Mr. V.R. Deshpande
3	20th Century Asset Mgmt. Corp. Ltd.	Mr. Vijay Kumar
4	Alliance Capital Asset Mgmt. India Pvt. Ltd.	Mr. Ajai Kaul
5	Apple Asset Management Ltd.	Mr. Shailesh K. Parekh
6	Apple Asset Management Ltd.	Mr. C.Y. Rane
7	Birla Capital International AMC Ltd.	Ms. Rekha Kapoor
8	Birla Capital International AMC Ltd.	Ms. Sharmila Pallod
9	BOB Asset Management Co. Ltd.	Mr. V.H. Bhatia
10	BOB Asset Management Co. Ltd.	Mr. M.D. Modi
11	BOB Asset Management Co. Ltd.	Mr. A.A. Gandhi
12	BOB Asset Management Co. Ltd.	Mr. Yash Kulshrestha
13	BOB Asset Management Co. Ltd.	Mr. Himanshu Shah
14	BOI Asset Management Co. Ltd.	Mr. M.M.S. Babu
15	BOI Asset Management Co. Ltd.	Mr. K.N. Khanna
16	Canbank Investment Management Services Ltd.	Mr. U.R. Rao
17	Canbank Investment Management Services Ltd.	Mr. K.V. Hegde
18	Cholamandalam Cazenove Asset Management Co. Ltd.	Mr. D. Ravishankar
19	Cholamandalam Cazenove Asset Management Co. Ltd.	Ms. P. Sujatha
20	DSP Merrill Lynch Asset Mgmt. (I) Ltd.	Mr. M. Lakshman Kumar
21	GIC Asset Management Co. Ltd.	Mr. A.R. Prabhu
22	GIC Asset Management Co. Ltd.	Mr. T. Rajgopalan
23	ICICI Asset Management Co. Ltd.	Mr. S.C. Bhate
24	ICICI Asset Management Co. Ltd.	Mr. Shrikant Dev
25	IDBI Investment Management Co. Ltd.	Mr. Upesh Shah
26	IDBI Investment Management Co. Ltd.	Mr. Shivprakasham
27	Ind Fund Management Ltd.	Mr. K.M. Gopinath
28	Ind Fund Management Ltd.	Mr. Y.G.V. Shivraman

29	ITC Classic Threadneedle Co. Ltd.	Mr. Iqbal Jugari
30	J.M. Capital Management Ltd.	Mr. R.S. Kini
31	J.M. Capital Management Ltd.	Mr. S.V. Prasad
32	J.M. Capital Management Ltd.	Mr. Neil D'Souza
33	Jardine Fleming India Asset Mgmt. Pvt. Ltd.	Mr. Irwin D'Souza
34	Jeevan Beema Sahayog Asset Mgmt. Co. Ltd.	Mr. Devesh Srivastava
35	Jeevan Beema Sahayog Asset Mgmt. Co. Ltd.	Ms. Jyoti Ruprel
36	Jeevan Beema Sahayog Asset Mgmt. Co. Ltd.	Ms. Shubhangi Naik
37	Morgan Stanley Asset Mgmt. India Pvt. Ltd.	Mr. Chetan Jain
38	Morgan Stanley Asset Mgmt. India Pvt. Ltd.	Mr. K.N. Vaidyanathan
39	PNB Asset Management Co. Ltd.	Mr. R.K. Rehani
40	PNB Asset Management Co. Ltd.	Mr. S.K. Agarwal
41	Reliance Capital Asset Management Co. Ltd.	Ms. Nita Mehta
42	Reliance Capital Asset Management Co. Ltd.	Mr. Piyush Surana
43	Reliance Capital Asset Management Co. Ltd.	Mr. Amit Prahladaka
44	SBI Funds Management Ltd.	Ms. Chaya Pisupati
45	SBI Funds Management Ltd.	Mr. Niamatullah
46	Shriram Asset Management Co. Ltd.	Ms. Smita B. Biwalkar
47	Sun F&C Asset Mgmt. (I) Ltd.	Mr. Yezdi Khariwal
48	Tata Asset Management Ltd.	Mr. Hormuz A. Bulsara
49	Tata Asset Management Ltd.	Mr. Parvez Pochkhanawala
50	Tata Asset Management Ltd.	Mr. K.N. Atmaramani
51	Templeton Asset Mgmt. (India) Pvt. Ltd.	Mr. Vijay C. Advani
52	Templeton Asset Mgmt. (India) Pvt. Ltd.	Mr. Rajesh Radhakrishnan
53	Unit Trust of India	Mr. S.K. Munda

**Appendix B:**

**Agenda and Course Materials for the  
AMFI Mutual Fund Compliance Workshop**

**December 4 - 5, 1997**

**Mumbai, India**

**AMFI Mutual Fund Compliance Workshop**

**December 4 - 5, 1997**

**"Meeting our Professional Responsibilities"**

**Price Waterhouse FIRE Project**

**AMFI Mutual Fund Compliance Workshop**

Thursday, December 4, 1997 - Friday, December 5, 1997

**Program Objectives:** The general purpose of this workshop is to provide a broad compliance framework for issues related to mutual funds in India. The specific objectives of the workshop are to promote and facilitate the implementation of the *AMFI Compliance Manual*, ensuring industry compliance with SEBI's Mutual Fund Regulations, 1996. Sessions 1 to 3 of the workshop target AMC CEOs, COOs and Compliance Officers. Session 4 to 6 are geared towards Compliance Officers.

**"Meeting Our Professional Responsibilities"**

AMFI Mutual Fund Compliance Workshop: December 4 - 5, 1997

**DAY 1: THURSDAY, DECEMBER 4, 1997**

- 9:30-10:00am      **Registration**
- 10:00-10:30am      **Opening Ceremonies**  
Welcome: Mr. W. Dennis Grubb, PW FIRE Project  
The Compliance Workshop: Mr. A.P. Kurian, Chairman, AMFI  
Overview of the Compliance Workshop  
Overview: Mr. L. Mendelson, PW FIRE Project
- 10:30-11:30pm      **Session 1. *Compliance as the Foundation for Industry Growth***  
*Keynote Address:* Mr. Pratip Kar, Executive Director, SEBI  
*Panel:* Mr. K. N. Vaidyanathan, Morgan Stanley Growth Fund  
          Mr. L. Mendelson, PW FIRE Project  
          Mr. S.V. Prasad, JM Mutual Fund  
*Objective:* To emphasize integrity and fairness in the industry as a spur to sustained growth and development.
- 11:30 - 11:45am      BREAK
- 11:45 - 12:45pm      **Session 2. *Case Study: The Rockford Mutual Fund***  
*Discussion Facilitator:* Ms. Maryann Kurtz, PW  
*Case Study Moderators:* Mr. Pratip Kar, Executive Director, SEBI  
                                  Mr. L. Mendelson, PW FIRE Project  
*Objective:* To involve participants in a discussion of critical compliance issues that affect the success of their funds.

AMFI Mutual Fund Compliance Workshop

Thursday, December 4, 1997 - Friday, December 5, 1997

**DAY 1: THURSDAY, DECEMBER 4, 1997 continued**

12:45 - 1:00pm      **Session 3. *The Role of the Compliance Officer***  
*Speaker:* Ms. S. Bhate, PW FIRE Project  
*Objective:* To highlight the importance of the compliance function and to define the responsibilities and functions of the Compliance Department.

1:00 - 2:00pm      LUNCH

2:00 - 3:15pm **Session 4. *Investment Management***

*Speakers:* Ms. S. Bhate, PW FIRE Project  
              Mr. L. Vedanarayanan, JM Mutual Fund  
              Mr. P.C. Singh, Morgan Stanley Growth Fund  
              Mr. P. Ghosh, PW India

*Objective:* To highlight compliance issues and monitoring requirements related to investment management activities.

- Portfolio decision-making process
- Brokerage issues (trade allocation)
- Custodial issues
- Affiliated transactions
- Management of multiple accounts
- Review of schemes and investments
- Periodic disclosure
- Fair valuation procedures
- Internal Controls

3:15 - 3:30 pm:      BREAK

3:30 - 4:45pm      **Session 4 cont.. *Investment Management cont.***

4:45 - 5:00pm      CLOSING REMARKS

14

AMFI Mutual Fund Compliance Workshop

Thursday, December 4, 1997 - Friday, December 5, 1997

DAY 2: FRIDAY, DECEMBER 5, 1997

9:30-10:00am      Tea, Coffee

10:00-11:15am      **Session 5. *Scheme Launch and Investor Services***  
*Speakers:* Mr. Ajai Kaul, Alliance Mutual Fund  
Mr. R.N.K. Prasad, PW FIRE Project  
*Objective:* To discuss the compliance issues and monitoring requirements related to the launch of schemes and investor services.

- Review of offer documents
- Transfer agent issues
- Customer complaints

11:15-11:30am      BREAK

11:30 - 12:45pm      **Session 6. *Preparing for an Inspection***  
*Speakers:* Ms. A. Kamat, PW, New York  
Mr. S. Haribhakti, Haribhakti & Co  
*Objective:* To discuss the steps a mutual fund should take in preparing for an inspection and to provide examples of deficiencies noted in regulatory examinations.

- The regulatory inspection process
- Corrective actions for identified deficiencies

12:45 - 1:00pm:      CLOSING REMARKS

1:00 - 2:00pm      LUNCH

15

# **Session 1**

## **Compliance as the Foundation for Industry Growth**

**Highlights of the remarks made by Mr. Pratip Kar, Executive Director, SEBI:**

- Mr. Kar expressed how pleased he was that a Compliance Workshop was being conducted. He stated that this was the first time such a workshop was being conducted and it should be beneficial for the industry as a whole.
- SEBI would be reviewing very carefully the reports that mutual funds send to SEBI confirming compliance with existing regulations. As the inspectors conduct their inspections, any inaccuracies in the reports submitted to SEBI would be viewed with great concern.
- SEBI was committed to promoting public trust and confidence in the marketplace. Trust was a key element in the long term growth of the industry. Sponsors should not be deriving any benefits for themselves or their affiliated companies by getting involved in fund launches. The goal was to promote long term investing rather than short term trading.
- SEBI was placing high responsibility on the in-house compliance function. This function was the first line of defense and adequate power should be given so that compliance could report directly to top management.
- Key areas for inspections include affiliated transactions and related backoffice procedures. Merely completing compliance reports were not enough - what was needed was a commitment by the firm to monitor these areas.

**Highlights of remarks made by Mr. K. N. Vaidyanathan, Vice President, Morgan Stanley Growth Fund:**

- Mr. Vaidyanathan discussed the compliance expectations of an AMC. He stated that compliance should be an on-going process and not restricted to just a particular point in time.
- The basic issues addressed were fairness to investors, best execution, fair valuation and Chinese walls.
- An investment advisor is often confronted with conflict of interest situations. These could arise as a result of managing different schemes, if the advisor was part of a conglomerate - then the conflict between all clients. These types of conflict could be handled either by regulation or by self-discipline or by a combination of both. A firm needed to clearly define its policy, laying out exactly how it was going to manage its clients, and then follow this policy. The underlying objective should be to treat clients fairly and equitably.
- The firm's employee trading policy should be clearly laid down and communicated to all employees. In addition, the allocation of costs between clients should be in accordance with procedures approved by the board and should be fair to all accounts.

**Highlights of remarks made by Mr. S.V. Prasad, CEO, JM Mutual Fund:**

- It is important to promote a culture of compliance. There are always conflicts that arise and a firm needs to have systems and controls in place to ensure appropriate resolution of these conflicts.
- At JM, senior management as well as the trustees were committed to ensuring adequate compliance controls were in place to provide independent feedback. They had created a two-tiered compliance structure: there was a compliance person at the AMC level to assess compliance with regulations as well as a compliance officer at the trustee level to ensure compliance of all entities - such as AMC, the broker-dealer, the investment banking activities etc. - and reporting directly to the trustees. The compliance person at the AMC level reported to the compliance officer at the trustee level.
- Compliance should be used as a unique selling point (USP).
- Compliance should not just be top-down - it should also be bottom-up. Management should be supportive but even the person at the lowest rung of the ladder should recognize that there is a compliance concern when looking at an issue. Also, one should acknowledge a mistake and ensure that it does not happen again rather than trying to cover up an issue.

## DISCLOSURE: THE MOST EFFECTIVE AND EASIEST WAY TO MAINTAIN COMPLIANCE

### BALANCE THE NEED FOR DISCLOSURE TO BE USER FRIENDLY AGAINST USING DISCLOSURE TO PROTECT USERS

#### 1. The Offer Document: Inform investors

*"What investors request time and time again is a fund prospectus that they can read, in language they can understand, in a form they can follow."* Arthur J. Levitt, Chairman, U.S. Securities and Exchange Commission

- provide **adequate, accurate, timely** information, fairly presented about the mutual fund and its schemes
- use a standardized format and terms (internally and industry-wide)
- make it understandable, easy to read, well written, well-organized
- focused on important issues—effectively disclose the scheme's features
  - ◊ performance -standardized measurement -standardized time periods
  - ◊ portfolio structure (portion equities/bonds)
  - ◊ securities holdings (periodic disclosure)
  - ◊ expenses (expense ratios)
  - ◊ portfolio turnover rate
  - ◊ rollovers -- policy and cost implications
- background and experience of key personnel
- expectations meaningful, not illusory:
  - guarantees and resources backing them
  - policy on repurchase and reissue of closed end units and its impact on market price

## 2. Compliance Functions

"*Sunlight is the best disinfectant.*" Justice Louis D. Brandeis, U.S. Sup.Ct.

Define what the fund will or will not do:

- fundamental policies
- investment strategy
- diversification policy and exposure limits
- expense allocations
- policy on affiliated transactions

Describe what the fund, its AMC and key staff have done:

- affiliated transactions (*in terrorem* effect)
- *adjudicated* violations of securities law or regs
- status of guarantees, procedures for assuring that guarantees will be met
- whether AMC will trade against the box, policy on cancellation -- pricing on reissue

### RECENTLY SURFACED SENSITIVE ISSUES

#### TRADE ALLOCATIONS --JARDINE FLEMING (HONG KONG)

#### INVESTMENT OBJECTIVES AND VALUATION OF PORTFOLIO SECURITIES - MORGAN GRENFELL/DEUTCHE BANK

TRADE ALLOCATIONS – *Put the client first.*

Rogue trader would buy portfolio securities and wait a few days before allocating them among various clients.

If it turned out that it was profitable, he'd allocate to his own account or to J&F's flagship mutual fund. If it lost money, it would be allocated to another public fund.

1993 –J&F's Management learned of this practice

1995—Regulator learned of practice

Result: British and HK Regulators fined J&F equivalent of several million dollars  
J&F trying to regain its reputation by instituting a strong compliance program.

## INVESTMENT OBJECTIVES AND PRICING PORTFOLIO SECURITIES

Manager invested a large proportion of the scheme's assets in unlisted shares of a little-known high tech company

Shares were improperly valued and violated the scheme's investment objective.  
When the stock price tumbled, the fund's adviser was left to make up for the loss.

The SEC is able to handle its broad mandate with a small staff by regulating, to a large extent, through a public-private partnership. The Commission takes responsibility for the "big picture" areas, -[5]- while much of the direct, day-to-day regulation of securities market participants is done by firms themselves-[6]- and by private membership organizations (self-regulatory organizations or SROs), under SEC oversight.-[7]-

TESTIMONY OF  
ARTHUR LEVITT, CHAIRMAN  
U.S. SECURITIES AND EXCHANGE COMMISSION  
CONCERNING THE COMMISSION'S AUTHORIZATION  
REQUEST FOR FISCAL YEAR 1997  
BEFORE THE SUBCOMMITTEE ON  
TELECOMMUNICATIONS AND FINANCE  
COMMITTEE ON COMMERCE  
U.S. HOUSE OF REPRESENTATIVES

EXTRACTS

February 28, 1996

Chairman Fields and Members of the Subcommittee:

I appreciate this opportunity to testify on behalf of the Securities and Exchange Commission (SEC or Commission) regarding the Commission's authorization for fiscal year 1997. The Commission seeks authorization for appropriations of \$317 million in fiscal year 1997.-[1]- This request represents a realistic estimate of the resources the SEC will need to maintain effective regulation of the U.S. securities markets in the face of rapid market growth, while recognizing Congressional budgetary concerns in an era of fiscal restraint.

The SEC performs an essential function: overseeing the fast-moving U.S. capital markets, worth trillions of dollars, that fuel the U.S. economy. The Commission does so, moreover, with a modest staff and limited resources, operating in partnership with the private sector rather than through pervasive regulation. Today's authorization request would put the Commission on a tight budget. It would allow for an increase of only \$16 million in funding above the level available to the Commission in fiscal year 1995 (following a year of no increases in SEC funding in 1996), nearly half of which is due to mandatory increases.-[2]- The \$317 million requested for 1997 will permit the SEC to maintain its current staffing levels of 2,797 full-time equivalents (FTEs). Funding at this level will require the Commission to stretch its limited resources to the maximum in 1997 in order to adequately fulfill its responsibilities to investors in the rapidly expanding, ever-complex U.S. securities markets. We are willing to take on that challenge.

----- FOOTNOTES -----

- [1]- The Commission last submitted an authorization request in June 1994, covering fiscal years 1995-97. That earlier request sought appropriations of \$382.7 million for fiscal year 1997. Today's revised request has been significantly reduced in recognition of current budget realities and would represent a modest increase over the SEC's 1995 and (projected) 1996 total budget authority of \$301 million (consisting of \$297 million in appropriations plus an additional \$4 million in prior year carryover funds).
- [2]- The authorization requested for 1997 represents a moderate increase over the Commission's (projected)

23

appropriation for FY 1996. After mandatory increases in pay and related personnel benefits, the remainder of the increase in the Commission's authorized funding would be available for such projects as EDGAR modernization and litigation support. Additional information regarding the Commission's 1997 authorization request is set forth in the attached appendix.

----- BEGINNING OF PAGE #3 -----

#### Role of the SEC

The U.S. securities markets are widely regarded as the deepest, most liquid, and fairest markets in the world. They serve the needs of almost 13,000 public corporations, -[3]- raising capital to support new industries, finance operations, create jobs, fund research and development, and support growth for the future. In 1995 alone, over \$800 billion of corporate securities were sold in our markets. Capital was raised directly from both institutional investors (including mutual funds and pension funds) and private individuals. One in three American households participates in the U.S. securities markets, directly or through mutual funds. -[4]- Thus, the U.S. securities markets serve not only as a powerful engine for capital formation but also as an important vehicle for savings and investments by U.S. citizens.

The Commission plays a vital role in preserving the strength and integrity of these markets. Since its creation in 1934, the Commission has been charged with protecting investors and maintaining fair and orderly markets. It is first and foremost a law enforcement agency. It fulfills its statutory mandate by policing fraud in the securities markets as a whole, requiring full disclosure by issuers of securities, overseeing the regulation of the nation's securities markets, and directly regulating the investment company and investment adviser industries. By protecting market integrity, the SEC's regulatory and enforcement programs foster the continued success of the U.S. capital markets.

The SEC is able to handle its broad mandate with a small staff by regulating, to a large extent, through a public-private partnership. The Commission takes responsibility for the "big picture" areas, -[5]- while much of the direct, day-to-day regulation of securities market participants is done by firms themselves -[6]- and by private membership organizations (self-regulatory organizations or SROs), under SEC oversight. -[7]-

#### ----- FOOTNOTES -----

-[3]- This figure does not include the roughly 5,000 registered investment companies (representing over 23,000 separate portfolios) that also raise capital in the U.S. markets.

-[4]- In 1995 alone, investors bought nearly \$120 billion worth of funds that invest primarily in U.S. stocks. See Investment Company Institute Press Release 96-02 (Jan. 25, 1996). Funds that invest primarily in American stocks had over \$1.07 trillion in assets at year-end 1995. See id.

-[5]- These include core regulations concerning fraud, financial responsibility of securities firms, the clearance and settlement process, and market structure.

21  
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-[6]- Under the federal securities laws' system of self-regulation, senior personnel at securities firms may be sanctioned if they fail to supervise their employees to ensure that they comply with the law in their trading and other activities. Thus, firms themselves are the first line of regulation and enforcement.

-[7]- Under the Exchange Act, SROs must register with the Commission and obtain Commission approval of their rules, and market participants must become members of the SROs through which they do business. SROs are responsible for monitoring the activities of SRO  
(continued...)

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This regulatory approach is markedly different from the approach taken by other federal regulators, and allows the SEC -- with only 2,797 employees across the country -- to oversee dynamic markets that have grown to be worth more than \$10 trillion.--(8)-

The key to making self-regulation work effectively is SEC oversight. Commission oversight helps to ensure that the SROs exercise their power responsibly: the SEC inspects SROs and performs targeted oversight examinations of their broker-dealer members to determine whether the SROs are in fact effectively supervising the financial condition and business practices of their members. The SEC also must approve (and may amend) SRO rules as consistent with the public interest.

Thus, the system for regulating the U.S. securities markets is one of shared regulation between the SEC and the industry. This cooperation means that informed industry participants can contribute their expertise and unique perspective in establishing and enforcing standards that protect the investing public and promote the fairness of the U.S. markets; the SEC, for its part, can concentrate its attention on monitoring the SROs, assuring financial responsibility, overseeing the markets generally, requiring full disclosure, and providing strong enforcement.

Mutual fund examinations. In December 1995, the

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Commission announced the formation of a public-private panel to study the agency's mutual fund examination program. The SEC, in consultation with the Investment Company Institute, asked several distinguished members of the mutual fund community to help review the Commission's new, not yet implemented, mutual fund examination manual. Panel members will field test portions of the manual on their own funds and will then provide the Commission with their findings and suggestions.

25

## Improving Disclosure Requirements

Through its work with the Task Force, the Advisory Committee and other initiatives, the Commission has sought to simplify and streamline its disclosure requirements. This is an important task: the Commission recognizes that compliance with the disclosure requirements of the federal securities laws can involve considerable expense. But disclosure simplification also calls for a careful balancing of interests, because disclosure is the cornerstone of the regulatory scheme established in the federal securities acts. Under the federal securities laws, the U.S. securities markets are open to all companies. Market integrity is safeguarded, not by barring companies from issuing securities in the market, but by requiring companies to disclose the information that investors need in order to make informed investment decisions.-(9)-

In order to reduce the costs, while retaining the benefits, of the disclosure-oriented federal securities regulatory scheme, the SEC in recent years has launched several efforts to simplify and streamline disclosures. The Commission has paid particular attention to improving the usefulness of the information received by investors (by encouraging, among other things, "plain English" disclosures) while at the same time minimizing the regulatory costs and burdens imposed on issuers.

**Profile prospectus.** In the investment company area, the SEC has worked with the investment company industry and state securities regulators to develop the concept of a "profile prospectus." The key element of the profile prospectus is a standardized, short-form summary that accompanies the full-length prospectus and is designed to enable mutual fund investors to better understand what they are buying. Pilot "profiles" developed by eight fund groups have been available to investors since August 1, 1995. Initial investor reaction has been very positive.

**Improved disclosures by mutual funds.** Toward the same end, the Commission in July 1995 proposed improved disclosure requirements for money market funds. The proposed standards are designed to simplify money market fund prospectuses considerably, making them less costly to prepare and allowing investors to focus on a short document (four to six pages) that contains the most essential information about the fund. In addition, the

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-(9)- While compliance with the securities disclosure requirements may involve costs to issuers, it is important to bear in mind that the principle of full disclosure protects the fairness, integrity, and ultimately the success of our markets -- and that issuers always have the choice of whether or not to go to the public markets for capital, and whether or not to subject themselves to the disclosure requirements that apply to publicly traded companies. A disclosure regime, moreover, is less intrusive than a regulatory scheme based on the direct regulation of securities issuers.

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Commission in March 1995 issued for public comment a concept release discussing the ways in which investment company risk disclosure can be improved so that investors better understand the risks presented by funds.

Electronic filings. In addition, the Commission is continuing to take steps to bring the filing and dissemination of

disclosure documents into the electronic era. By May 1995, most issuer filings with the SEC will be submitted electronically through the Commission's EDGAR system. In September 1995, the Commission initiated its own Internet Web site, following up on a National Science Foundation initiative funded by Congress. The SEC's "home page" contains SEC releases and announcements, investor information, and EDGAR filings, updated on a daily, 24-hour delayed basis. The Commission also approved the issuance of an interpretive release designed to encourage the use of electronic media in providing prospectuses and other disclosure documents to investors. In this rapidly developing area, the Commission and its staff will continue to support the development of various means of electronic delivery of information to investors and the market.

Examinations. Investment adviser inspections present a continuing challenge for the Commission. Today, investment

advisers (excluding investment advisers to mutual funds) are responsible for managing almost \$7.6 trillion of investor assets, sixteen times the figure of ten years ago. Unfortunately, while investors have entrusted more and more of their savings to the care of investment advisers, the SEC's inspection resources have not increased commensurately. As a result, at present, the SEC inspects the 8,000 higher-risk investment advisers with custody of or discretionary management authority over client assets only once every 3-10 years, on average. The remaining 13,000 advisers are currently inspected only on a "for cause" basis or in geographic sweep examinations conducted with the state securities regulators; as a result, such advisers are inspected, on average, only once every 44 years.

In 1995 (as noted above), the Commission transferred existing headquarters staff to a new Office of Compliance Inspections and Examinations. While this reallocation of internal resources has helped to improve the efficiency of inspections, it will not necessarily make adviser inspections more frequent.

In the current budgetary environment, the Commission has sought to develop alternative approaches to shortening the inspection cycles for investment advisers. One such approach would be to change the existing regulatory scheme through legislative action. If Congress delegated responsibility for the regulation of smaller advisers to state regulators, the SEC could focus its efforts on larger investment advisers, i.e., those who have the most assets under management. These advisers tend to have business activities that cross many state lines and that affect national markets. The states, in turn, could regulate and examine smaller advisers, who tend to have community-based business and, therefore, are best regulated at the state level. -[13]-

Since this approach would require legislative action to implement, the SEC has also sought other ways to improve the efficiency of its examinations.

By shifting resources within the agency (as described above), the Commission plans to reallocate 38 staff

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-[13]- A similar approach is set forth in S. 148, the "Investment Advisers Integrity Act," introduced last year by Senator Gramm.

positions to the investment adviser examination program. When this staff is in place and fully trained, the SEC will be able to shorten the examination cycle for advisers with discretion over client funds to one examination every five years.

The examination staff has increased the extent to which it coordinates inspection efforts with state securities regulators. SEC examination staff conduct specialized adviser inspection training programs for state examiners with follow-up joint inspections with the trainees from the states.

In June 1995, the Commission and the Office of the Comptroller of the Currency (OCC) agreed on a framework for conducting joint examinations of bank-related mutual funds and investment advisers. We expect this arrangement with the OCC to serve as a model for future

discussions with other banking regulators.

Staff from the Office of Compliance Inspections and Examinations recently began conducting geographical sweep examinations of financial planners on a joint basis with state securities examiners. Going forward, the SEC plans to conduct at least eight such joint sweeps each year in various locations throughout the country.

In May 1995, the SEC and the United Kingdom's Investment Management Regulatory Organization entered an understanding to facilitate the sharing of information, cooperation in inspections, and access to reports generated in the oversight of cross-border investment management activity. A similar understanding was reached with the Hong Kong Securities and Futures Commission in October 1995.

#### Conclusion

The Commission is a small agency that has a large and vitally important job: oversight of the world's largest and most dynamic securities markets. With modest resources, we protect investors and promote the fairness, stability, and capital-raising potential of the markets that fuel the U.S. economy.

The Commission is also an agency that takes very seriously the directive to "reinvent" government. Through the initiatives described in this testimony, we have taken important steps toward reducing bureaucracy, streamlining regulatory requirements and eliminating unnecessary burdens. We have done so, throughout, with the input of the industry we regulate, working in a public-private partnership.

# **Session 2**

**Case Study: The Rockford Mutual Fund**

## CASE STUDY

### Rockford Mutual Fund: A Problem of Non-Compliance

#### Introduction<sup>1</sup>

On the morning of January 15, 1997, a throbbing headache threatened to worsen Dr. Albert Stone's already dark mood. Dr. Stone was formerly one of Boulderia's most renowned brain surgeons, with an even greater reputation as a missionary medical practitioner the last ten years of his medical career. His outstanding public service earned him an offer upon early retirement in 1995 to serve as a senior trustee of Rockford Mutual Fund, one of Boulderia's largest and, at one time, most promising investment funds. Rockford was best known for its highly advertised and seemingly successful Stoneridge Growth Scheme.

Today, Dr. Stone was fielding phone calls from angry investors. The Rockford fund had come under intense scrutiny by Boulderia's Public Securities Commission (PSC) following a routine compliance review. The review revealed several irregularities and "severe deficiencies" in Rockford's operations. As a result, the PSC publicly announced that administrative sanctions would be imposed on the fund.

Investors in the Stoneridge scheme were confused and frightened by the PSC's actions. Dr. Stone himself was puzzled about how the current circumstances came about and wondered how to respond to the inquiries of an influential investor who was also a personal friend of his. Among his friend's questions: Were the infractions noted by the PSC valid? If so, how would Rockford insure the security of the Stoneridge scheme to its investors? And how would Rockford and its Asset Management Company and Trustee remedy the fund's now public wrong-doings? Dr. Stone knew these were the same questions faced by his Trust Company. He pondered how to correct any dangerous practices, limit the sanctions, minimize personal liability and maintain credibility with investors.

#### Background on Rockford Mutual Fund

Boulderia had a fairly large capital market, with total market capitalization of \$30 billion by January 1997. The country had three major exchanges located in the cities of Concretia, Cragmont, and Rocktown. The number of funds trading on the various exchanges numbered around 50, but less than five funds (including Rockford) accounted for over 75% of the trading and volume on the exchanges.

Created in January 1995, Rockford Mutual Fund was one of the country's first and largest mutual funds. The force behind the fund was one of Boulderia's more highly respected philanthropists, Preston Sands. He was widely known throughout Boulderia for his establishment of organizations such as Children First, the Wildlife Support Fund, and the National Education Council.

The Rockford Group was made up of the following entities:

- Rockford Capital Markets, Ltd. ("Rockford Cap"): the fund's sponsor. Rockford Cap was a holding company established in 1993 with interests in investment banking, broker-dealer services, a pricing

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<sup>1</sup> The case was written by *Price Waterhouse LLP*, and is intended to serve as a basis for class discussion, rather than to illustrate either effective or ineffective handling of an administrative situation. Names and positions have been fictionalized for the purpose of case writing. This case study was undertaken in cooperation with the Financial Institutions Reforms and Expansion project, funded by the United States Agency for International Development (USAID). Further use or reproduction of this case study is forbidden without permission from *USAID* and *Price Waterhouse LLP*.

organization for portfolio valuations, and several collective investment vehicles investing in both liquid and non-liquid assets. Among its interests were two brokerage houses: Pebble Securities and Docks & Fisher.

- Rockford Asset Management Company (AMC): responsible for floating and managing the fund's various schemes.
- Stone Trust Company: the trustee responsible for raising money from the public through the sale of units in one or more funds for investing in securities. It also oversaw all the entities employed such as the asset management company, custodian, registrars, and transfer agents.

In addition, Granite Ltd. was contracted to serve as the fund's independent custodian responsible for holding the fund's assets.

In August 1996, Rockford launched a fifteen year closed-end scheme, the Stoneridge Growth Scheme, aimed at achieving long-term growth through investment in growth stocks. The scheme was to be managed by the newly created Rockford AMC, and overseen by the trustee, Stone Trust Company. The scheme's launch appeared successful, raising \$40 million, of which \$30 million was invested by various corporate entities and \$10 million by individual investors.

### **PSC Compliance Review**

In December 1996, the PSC initiated a routine compliance inspection of Rockford Mutual Fund. The PSC inspection team was also accompanied by an independent auditor, Flint Chartered Accountants. The PSC's report, released in January 1997, identified several issues:

- **Back-to-back transactions.** Of the \$40 million invested in Stoneridge, over 35% of the total investment in the scheme originated with the Rockford Group, either directly from Rockford Cap or indirectly from other Rockford Group companies. In addition, a review of the scheme's shareholder registry indicated that a large number of its corporate investors were also the same companies in which the scheme was investing. Furthermore, transaction records indicated that more than 40% of the Stoneridge's corpus was invested in bonds rather than growth stocks.
- **Lack of independent portfolio valuation.** Rockford AMC failed to produce a paper trail or give any indication that an independent broker-dealer valuation of the fund's portfolio had been conducted since the establishment of the fund.
- **Lack of arms-length dealings.** Instead of Rockford AMC managing the fund and maintaining its accounts, all checks and deeds were issued from and received at the office of Pebble Securities, a broker-dealer office providing services to Rockford Cap. These items were usually prepared by Mr. Cliff Gravel, who was Pebble Securities' proprietor, Rockford AMC's compliance officer and the cousin of Preston Sands.
- **Use of affiliated brokers.** The Stoneridge Growth Scheme had invested \$25 million through two broker-dealers whose offices were at Rockford House, the same address as Rockford Cap. The two brokers were:
  - Pebble Securities (proprietor: Cliff Gravel), Member Cragmont Stock Exchange which received 50 % of the scheme's business;
  - Docks & Fisher, Member Concretia Stock Exchange.

- **Lack of best price and execution.** According to PSC regulations, the broker-dealer must seek the best price and execution on shares for its clients. Rockford Mutual Fund demonstrated a high portfolio turnover ratio in comparison to other funds in its category. Furthermore, the Stoneridge Growth Scheme paid the broker-dealers commissions that were higher than the value of the shares it or its custodian, Granite Ltd., received. Pebble Securities was paid \$300,000 more than the total purchases contracted for or delivered.
- **Failure to supervise the activities of the fund's custodian.** PSC regulations required that fund transactions in and delivery of securities be routed through a custodian. Rockford Mutual Fund's transactions, however, were being handled directly by Pebble Securities instead of Granite Ltd. Without physical receipt or actual delivery of shares, Granite Ltd. recorded entries for the purchase and sale of securities by the fund solely by verbal communication from the AMC. Furthermore, during a walk-through tour of Rockford Cap's offices, a PSC officer stumbled upon several open boxes which contained securities certificates of companies within Stoneridge's portfolio. The officer also found on top of one of the boxes a receipt contracting an armored car service to deliver the boxes to Rockford Cap's corporate vault.
- **Indications of affiliated transactions.** Rockford Mutual Fund recently invested \$10 million in the newly-established Quarry Mills, equal to 51% of the company's outstanding shares. This company was founded by Andrew Sands, the brother of Preston Sands.
- **Indications of front running.** According to trading records obtained by the PSC, Preston Sands placed an order for shares in Quarry Mills through the brokerage firm, Docks & Fisher. Prior to placing the order for the fund, Preston Sands ordered Docks & Fisher to purchase 100 shares in the company for his own personal account. The day following the company's IPO, stock prices soared 10% but then shortly thereafter settled down to half of what was the initial price by the following week. Mr. Preston managed to sell his shares prior to the stock price drop.

### **Rockford AMC's Explanation**

In January 1997, Rockford AMC was asked to respond to the PSC's report. Rockford AMC believed that the PSC had misunderstood the workings of the Fund and that the findings were misconstrued. The AMC claimed that the discrepancies reflected technical errors, and by the AMC's view were considered insignificant and not in violation of any material provisions or PSC regulations.

The AMC explained that certain violations such as not maintaining an arm's length relationship with associates were attributed to the convenience in sharing of operational premises. Furthermore, the AMC used Rockford Cap's brokers because they were well-known in the market, and their principals were well known to the AMC's management. Finally, checks issued by Cliff Gravel were described as "administrative" only, since the investment decisions were taken by the investment committee comprising the senior executives.

In response to other findings, the AMC claimed that it invested in affiliated corporations due to their high growth potential within an environment that offered Rockford limited investment opportunities. The high portfolio turnover was reflected in the fact that Rockford had to take the investment opportunities as they turned up. The high brokerage commissions were deemed well-deserved by the broker-dealers because of their excellent service.

Regarding the front running issue, the AMC explained that it did not have the financial means to pay Mr. Preston adequately, and therefore incorporated his ability to purchase stock in companies invested by Rockford as part of his compensation package. Lastly, Rockford was in the middle of contractual disputes with Granite Ltd., and clarified that it would serve as its own custodian of the securities until the contractual matter was settled.

### **PSC Action**

The PSC did not accept Rockford AMC's explanations. The PSC felt the results of its investigation made it imperative to impose administrative sanctions on the Rockford Group. In deliberating what sanctions to impose, the PSC contemplated how far to go to separate Rockford Cap and Rockford AMC, knowing that it did not want the sanctions to negatively effect the fund's unitholders. It was also considering whether or not to write a public report on its findings.

### **Rockford Trust Company's Response to PSC**

Dr. Stone, along with Preston Sands, were now debating the appropriate response to the PSC. Their main concern was limiting the potential sanctions against the fund and maintaining investor confidence. They had to ponder what actions Rockford should take.

Issues to consider:

- What should have been the role of each member of the Rockford Group (i.e, the sponsor, AMC, trustee) and the custodian to prevent the violations identified by the PSC?
- What should be the compliance officer's relationship to the fund, AMC and trustee? What should the compliance officer have done to prevent the wrong-doings?
- What should be the role of the auditor, Flint Chartered Accountants?
- What sanctions and other corrective actions should the PSC impose to prevent similar abuses in the future?

# **Session 3**

## **Role of a Compliance Officer**

## Role of a Compliance Officer:

⇒ Reporting Structure

⇒ Responsibilities

### **Reporting Structure**

- The Compliance Officer (CO) should present reports directly to the trustees
- The CO may, alternatively, report to the Legal Department/Legal Counsel of an AMC
- The CO would typically be an employee of the AMC with “dotted-line” (indirect) reporting to senior management of the AMC and direct reporting to either the Legal Department or the trustees.

## **Considerations in designing the reporting structure:**

- ⇒ Trustees have the ultimate responsibility of safeguarding the interests of the shareholders
- ⇒ There should be a direct avenue for informing trustees of deficiencies and concerns identified by the CO
- ⇒ The daily operations of the fund are handled by the AMC and the CO's main interactions are with the AMC staff and management
- ⇒ Routine administrative matters concerning the CO would be handled by the AMC or its Legal Department

## **CO's experience and qualifications**

- the CO position is a senior position
- requires integrity and high ethical standards
- ability to interface with all levels of the AMC
- internal/ external/ compliance/ regulatory auditing experience; or
- Company Secretary/ legal background

## **Responsibilities**

- AMC's responsibilities
- CO's responsibilities

## **AMC's Responsibilities**

- Promoting a culture of compliance
- Ensuring that each employee is informed of the compliance requirements related to their function
- Ensuring an adequate supervisory review structure

## **AMC's Responsibilities cont.**

- Full support to all independent review functions including compliance reviews
- Facilitate CO access to all relevant information
- Prompt action to deficiencies identified
- Responsiveness to compliance concerns noted
- Business decisions and compliance risk

## **Compliance Officer's Responsibilities**

- Evaluation of the risks associated with various operations and activities of the AMC
  - regulatory risk
  - operational/business risk
  - investor perception

## **Compliance Officer's Responsibilities cont.**

- Assigning compliance resources to identified risk areas:
  - determining if there is already an independent review function performed for these areas (compliance vs. internal audit vs. external audit)
  - designing a compliance control program/ calendar (review of schemes, adherence to the Code of Ethics, transaction processing, regulatory reporting)
  - preventive vs. corrective compliance monitoring

## **CO's Responsibilities cont.**

- Conducting compliance reviews
  - sampling
  - limitations of certifications
- Discussing results with departmental and AMC senior management to ensure complete information was obtained prior to drafting the compliance report
- Forwarding compliance reports to trustees/ legal department
  - routine quarterly reports
  - ad hoc reports
  - other reports

## **CO's Responsibilities cont.**

- Following up on corrective action planned or taken by the affected department
  - seriousness of the violation
  - timing of follow up: immediate, end of month, quarter or by next review
- Dissemination of compliance developments or changes in regulations to affected departments
- Ensuring timely and adequate responses to investor grievances
  - direct responses by the CO
  - direct responses by the AMC
  - monitoring of responses by the transfer agent

## **Issues related to CO functions**

- segregation of duties
  - portfolio/ backshop or accounting/ custodial/ compliance
  - consultation prior to execution - independence issue
- compliance perspective vs. accounting/ financial statements outlook
- adequate staffing

## **Issues related to CO functions cont.**

- workpapers
  - documentation of work performed
  - supervisory review
  - continuity
  - training tool
  - concerns: limiting regulatory access
- professional judgement, CO's liability

## **The Role of the Compliance Officer:**

**“The Compliance Officer is in the  
business of keeping YOU in  
business.”**

Remarks Of  
Richard Y. Roberts  
Commissioner\*  
U.S. Securities and Exchange Commission  
Washington, D.C.

"The Role of Compliance Personnel"

National Regulatory Services  
10th Anniversary Investment Adviser &  
Broker-Dealer Compliance Conference  
Paget Parish, Bermuda  
April 7, 1995

The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

"The Role of Compliance Personnel"

I. Introduction

I appreciate the opportunity to participate once again in an NRS conference. It has been my pleasure during the past few years to discuss with you a number of securities public policy issues in such diverse areas as market structure, wrap fee programs, investment adviser legislation, derivative securities and foreign listings, and I have always found the inevitable debate that follows both enjoyable and educational. This year it is my intention to speak on what I view to be the proper role of compliance personnel for broker-dealers and investment advisers. I plan to provide you with an overall personal view of that role, discuss a few noteworthy Commission enforcement actions in the area, and conclude with a few remarks about wrap fee programs.

II. The Role of a Compliance Officer

It should come as no surprise to you that the Commission views the role of inhouse compliance personnel as being critical to the maintenance of the integrity of our securities markets. You are the first line of defense against fraud and sales practice abuse, and you can serve your employer well by serving the public well. The Commission enforcement cases against Prudential Securities and Paine Webber should have demonstrated that point adequately.

As the first line of defense, what weapons should you have in your arsenal? First, in my view, it is essential for a compliance officer to have the authority within the firm to remedy inappropriate conduct. This authority should include the ability to sanction, or maybe even fire, rogue employees. At a minimum, there should be the ability to notify and follow up with supervisors all the way up to the top of the chain of command until the problem is remedied.

Second, the firm should have in place strong compliance procedures that both educate and monitor employees. For procedures to be effective, however, there must be a commitment by the firm to enforce the procedures and to educate the employees appropriately.

Last, compliance must have the proper resources to be effective. I recognize that a compliance department is without

immediate tangible benefits; and, as such, it is not naturally high on the priority list for resource allocation. Nevertheless, public trust and confidence is a critical component of any successful securities market operation in my view, so compliance should be provided with sufficient resources to be effective.

Certainly, any compliance officer must exercise vigilance in monitoring conduct. A compliance officer must be especially alert for "red flags" that suggest questionable conduct. The best early warning systems, as far as I can tell, are automated exception reports and, most importantly, customer complaints. A compliance officer that fails to take adequate steps to respond to these red flags risks a visit from the Commission's Division of Enforcement. Unfortunately, the Commission's enforcement personnel are ordinarily the last to arrive on the scene, and by then there usually has already been significant damage to the firm and its customers.

III. Compliance Procedures

No doubt you heard this morning how to develop effective compliance procedures. Except for Section 15(f) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 204A of the Investment Advisers Act of 1940, there are no federal securities law requirements of which I am aware that imposes a duty to adopt compliance procedures. Reasonable procedures, however, can be an affirmative defense to a failure to supervise action. Further, good compliance procedures make excellent business sense as they protect the integrity of the firm. Just as important as developing compliance procedures is the need to revisit them periodically to determine their effectiveness. Procedures that are not adequately monitored and updated are little better than having no procedures at all.

As I indicated, there is a federal securities law requirement contained in Section 15(f) and Section 204A to adopt compliance procedures; however, these provisions address the misuse of material nonpublic information only. These sections require that broker-dealers and investment advisers establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information by such broker-dealer, investment adviser, or any person associated with them. Of course, these requirements were a part of the Insider Trading and Securities Fraud Enforcement Act of 1988.

The Commission brought its first enforcement case under these sections late last year against Gabelli & Company and GAMCO Investors, Inc. This case arose out of trading in Lynch Corporation securities by the defendant companies. The policies, procedures, and practices in place at the defendant firms did not adequately take into account the special circumstances presented by Mario Gabelli's role as chairman of the board of directors and chief executive officer ("CEO") of Lynch and his roles as de facto chief investment officer of Gabelli & Company and GAMCO. In the Commission's view, the policies in place were not reasonably designed, in view of the defendant's overall business, to prevent the misuse of material, nonpublic information.

As CEO of Lynch, Gabelli was in a position to possess material, nonpublic information about Lynch's financial position and operating results. The Gabelli investment companies had an informal "three day rule" which put Lynch securities on the restricted list only on the three days surrounding the issuance of Lynch press releases and board meetings. There were no

43

written procedures in place, and compliance with the three day rule was not consistent.

The defendants were ordered to cease and desist from further violations of Sections 15(f) and 204A and were fined \$50,000. In addition, they undertook to implement changes recommended by an independent consultant, who would provide the Commission with follow up reports.

#### IV. Failure to Supervise Liability

While failure to implement reasonable procedures to prevent the misuse of material, nonpublic information is an actionable offense, the failure to adopt procedures to address other types of misconduct is not necessarily a violation. Yet, as I mentioned earlier, adopting reasonable procedures is an affirmative defense to a charge of failure to supervise under Exchange Act Section 15(b)(4)(E). Although the subject of failure to supervise lends itself easily to a long discussion, I plan to touch upon only the area that I believe is of greatest interest to this audience ... and that is failure to supervise liability for legal and compliance personnel.

In 1964, Congress enacted what are now Sections 15(b)(4) and (b)(6) of the Exchange Act. Section 15(b)(4)(E) authorizes the Commission to impose sanctions against a broker-dealer if the firm has "failed reasonably to supervise, with a view to preventing violations [of the federal securities laws], another person who commits such a violation, if such other person is subject to his supervision." It is interesting to note that this statutory provision refers to "preventing violations of the provisions of ... statutes, rules, and regulations ..." The word "order" does not appear on this list, which has given rise to some intriguing discussions at the Commission.

Section 15(b)(6) of the Exchange Act incorporates Section 15(b)(4)(E) by reference and authorizes the Commission to impose sanctions for deficient supervision on individuals associated with broker-dealers. Unfortunately, the legislative history behind these provisions provides little guidance as to what was intended by the phrase "subject to his supervision." This has led to a great deal of uncertainty as to who can be a supervisor within the meaning of the failure to supervise liability provisions of the Exchange Act.

Typically, a finding of liability involves two distinct considerations: (1) whether the person was the supervisor of a person who violated the federal securities laws and (2) whether the person performed reasonably in discharging his or her supervisory responsibilities. Both of these questions ordinarily entail a fact specific inquiry, especially in the case of "non-line" personnel, such as most legal and compliance personnel, where the concept of supervisory responsibility is far less developed than in the case of "line supervisors."

Taking the second liability consideration first, as the case law demonstrates, it is easier to determine when a person has performed reasonably in discharging supervisory responsibilities than it is to determine when a person is a supervisor. There exist a few Commission proceedings involving compliance or non-line supervisory personnel where the Commission declined to find that the person acted unreasonably.

For example, in "Louis J. Trujillo", the Commission overturned an administrative law judge's determination that a

surveillance and compliance person had failed to supervise a registered representative who churned and made unauthorized trades in customer accounts.-[3]- The Commission found that Trujillo's conduct, although not exemplary, was reasonable in that he had taken diligent efforts to inform the branch manager of the need to discipline the employee. The opinion took no position as to whether Trujillo was a supervisor of the rep in question.

Another example is "Arthur James Huff", in which the Commission divided over whether Huff, a compliance officer, was a supervisor.-[4]- Chairman Breeden and I found that although Huff may have been a supervisor, he did not act unreasonably in view of the limited scope of duties he was given by the firm.

The more difficult issue unresolved by "Huff" was when compliance officers are considered to be supervisors of a non-line employee. A segment of the securities industry apparently continues to question whether compliance officers should ever be deemed supervisors within the meaning of Exchange Act Section 15(b)(4)(E) when they are not a line supervisor of the employee who committed the violation. Although this debate does continue, I think it is fair to say that the present Commission does not view itself as being barred from charging compliance officers with liability for failing to supervise, even when the compliance officer is not a line supervisor of the employee in question.

So, when is a compliance officer a supervisor? The test is necessarily a facts and circumstances determination. As such, there is no bright-line standard, rather guidance must be gleaned from Commission decisions and orders.

Three fairly recent Commission proceedings do shed some light on the subject. In the "Gary W. Chambers" case, the Commission found that Chambers had failed reasonably to supervise in failing to discharge his responsibility to ensure that his firm "adopted and maintained adequately supervisory and compliance policies and procedures."-[5]- Although the firm compliance manual vested him with designing procedures, he failed to do so. The Commission order identified other factors as well suggesting that Chambers assumed supervisory responsibility for the persons committing the violations, including his role in reviewing transactions, his failure to discover misconduct of the persons at a previous employer, and his knowledge that there was no one else supervising the persons.

In the 1992 case of "First Albany Corporation", the firm's chief compliance officer was also the general counsel and had the responsibility to implement compliance procedures and enforce the firm's trading restrictions.-[6]- This compliance person had the power "to take disciplinary action against a registered representative who violated firm policy by removing commissions and imposing small fines." The Commission concluded that a violation occurred when the compliance person was alerted to a violation and failed to determine whether the branch office instituted corrective measures.

The most important Commission proceeding in the area in my view, however, was the Commission report under Section 21(a) of the Exchange Act concerning the actions of Donald Feuerstein, the chief legal officer of Salomon Brothers. Of course, the Commission did charge John Meriwether, Thomas Strauss, and John Gutfriend with failure to supervise Paul Mozer, a Salomon trader who submitted false bids to the Treasury Department. The false bids came to the attention of these three top management

45

supervisors, as well as Feuerstein. Although Feuerstein was not technically Mozer's line supervisor, he became part of the management team response to the violation of law. Given the confusion that resulted from the divided "Huff" opinion, rather than name Feuerstein in the action with the other supervisors, the Commission elected instead to issue a report under Section 21(a) of the Exchange Act (the "Report").-[7]-

The Report clarified the "Huff" opinion to some extent and validated the progression of cases holding that non-line supervisors can become supervisors, depending upon the facts and circumstances, even where the person has no hire, fire, reward or punishment authority. In my opinion, the key sentence in the Report appears on page 23. "Rather, determining if a particular person is a 'supervisor' depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue." This language, in my view, expanded the traditional definition of "supervisor" even from that contained in the Breeden-Roberts opinion in "Huff".

Interestingly enough, there is no specific knowledge condition appearing in the Feuerstein standard. However, I am of the view that the more knowledge a compliance person has of misconduct, that is not responded to in a reasonable compliance manner and then is repeated, the more likely that person will be deemed to be a supervisor within the meaning of Exchange Act Section 15(b)(4)(E).

Hopefully, future Commission actions in the failure to supervise area involving legal and compliance personnel will clarify how the Feuerstein standard will be applied. I know that those employed in this sector of the securities industry would welcome some certainty in the area. It is my fervent hope that the Commission would not waver from utilizing its enforcement authority in this area when the facts and circumstances are appropriate, but would do so in a balanced and responsible manner. I see nothing to be gained from a policy of instituting failure to supervise actions against legal and compliance personnel on a routine basis.

#### V. Wrap Fee Accounts

Before concluding my remarks today, I would like to discuss briefly the primary legal issue surrounding wrap accounts. I believe that the members of this audience should be on the lookout for Commission enforcement activity which may be forthcoming in this area. I know that you have already heard a program about wrap accounts this morning and about the potential for troubling conflicts of interest that may appear in the administration of these accounts.

For a long time, the Commission has been concerned that some have obliterated the admittedly fuzzy line that exists between a legitimate wrap fee program that does not need to be registered and a wrap account program that pools investment capital and selects securities for the pool as a whole. The latter may be no different from a mutual fund and may need to be registered if there are more than 100 participants. Of course, in wrap fee programs, clients matched with a particular portfolio manager often receive substantially the same securities advice and their accounts often hold the same or substantially the same securities. If the investors do not retain individual ownership of the securities in their accounts and do not receive

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individualized treatment, the program probably should be treated as an investment company because it would be an "issuer" primarily engaged in investing and trading in securities.

The first Commission foray in this area was more than twenty years ago with an enforcement action against an investment adviser and a broker-dealer who operated a program similar to a wrap fee program.--(8)-- While the program involved in that action was advertised as offering personalized advice, the Commission found that the adviser invested client funds in a virtually uniform manner.

As you heard this morning, fifteen years ago the Commission proposed Investment Company Act Rule 3a-4 to provide some clarity in the area. This proposed rule would have provided a safe harbor for programs satisfying the requirements of the rule. Although the rule was never adopted, the Division of Investment Management has issued more than twenty no-action letters using, in part, the standards contained in the proposed rule.

I understand that some wrap fee sponsors have taken a mechanical approach to providing individualized treatment to clients. I am of the view that quarterly mass mailings and perfunctory annual check-ups are insufficient, by themselves, to demonstrate that clients are receiving investment advice tailored to their individual needs. A lack of diversity among client accounts suggests to me that clients are not receiving a meaningful opportunity to exclude particular securities from their accounts. In my opinion, this opportunity to exclude certain securities is one of the most telling differences between a wrap fee program and a mutual fund.

Apparently, the Division of Investment Management's long-anticipated release more clearly delineating the line between a legitimate wrap fee program and an unregistered investment company is expected to be considered by the Commission shortly. I have been somewhat frustrated by the length of time necessary to bring this project to Commission consideration, but I have recently been assured that the release is just around the corner.

Therefore, I do advise you to remain alert for potential Commission action in this area.

VI. Conclusion

In its enforcement program, the Commission has attempted to be tough and aggressive on the one hand and fair and reasonable on the other. That is a difficult balance to maintain, especially in the failure to supervise area involving legal and compliance personnel where the facts and circumstances so often control. I can assure you that the Commission strives to "do the right thing" in its enforcement program, and in the almost five years that I have been on the Commission, I generally have been proud of the result.

My parting advice to you today is to consider whether you have the authority, procedures, and resources to carry out your compliance functions effectively. They are critical to the success of your employer. Further, it may be worth revisiting your wrap fee programs to ensure that they provide the necessary individualized client treatment to qualify as a legitimate wrap fee program.

ENDNOTES

-(1)- Arguably, Rule 17j-1(d) under the Investment

41

Company Act of 1940 imposes such a requirement by requiring a fund to adopt a code of ethics.

- (2)- In the Matter of Gabelli & Co., Inc. and GAMCO Investors, Inc. Securities Exchange Act Release No. 35057 (Dec. 8, 1994).
- (3)- Exchange Act Release No. 26635 (March 16, 1989).
- (4)- Exchange Act Release No. 29017 (March 28, 1991).
- (5)- Exchange Act Release No. 27963 (April 30, 1990).
- (6)- Exchange Act Release No. 30515 (March 25, 1992).
- (7)- Exchange Act Release No. 31554 (Dec. 3, 1992).
- (8)- SEC v. First National City Bank, Litigation Release No. 4534 (Feb. 6, 1970).

# **Session 4**

## **Investment Management**



THE COMPLIANCE  
FUNCTION

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*P. C. SINGH*

*MORGAN STANLEY INDIA*

*December 4, 1997*



# *OUTLINE*

- WHY COMPLIANCE MATTERS
- REGULATORY FRAMEWORK
- THE COMPLIANCE FUNCTION
  - BEST EXECUTION
  - FAIRNESS TO CLIENTS
- FIRM POLICIES & PROCEDURES



# *WHY COMPLIANCE MATTERS*

- FIRM FRANCHISE
- HELPS AVOID LEGAL ACTION - CIVIL AND CRIMINAL
- HELPS AVOID DISCIPLINARY ACTIONS BY REGULATORS
- HELPS AVOID UNENFORCEABLE TRANSACTIONS

AD

# *THE REGULATORY FRAMEWORK*

- Lead Regulator - Securities and Exchange Board of India ('SEBI')
- Key Regulations:
  - SEBI Act, 1992
  - SEBI (Mutual Funds) Regulations
- Trust Deed, Investment Management Agreement and Offer document

# ***BEST EXECUTION***

- INVESTMENT RESTRICTIONS:
  - Regulatory restrictions
  - Client guidelines/ Investment objectives
  - Restricted List/ Watch List
- BEST PRICE (Price variance):
  - Trades outside the high/ low prices for the day
- COMMISSION (Brokerage variance):
  - Trades in excess of negotiated commissions

# ***BEST EXECUTION***

- AFFILIATED TRADING RESTRICTIONS:
  - Proprietary - with client consent
  - Agency - best execution
  - Agency cross - NO
  - Underwriting
- PRIVATE PLACEMENTS:
  - Adequate documentation

5

# *BEST EXECUTION*

- BUSINESS DISTRIBUTION
- RISK MANAGEMENT:
  - Tolerance limits for brokers
  - Suspension of brokers (Distribution/ Risk)
  - Procedures for trades with brokers on restricted list



# *FAIRNESS TO CLIENTS*

- PRE-TRADE ALLOCATION
- AVERAGE PRICING
- CANCEL/ CORRECTS:
  - duty of utmost care
  - no loss to client
  - no allocation to another account
  - costs to be borne by AMC



# *FAIRNESS TO CLIENTS*

- EXECUTION ACROSS SCHEMES/  
FUNDS:
  - Fair allocation (Buy/ Sell)
  - Holding across funds/ schemes
- CROSS SALES
- PROPRIETARY TRADES

# *FAIRNESS TO CLIENTS*

- DISCLOSURES
  - Transparency
  - Accuracy
  - Timely
- REPORTS
  - to Trustees
  - to Unitholders
  - to SEBI

# *FIRM POLICIES*

- CODE OF CONDUCT
- CHINESE WALLS
  - fund management/ operations
  - affiliates
- EMPLOYEE TRADES:
  - pre-approvals
  - blackout periods
  - holding period

## Objective:

- To highlight compliance issues and monitoring requirements related to investment management activities

## Compliance Framework

- Regulations
- Internal Policies and Procedures
- Fund/ Scheme Restrictions

# Regulatory Environment

- SEBI regulations
- the Companies Act of 1956
- the Indian Trust Act
- RBI rules
- Other laws, rules and regulations

## SEBI Regulations

- (Mutual Funds) Regulations, 1996
- (Portfolio Managers) Rules and Regulations, 1993
- (Stock Brokers and Sub-Brokers) Rules and Regulations, 1992
- (Registrars to an issue and share transfer agents) Rules and Regulations, 1993
- Prohibition of Fraudulent and Unfair Trading Practices relating to Securities Markets
- Other SEBI Regulations

## **SEBI (Mutual Funds) Regulations, 1996**

Adoption by the Board of Trustees of:

- Compliance Manual
- Code of Conduct/ Ethics
- Advertising Guidelines
- Valuation Guidelines

### **Other Procedures:**

Examples of procedures typically approved by the Board of Trustees:

- brokerage allocation; trade allocation
- diversification; interfund transactions
- money market fund valuation; repurchase transaction guidelines
- securities lending, counterparty credit review standards

## Compliance Control Program

- Identification of all Compliance Requirements
- Assignment of Independent Review Functions
- Design and Implementation of Audit Programs
- Consideration: Preventive or Corrective

## Compliance Areas:

- Trade allocations
  - fairness to all accounts
  - documentation of the process
  - pro-rata, random or other process
- Portfolio decision-making process

## Compliance Areas cont.:

- Management of multiple accounts
- Custodial issues - reconciliation
- Review of contracts

## Compliance Areas cont.:

- Trading System - access, interface, ad-hoc reports
- Review of schemes
- Pricing procedures
- Fair valuation procedures

## Compliance Areas cont.:

- Code of Ethics compliance
  - personal transactions
  - affiliated transactions
  - other considerations

## Session 4

S. Chatterjee

**Securities and Exchange  
Board of India**

**PRESS RELEASE**

Dated September 5, 1997

Ref.No.PR 100/97

**SUBJECT : SEBI BOARD MEETING**.....

.....  
.....

Issued by : .....

**TEXT**  
====

**PRIMARY MARKET DEPARTMENT :**

1. On receiving recommendation from RBI, the entry norms and the norms for free pricing shall not be applicable to the private sector banks and the local area banks which have been granted license to set up banks by the Reserve Bank of India.

67

2. With a view to facilitate fund raising by infrastructure projects which have long gestation periods and entities like Municipal Corporations which can only raise funds through debt instruments, SEBI had allowed that such debt instruments will be allowed to be listed on the Stock Exchanges without the pre-existing requirement of the equity being listed first. Doubts, however, were expressed regarding the listing of instruments convertible into equity such as PCDs, FCDs or OCDs, etc. It has been decided that the corporates with infrastructure projects and Municipal Corporations shall be exempted from the requirement of Rule 19(2b) of Securities (Contract) Regulation Rules, to enable such companies/corporations, to make a public offer and list its pure debt instruments as well as debt instruments fully or partly convertible into equity without the pre-existing requirement of prior listing of its equity subject to the condition that such instruments carry an investment grade rating and are fully secured irrespective of the maturity of the instruments and in case of debt instruments fully or partly convertible into equity, the equity issued prior to the issue of debt shall be listed only at the time when the equity arising on conversion of such convertible instruments get listed.
3. The Board considered the proposal of Book building to the extent of 100% and has decided that an issuer shall have option to make an issue through Book building route upto 100% of its offer, provided the issue size is Rs.100.00 crores or more. However, the present stipulation of priority for such small investors will continue.
4. The SEBI Board considered the draft regulations for credit rating agencies and decided to set up a committee consisting of representatives from Reserve Bank of India, Credit Rating agencies, Institute of Chartered Accountants of India, SEBI and also from amongst the corporates. This committee will examine the draft regulations prepared by SEBI and shall make its recommendations for suitable modifications to the SEBI Board.

5. The SEBI Board approved the following changes in the SEBI (Merchant Bankers) Rules & Regulations, 1992 :
  - a. Only body corporates shall be allowed to function as Merchant Bankers.
  - b. That the multiple categories of merchant bankers shall be abolished and there shall be only one entity viz. Merchant Banker. The Merchant Bankers presently functioning as Merchant Bankers Category II, III and IV shall be given an option to either upgrade themselves as the Merchant Banker (presently Merchant Banker Category I) or seek separate registrations as Underwriter or Portfolio Manager under the respective regulations or at the end of their present period of registration, their registration shall lapse. In other words, with the implementation of this decision, fresh registrations to Merchant Bankers in Category II, III and IV shall be discontinued.
  - c. Presently, the Merchant Banker Category I, in addition to issue management is also allowed to undertake underwriting and portfolio management activities. With the revised proposals, while the Merchant Banker will continue to perform underwriting activity, it shall have to seek separate registration to function as a Portfolio Manager under the SEBI (Portfolio Manager) Rules & Regulations, 1993..
  - d. It has been decided that Merchant Bankers shall be prohibited from carrying on fund based activities other than those related exclusively to the capital market. In effect, therefore, the activities undertaken by NBFCs such as accepting deposits, leasing, bill discounting, etc would not be allowed to be undertaken by a merchant banker. The existing NBFCs performing merchant banking activities will be given suitable time to restructure their activities.

69

## MUTUAL FUNDS:

The Board of SEBI noted the positive impact of the revised Mutual Fund Regulations, 1996 on the Mutual Funds, particularly in the areas of disclosure in the offer documents, disclosures of fundamental attributes of schemes, and greater clarity in the disclosure of investment objective, weekly/daily disclosures of NAVs and standardization of computation of NAVs.

The Board also reviewed the various monthly, quarterly, half yearly and annual reporting formats introduced by SEBI for strengthening monitoring, compliance and strengthening of internal systems by Mutual Funds. These reporting would facilitate an understanding of the operations of the Mutual Fund and throw up early warning signals in this regard.

The Board also approved the following amendments to the SEBI (Mutual Funds) Regulations, 1996:

1. A Mutual Fund shall not make any investments in any un-listed securities of associate/group companies of the sponsor;
2. A Mutual Fund shall not make any investment in privately placed securities issued by associate/group companies of the sponsored;
3. The aggregate investment of a Mutual Fund in the listed and/or to be listed securities of group companies of the sponsor shall not exceed 25% of the net assets of all schemes of the fund;
4. AMCs would be required to disclose in the offer document maximum investments proposed to be made by the Scheme in the securities of the group companies of the sponsor and also aggregate investment made by all schemes in the group companies.

5. The AMCs shall have to submit quarterly report to the trustees giving details about the transactions in the securities of the group companies during the quarter and the trustees could have to make specific comments in its half yearly reports to SEBI on those investments.
6. The "Group" for this purpose would have the same meaning as provided in the Monopolies and Restrictive Trade Practices Act, 1969.
7. An AMC cannot can not purchase or sell securities through a Broker who is an associate of a sponsor beyond 5% of the gross business of the Mutual Fund which will be monitored on a quarterly average than on a daily basis.
8. AMC shall not in a quarter purchase or sell securities for any of the schemes through any broker beyond 5% of the aggregate business of the securities in a quarter, unless the AMC records the justification for exceeding the limit and reports such cases to the Trustees on a quarterly basis.
9. To help trustees play their role in a more effective manner, the independent trustees shall constitute 2/3 of the Board.
10. Inclusion of abridged prospectus will now be circulated along with all application forms which will now have key information and be available to all investors. The full portfolio disclosure in the Annual Reports will now be mandatory. The fundamental attributes of a scheme have now been defined to include, type of a scheme, investment objective, terms of issue and will not be changed without the approval of the unit holders.
11. Conversion of closed ended scheme into open ended scheme, and roll-over of a closed ended scheme, shall not require approval of unit holders provided that all unit holders who express their consent in writing and the unit holders who do not opt for the roll over or has not expressed written consent shall be allowed to redeem their holdings in full at NAV based price.

12. The norms of valuation of money market instruments have been further standard, this will facilitate MBF.
13. Greater clarity in the expense structure, by including certain expenses as allowable recurring expenditure with the existing limit in the regulator.
14. The auditors will now be required to comment on the compliance of the Regulations and investors grievances and redressal of Mutual Funds.

The other decision taken by the SEBI Board was that the regulation which specify the eligibility criteria for grant of initial registration/renewal to intermediaries would be amended. The concept of 'fit and proper' person would be introduced as an eligibility criteria in the regulations.

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## SAMPLE COMPLIANCE REVIEW PROCEDURES.

### 1. FUND PORTFOLIO INVESTMENT ACTIVITES.

#### A. Investment Decisions

1. Review each fund's prospectus and verify that disclosure is consistent with actual practice.
  - a. Where do investment ideas originate?
  - b. Who selects the individual securities to be purchased or sold?
  - c. Who authorises the actual securities transactions?
  - d. Who recommends and decides broader investment policies?
  - e. What investment information or materials is provided to the fund's trustees?
2. Review checklists prepared by portfolio manager for prior 12 months.
3. If the fund utilizes a sub-advisor , review contracts/agreements and note any discrepancies.

#### B. Transactions in Portfolio Securities

1. List all trading personnel that execute orders for the fund's portfolio. Identify all supervisors.
2. Describe the process used to select broker-dealers and any arrangements (written and unwritten) for the following purposes:
  - a. Sales of fund's shares , including all direct and indirect promotional efforts.
  - b. Advisory, research services , computer hardware and software , and any other services provided.
  - c. Review brokerage allocation disclosures.
  - d. Any other arrangements (e.g. , directed brokerage or payment for order flow).
3. Review brokerage allocation reports prepared by trading department.
  - a. Select a sampling of order tickets and compare to the brokerage allocation report.
    - (1) Is all required information contained on the order ticket?
  - b. Obtain list of broker-dealers who sell the fund's shares and compare to the brokerage allocation report.
  - c. Discuss any discrepancies, inconsistencies or other unusual findings.
4. Obtain from MIS a download of the fund's securities transaction for the most recent 12 months and review for the following:
  - a. Crossing transactions between fund portfolios/affiliates
    - (1) Were the transactions properly reported to the fund's trustees?
  - b. Transactions involving affiliated broker-dealer/advisors.
  - c. Transactions between the fund and any officer , director or employee.
  - d. Transactions between the fund and the "unknown " broker-dealer.
  - e. Transactions in illiquid securities , private placements and restricted securities .
  - f. Transactions that do not appear to be consistent with "best execution".
    - (1) Review the cents per share cost of the fund's agency trades.
  - g. Transactions involving IPOs , securities held for a very short time or not consistent

SAMPLE COMPLIANCE REVIEW PROCEDURES continued

with fund's investment objectives.

h. Transactions during the weeks prior to the fund's fiscal quarter-end.

i. Transactions in securities that were in chapter 11 reorganisation (Obtain Creditor's Committee Report from Legal Department).

5. Review the current portfolio turnover for each quarter and the year (obtain appropriate reports from Fund Accounting).

a. Is it consistent with the fund's investment objectives?

b. Has there been a significant increase/decrease in portfolio turnover rate ?

6. Review process utilized by Trading Department to communicate transaction information to bank custodian and fund accounting department.

a. Are only authorized personnel , as provided in letter to bank custodian, providing settlement instructions?

b. Are original signatures provided to bank on every instruction?

C. Fund Accounting Review

1. Compare downloaded trading blotter and brokerage allocation reports.

2. Review policy for handling trade errors and general ledger account established to record such transactions.

D. Portfolio Pricing Review

1. Review the pricing reports maintained in Fund Accounting for compliance with Pricing Procedures.

a. Have the Market Value Impact on NAV Report, and Pricing Exception Report , been initialled by the portfolio manager and returned to Fund Accounting each day?

b. Do the reports show any unusual pricing problems ?

c. Do the manual over-rides of the pricing service prices have adequate documentation?

(1) Are the reason codes identified ?

(2) If not over-ride , but price is unchanged greater than 7 days, is there documentation that price was reviewed and verified as correct?

2. Review Pricing Control Report in Fund Accounting

a. Are all reports being returned timely?

b. Are all reports being returned signed ?

## SAMPLE COMPLIANCE REVIEW PROCEDURES.

### II. INSIDER TRADING , CODE OF ETHICS AND PERSONAL SECURITIES TRANSACTIONS.

- A. Request a copy of the "Code of Ethics" and the list of access, non- access and NASD registered employees from Human Resources.
  - 1. By sampling , confirm that each access employee's personnel file contains a signed acknowledgement form, evidencing receipt of the Code of Ethics
- B. Review for compliance with current Code of Ethics
  - 1. Obtain transaction log from trading department and securities transaction request forms from Director of Research
    - a. Is there an approved securities transaction request form for each trade listed on the transaction log?
    - b. Are there any transactions by employees in violation of Code of Ethics?
      - (1) Purchased or sold within 5 days of a fund's transaction?
      - (2) Purchased or sold within 15 days of a written buy or sell recommendation ?
      - (3) Purchased or sold while securities were actively contemplated for fund?
      - (4) Purchased IPOs , including municipal securities?
      - (5) Purchased equity securities of any broker -dealer that is effecting or in the position to effect brokerage transactions for a Fund?
      - (6) Purchase securities of any corporation of which 10% or more of the outstanding shares are held aggregated in portfolios managed by the adviser?
- C. Obtain a list of the companies held by the funds that underwent Chapter 11 bankruptcy reorganization
  - 1. Were there any securities transactions by the fund subsequent to Chapter 11 reorganisation?
  - 2. Did any employee (e.g. , the portfolio manager/research analyst ) transact in securities that became bankrupt?
- D. Review the record of consultations of the Director of Research.
  - 1. Were there any transactions prohibited?
  - 2. Were any exceptions to the Code of Ethics granted?
  - 3. Were any transactions reported to the Board of Directors?
- E. Review the Legal Department's monthly audit/reconciliation of employee's personal transactions.
  - 1. Were they filed timely?
  - 2. Were there any repetitive problems?
    - a. Employee failed to report transactions.
    - b. Employee failed to get prior approval for transaction.
- F. Review the duplicate broker-dealer confirms and monthly statements
  - 1. Does any employee have an account at a brokerage firm with whom the employee also conducts business on behalf of the funds?
  - 2. Are ther transactions on the broker-dealer statement that are not reported?

# VALUATION OF SECURITIES

## What is Value

- ▼ Defined as the quoted market price for securities for which market quotations are readily available, or an estimate of value (fair value) as determined in good faith by the board of trustees for other securities

## What is Fair Value

- ▼ Fair value of a security is the estimate of the amount the owner of the security expects to receive for it in a current sale, though the owner may not intend to sell them.



76

# VALUATION POLICIES AND FRAMEWORK IN THE U.S.

*(Continued)*

## Securities Valued “In Good Faith”

### ▼ Board Responsibility

- To the extent necessary, the board may appoint persons to assist them in the determination of such value, and to make the actual calculations pursuant to the board’s direction. Frequently, the board will delegate responsibility for fair valuation to a “valuation committee” composed of several board members and staff of the investment adviser



# VALUATION POLICIES AND FRAMEWORK IN THE U.S.

*(Continued)*

## ☐ Securities Valued “In Good Faith”

### ▼ Board Responsibility

- However, the board must review and approve the appropriateness of the fair valuation procedures and must also review and approve the actual valuations in order to satisfy themselves that the valuations are fair.



# VALUATION POLICIES AND FRAMEWORK IN THE U.S.

*(Continued)*

## ☐ Securities Valued “In Good Faith”

### ▼ Board Responsibility

- SEC staff generic comment letters reiterated the board’s responsibility to establish policies and procedures for the valuation of securities for which market quotations are not readily available. Any deviation from the established policies should be disclosed in the footnotes to the financial statements.



# VALUATION POLICIES AND FRAMEWORK IN THE U.S.

*(Continued)*

## Securities Valued “In Good Faith”

### ▼ Board Responsibility

- The information used by the board (or a valuation committee) in determining fair value, together with, to the extent possible, judgment factors considered in reaching a valuation should be documented and the supporting data retained for the inspection of the fund’s independent accountant.



**VALUATION POLICIES AND  
FRAMEWORK IN THE U.S.**

*(Continued)*

**□ Securities Valued “In Good Faith”**

**▼ Fair Valuation Procedures**

**• Acceptable Valuation Methods:**

- Multiple of Earnings**
- Discount from market of similar freely traded security**
- Yield to Maturity**
- Combination of these and other methods**



# VALUATION POLICIES AND FRAMEWORK IN THE U.S.

*(Continued)*

## Securities Valued “In Good Faith”

### ▼ Fair Valuation Procedures

#### • Specific Factors Affecting Valuation

- Type of security
- Issuer’s financial statements
- Cost at date of purchase
- Size of holding
- Discount from market value of unrestricted securities of the same class at time of purchase
- Special reports prepared by analysts
- Information as to any transactions or offers with respect to the security
- Existence of merger proposals or tender offers
- Price and extent of public trading in similar securities of the issuer or comparable companies



22

# ADDITIONAL MATTERS RELATING TO VALUATION

- Documentation of Valuation
  - ▼ Written Quotes
  - ▼ Fair valuation
    - Documentation of policies
    - Documentation of methodology
    - Factors considered
    - Authorization and approval
    - Validation



# ROLE OF VALUATION COMMITTEES

- Established by the board
  - ▼ Membership
    - Investment adviser
    - Independent board members
    - Specialists
- Regular scheduled meetings and/or special meetings
- Matters that may be addressed
  - ▼ Valuation for securities with no independent pricing source
  - ▼ Review of valuation policies and methodologies
  - ▼ Determination of reliability of market quotes for thinly traded securities
  - ▼ Review of liquidity policies
  - ▼ Review of fund's portfolio of illiquid securities
- Minutes of the meeting



*LF*

Mutual Funds: SEC Adjusted Its Oversight in Response to Rapid Industry Growth (Letter Report, 05/28/97 GAO/GGD-97-67).

GAO reviewed the Securities and Exchange Commission's (SEC) regulation and oversight of open-end investment companies, focusing on how SEC has responded to rapid industry growth in carrying out its mutual fund oversight through inspections, disclosure review, and other regulatory activities.

MAIN POINTS

GAO noted that: (1) SEC has increased its inspection staffing and adjusted the focus of its inspections to keep up with the rapid growth in the mutual fund industry; (2) since fiscal year (FY) 1990, SEC has more than doubled the number available to do mutual fund inspections; (3) SEC used the increased staff to 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; (4) it also expanded its coverage of investment advisers, and SEC inspectors spent more time on each mutual fund inspection; (5) as a result, the number of mutual fund inspections completed each year has remained relatively constant; (6) 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 FY 1992; (7) as inspections became more comprehensive, the number of deficiencies that inspectors found increased each year, but few deficiencies were serious enough to be considered for potential enforcement action; (8) SEC reported that the mutual fund industry had generally been free of major scandal for the last 2 decades; (9) SEC selectively reviews mutual funds' disclosure documents; (10) a large part of the growth in the mutual fund industry has been in adding new funds to already existing fund complexes; (11) 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; (12) SEC officials told GAO 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 FY 1994 and despite a relatively constant staffing level in this function over the same period; (13) SEC's other regulatory activities relating to mutual funds include: (a) granting exemptions from various provisions in mutual fund laws and regulations, (b) developing and modifying rules to implement these provisions, and (c) providing the industry, Congress, and other government agencies with SEC interpretations of mutual fund laws and regulations; (14) these activities have allowed the mutual fund industry to change dramatically in size and scope without substantially amending existing laws; (15) SEC staff devoted to these regulatory acti\*

----- Indexing Terms -----

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85

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Report to Congressional Committees

May 1997

MUTUAL FUNDS - SEC ADJUSTED ITS  
 OVERSIGHT IN RESPONSE TO RAPID  
 INDUSTRY GROWTH

GAO/GGD-97-67

SEC Adjusted Its Mutual Fund Oversight

(233490)

Abbreviations

===== ABBREV

- 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

Letter

===== LETTER

B-271654

May 28, 1997

The Honorable Alfonse M. D'Amato  
 Chairman  
 The Honorable Paul S. Sarbanes  
 Ranking Minority Member  
 Committee on Banking, Housing, and  
 Urban Affairs  
 United States Senate

The Honorable Thomas J. Bliley, Jr.  
 Chairman  
 The Honorable John D. Dingell

86

The Honorable John D. Dingell  
Ranking Minority Member  
Committee on Commerce  
House of Representatives

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.

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\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).

#### RESULTS IN BRIEF

----- Letter :1

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 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

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

----- Letter :2

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



Investment Company Act that require extensive disclosures in a mutual fund's prospectus. The 1933 Act 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 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.

\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.

\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.

\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.

OBJECTIVE, SCOPE, AND  
METHODOLOGY

----- Letter :3

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 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.

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\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

----- Letter :4

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

----- Letter :4.1

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. 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 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.

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. 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

98

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 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.

\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.

\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.

INCREASES IN INSPECTION  
STAFFING ALLOWED SEC TO  
BROADEN ITS INSPECTION  
OBJECTIVES

----- Letter :4.2

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%

94

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," (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 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.

-----  
\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.

DESPITE CHANGING OBJECTIVES,  
SEC INSPECTED MOST FUND  
COMPLEXES

----- Letter :4.3

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.

Table 2

Inspections of Fund Complexes by Year

96

Last Inspected for Five SEC Field  
Offices, Fiscal Years 1992-96

Field office	Fund complexes at end of fiscal year 1996	1992	1993	1994	1995	1996	Total fund complexes inspected
Boston	82	0	19	16	25	18	78
Chicag	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
Philad elphia	80	3	11	23	22	17	76
<b>Total</b>	<b>519</b>	<b>7</b>	<b>78</b>	<b>122</b>	<b>163</b>	<b>123</b>	<b>493</b>
<b>Percentage</b>	<b>--</b>	<b>1%</b>	<b>15%</b>	<b>24%</b>	<b>31%</b>	<b>24%</b>	<b>95%</b>

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.

\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.

NUMBER OF INVESTMENT COMPANY  
INSPECTIONS HAS NOT  
INCREASED

Letter :4.4

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 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.

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\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.

\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

----- Letter :4.5

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. 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.

Table 3

Disposition of Investment Company  
Inspections, Fiscal Years 1992-96

Disposition	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)
<b>Total</b>	<b>316</b> (100)	<b>328</b> (100)	<b>313</b> (100)	<b>348</b> (100)	<b>308</b> (100)	<b>1,613</b> (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.

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

SEC SELECTIVELY REVIEWED  
DISCLOSURE DOCUMENTS

----- Letter :5

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 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.

Table 4

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

(fiscal year)

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

103

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

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\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.

\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.

\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.

SEC'S OTHER REGULATORY  
ACTIVITIES ENABLED THE INDUSTRY  
TO EVOLVE WITHOUT MAJOR  
LEGISLATIVE CHANGES

----- Letter :6

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.

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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.

EXEMPTIVE ORDERS ENABLE SEC  
TO ADAPT ITS REGULATION TO  
INDUSTRY CHANGES

----- Letter :6.1

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 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, 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.<sup>26</sup>

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 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.

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\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.

SEC SHAPES MUTUAL FUND  
REGULATION THROUGH  
RULEMAKING

----- Letter :6.2

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.

106

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."<sup>27</sup> 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.

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.

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<sup>27</sup> 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.

SEC PROVIDES INFORMAL VIEWS  
AND INTERPRETATIONS OF  
SECURITIES LAWS

----- Letter :6.3

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

----- Letter :7

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

----- Letter :8

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.

----- Letter :8.1

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

(See figure in printed edition.) Appendix I  
COMMENTS FROM THE SECURITIES AND  
EXCHANGE COMMISSION

===== Letter

MAJOR CONTRIBUTORS TO THIS REPORT

===== Appendix II

GENERAL GOVERNMENT DIVISION,  
WASHINGTON, D.C.

Michael A. Burnett, Assistant Director  
Frank J. Philippi, Assignment Manager  
Suzanne Bright, Evaluator-in-Charge  
Darleen A. Wall, Evaluator

\*\*\* End of document. \*\*\*

"Mutual Fund Regulation:  
Developments At Home and Abroad"

Remarks By

Isaac C. Hunt, Jr., Commissioner,  
U.S. Securities and Exchange Commission

8th Annual Seminar on the Globalisation of Mutual Funds  
Sponsors: The International Bar Association\* and  
the Investment Company Institute  
Bermuda

May 5, 1997

In the United States:

The legislation was designed to eliminate duplicative  
state and federal securities regulation.

Federal law now preempts state blue-sky regulation of  
certain securities, such as securities listed on national  
exchanges, shares issued by mutual funds, and some private  
placement offerings.

States, however, retain the authority to investigate  
and bring enforcement actions with respect to a broker-  
dealer's fraudulent and deceitful activities in connection  
with the sale of all securities.

Federal law also now preempts state law requirements in  
the area of broker-dealer regulation that imposed financial  
responsibility and recordkeeping requirements. Simply put,  
broker-dealers are no longer subject to differing state net  
capital and book & records requirements.

In addition, the new legislation provides the SEC with  
general exemptive authority under the Securities Act and the

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Exchange Act.

Furthermore, the new legislation amended several provisions of the Investment Company Act and the Advisers

Fund of Funds restrictions were relaxed. These arrangements are now permitted for funds that are within the same fund complex.

The law also gives funds greater flexibility in their advertising.

The SEC has expanded recordkeeping authority with respect to mutual fund operations.

Furthermore, there is a new Investment Company Act exemption for privately offered investment funds that sell their shares solely to sophisticated investors -- who are referred to as "qualified purchasers." The investors would be limited to individuals who own at least \$5 million in investments, or institutions which manage at least \$25 million.

The bill also divides federal and state authority for investment adviser regulation. This division is based on the amount of assets under management. The SEC is presently considering rules to implement these provisions.

\* \* \*

the United States:

The SEC is trying to minimize prospectus disclosure about technical, legal and operational matters that are common to all mutual funds.

We want to focus prospectus disclosure on essential information about a particular fund that would assist investors in deciding whether to invest in that fund.

The profile would present a summary of key information about a fund, including the fund's investment strategies, risks, performance and fees -- in a concise, standardized format.

A fund that provides investors with profiles would be required to offer investors a choice of the amount of information they wish to consider before making an

investment decision.

Investors would have the option of purchasing a fund's shares based on the information in the profile or requesting and reviewing the fund's complete prospectus.

An investor deciding to purchase fund shares based on information in a profile would receive the fund's prospectus with the confirmation of the purchase.

Abroad:

With globalized markets come market professionals that act globally -- across both geographic and regulatory boundaries. Indeed, foreign investment advisers can register to provide advice to U.S. mutual funds merely by completing a simple SEC form and paying a nominal fee.

Since our markets are open to foreign advisers, we must make sure that our means of oversight are sufficient to ensure that investors remain protected. There are approximately 392 foreign investment advisers registered with the SEC, with an aggregate of over \$1.2 trillion under management. Some of these advise U.S. mutual and pension funds. Others advise individual investors about direct overseas investments. Unless we work with our counterparts to ensure compliance of market professionals who are based overseas, investors who look for opportunities beyond our borders will be unprotected.

In 1995, the SEC and IMRO were proud to announce that they had signed the first joint Declaration on Cooperation and Supervision of Cross-Border Investment Management Activity. This Declaration was a dynamic response to the challenges presented by the internationalization of the markets and the explosive growth in the mutual fund industry.

By using the Declaration, the SEC and IMRO are able to obtain on a regular basis information about U.S. and U.K. advisers who offer cross-border services. As a result, we are better positioned to detect and deter potential problems, and we continue to work together to conduct more efficient joint, on-site inspections. The Declaration enhances both the SEC's and IMRO's ability to oversee the markets and strengthens our hand as we seek to protect investors in this era of internationalization.

Since the SEC-IMRO Declaration, the SEC and IMRO have each signed similar Declarations with the Hong Kong Securities and Futures Commission. In addition, in 1996, the International Organization of Securities Commissions issued a model Declaration of Investment Advisory Oversight for its members to consider when negotiating similar bilateral Declarations. Thus, the SEC continues to work together with IMRO, the SFC and other foreign counterparts

to enhance our supervision and compliance programs for those located outside of the United States. The more countries that enter into similar Declarations, the greater the safety net for all investors.

Abroad:

Since 1988 when the first joint inspection of a U.S. registered adviser was conducted with regulators from another country, inspections have been conducted of 42 investment advisers and one investment company located outside the U.S.

The joint inspections were conducted in the following countries: Argentina, Brazil, Chile, England, Hong Kong, Mexico and Scotland. The Commission staff has conducted inspections of advisers located in Brazil, England and Hong Kong on more than one occasion.

Staff from IMRO and the CVN in Brazil have been to the U.S. to conduct joint inspections of several jointly registered advisers and one mutual fund.

A majority of the 42 advisers inspected serve either as the primary or a sub-adviser to a U.S. registered mutual fund. Their role in the fund investment management process ranges from producing a list of recommended securities which is sent to the primary adviser located in the U.S. -- to making the final decisions concerning what securities a fund should purchase or sell and entering the orders for the fund with virtually no oversight by a U.S. based adviser.

The ability to conduct joint inspections and share inspection information is extremely important because of the organizational structure of multi-national investment advisory firms. These firms usually have subsidiaries or offices located in many countries and have created holding company structures which could facilitate a variety of abusive investment schemes. Conducting inspections country by country without a sharing of information might well result in any such schemes going undetected.

Most of the joint inspections the staff has conducted have found problems that were resolved through the use of deficiency letters.

The staff has found that there is a substantial overlap in the regulatory concerns related to investment advisers by regulators in these countries.

Enforcement:

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114

RUSS-INVEST was founded in 1992 and was licensed by the Russian government as a voucher investment fund, a type of entity created as part of Russia's privatization process. The Fund sold its shares to Russian investors in exchange for Russian privatization vouchers or cash, and it invested in the stock of Russian companies and Russian government securities.

On June 8, 1995, the Fund placed a half-page advertisement in The New York Times. The ad identified RUSS-INVEST as Russia's largest voucher investment fund, with \$35 million in claimed share value. The ad solicited readers to call the Fund for additional information or to fax orders to buy and sell its shares. It also supplied telephone numbers in Russia and the United States for readers to use to respond.

In the next month, the SEC instituted an administrative proceeding against RUSS-INVEST. We took the position that the Fund had made a public offering of securities in the United States but did not register the offering with the Commission or register itself as an investment company. In a settled action, the Fund consented to an SEC order to cease and desist from further violations of the registration provisions.

#### Conclusion

As you can see, at home and abroad, the SEC is steadfastly continuing its mission to protect investors.

16

# **Session 5**

**Scheme Launch and Investor Services**

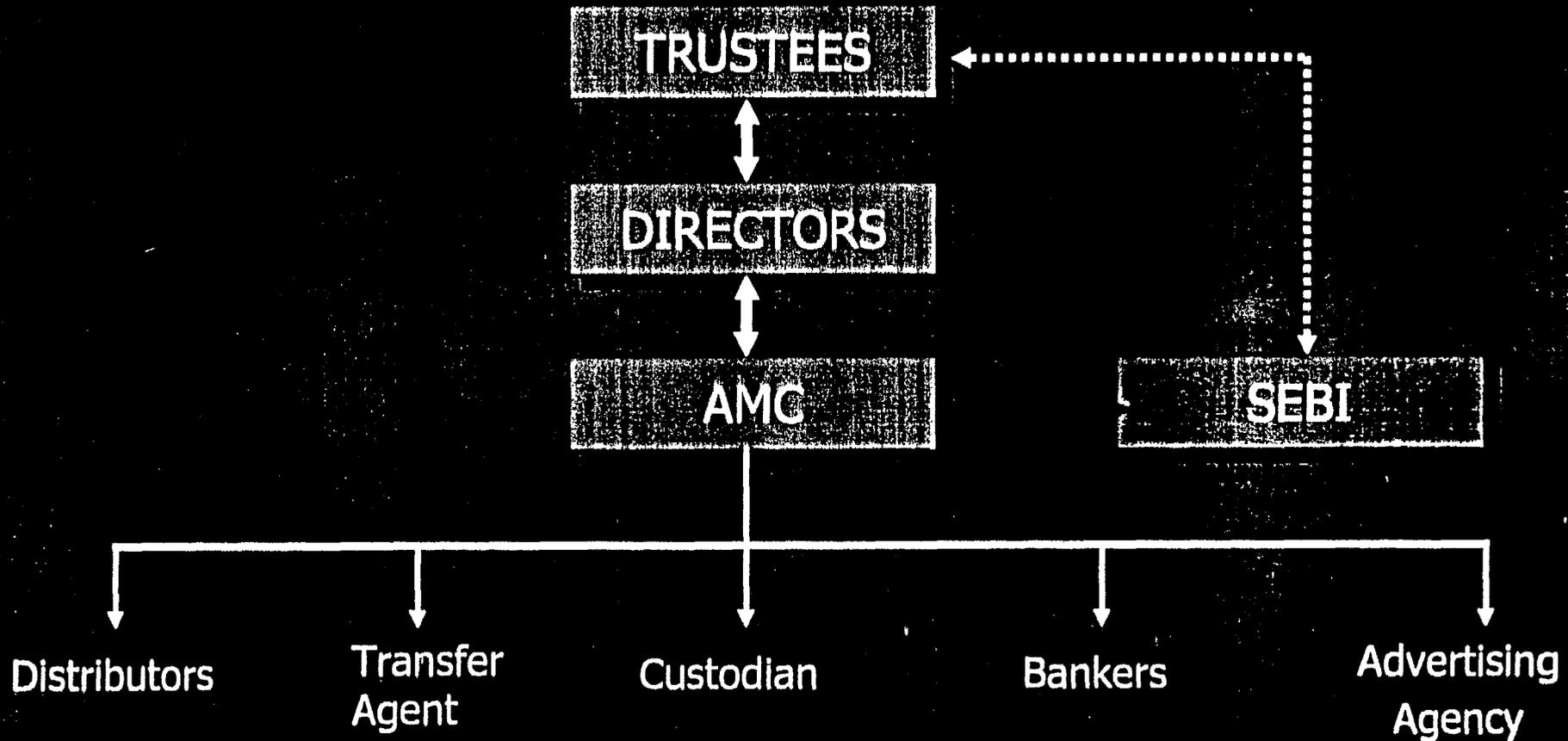
# WHAT WE CAN TALK ABOUT?

- ▼ Offer document
- ▼ Service providers
  - Transfer agent
  - Custodian
- ▼ Distributors / Selling agents

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119

# COMMUNICATION IS VITAL



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# THE DEFINITIVE REGULATION

## REGULATION 18 (4)

**Trustees to ensure before the launch of any scheme...**

- ▼ Systems in place
- ▼ Key personnel, Auditors, Compliance Officer, Registrars appointed
- ▼ Compliance manual and internal controls
- ▼ Norms for empanelment of brokers and marketing agents

1/8

# THE OFFER DOCUMENT - YOUR CALLING CARD

- ▼ Explain yourself clearly; do not be ambiguous
- ▼ Define and manage expectations
- ▼ Share information
- ▼ Define roles and procedures clearly
- ▼ Do not speculate and hypothesize about performance

# THE OFFER DOCUMENT

- ▼ What is the Fund's goal ?
  - What are you trying to do with my money?
- ▼ How do you plan to achieve this goal?
  - Where are you going to invest my money?
- ▼ Am I liable to lose money?
  - What are the risks of investing in this fund?
- ▼ What am I paying for the privilege ?
  - Loads, fees and expenses.
- ▼ Why should I buy this ?
  - Who should buy this ?

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121

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**UPDATE THE OFFER DOCUMENT**

122

# PRESENTING INFORMATION

## THE KEY ISSUE IS STANDARDISATION

- ▼ Presenting performance information
  - Net returns not gross
  - Annualised returns not cumulative
    - Annualised returns since inception
  - Do not annualise periods less than a year
  - Relative to what ? Do not change the index.

127

# THE CHANGING ROLE OF THE TRANSFER AGENT

- ▼ SIPs AND SWPs
- ▼ Switching options
- ▼ 54EA and 54EB plans
- ▼ Consolidated account statements
- ▼ Trailer fees
- ▼ Telephone redemption

THE TRANSFER AGENT IS A KEY ALLY OF THE AMC

20

# TRANSFER AGENT - YOUR KEY ALLY

Investor servicing begins and ends with the Transfer Agent

- ▼ Operating policies and procedures
  - Consider creating an operations handbook
  - Put MIS in place. Follow through on it.
  - Reconciliation of the fund accounting records with the shareholder records
  - Investor complaints redressal and response

TECHNOLOGY, THE KEY TO SUPERIOR INVESTOR SERVICING

105

# ARE YOU READY FOR TRAILER FEES?

## ▼ Trailers - A technology challenge

- What happens if you change the trailer?
- What happens if the investor comes through another broker?
- What happens if you have two schemes with switching options but different brokerage schedules?

## ▼ CDSLs

- Is your system capable of aging transactions?
- What are your redemption rules, LIFO or FIFO?

1/2/06

# DISTRIBUTION AND DISTRIBUTORS

- ▼ Positioning your fund
  - Does your sales team know the pitch? Do your distributors?
- ▼ What training have you provided them?
  - New features, procedures and policy.
- ▼ Sales material - Who has approved it?
  - Performance information
  - Tax benefits
  - Is the distributor in turn preparing sales material?

# CURRENT ISSUES

- ▼ Initial issue expenses - amortisation or write down
- ▼ Investment management philosophy
- ▼ Debt valuation
- ▼ Shareholder voting procedure

## MUTUAL FUND COMPLIANCE

SCHEME LAUNCH  
AND  
INVESTOR SERVICES

PW FIRE Project

Praxis-Intelligence



## ROLE OF COMPLIANCE

COMPLIANCE IS RISK  
MANAGEMENT. KEEPING  
THE AMC IN BUSINESS IS THE  
JOB OF COMPLIANCE  
OFFICER

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2

## SCOPE OF OPERATIONAL RISK

- PROCEDURAL LAPSES
- TECHNOLOGY FAILURE
- HUMAN ERROR
- DISASTER
- DELIBERATE ATTACKS
- STRUCTURAL ISSUES

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3

## ESTABLISH OPERATIONAL RISK MANAGEMENT PROCESS

- DEFINED REPORTING LINES AND ROLES AND RESPONSIBILITIES
- INFRASTRUCTURE
- STRUCTURED INFORMATION FLOWS
- PROACTIVE CONTROL PROGRAMS
- TRAINING

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## MONITOR OPERATIONAL RISK MANAGEMENT PROCESS

- ACCOUNTABILITY OF THE LINE MANAGEMENT
- ROLE OF INTERNAL AUDIT/ EXTERNAL AUDIT AND REGULATORY INSPECTIONS
- TRUSTEE REPORTING SYSTEMS

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5

## PRODUCT AND PROSPECTUS

- Product Specification And Internal Approvals
- Unique features of the Product
  - ♥ Operational Concerns
  - ♥ Investment Management Concerns
  - ♥ Accounting and Valuation Concerns
- Prospectus to be signed off by Compliance Officer

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6

## OFFER DOCUMENT - ISSUES IN DUE DILIGENCE

- Supporting Documentation
- Adequate disclosures
- No Misleading Statements
- Adequate explanations on the unique features
- Vetting by the Legal Counsel
- Documentation of Trustee's Approval
- Filing with SEBI

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7

## PRE LAUNCH - ISSUES FOR COMPLIANCE

- Appointment of Custodian, Registrar & Share Transfer Agent and Bankers
  - ✦ Documentation of Board approvals
  - ✦ Legal vetting of agreements
  - ✦ Adoption of Standard Operating Procedures for initial offer, continuous offer and after sales service
- Finalisation of Instructions to Bankers and Operational guidelines to R&T

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8

## PRE LAUNCH - ISSUES FOR COMPLIANCE

- Appointment of Marketing Associates & Design of Marketing/Issue Materials
  - ✦ Authorization for appointment of marketing associates/agents and accompanying procedures
  - ✦ Trustees liability for agent's actions and misleading statements by agents
  - ✦ Compliance review and approvals

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## PRE LAUNCH - ISSUES FOR COMPLIANCE

- Design of Forms for pre issue and post issue investor services
  - ✦ Compliance Review
  - ✦ R T A Review

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## REVIEW OF R&T AGENTS

Compliance Officer to conduct periodic review of operating procedures at R & T and AMC to ensure that these are being conducted in a Satisfactory manner and report to the Board

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## R & T AGENT - ISSUES FOR REVIEW

- Segregation of Duties
- Authorization, Approval And Access Controls
- Cash control procedures
- Pre-signed Instrument control
- Indemnity Insurance
- Issue of Units to Non-residents - FX procedures

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12

## R&T AGENT - ISSUES FOR REVIEW

- Treatment of Applications that do not meet the limits set within the prospectus
- Arithmetical and Accounting Controls
- Systems capability to handle the data from Investors
- Outstation Cheques acceptance
  - ✦ System controls not to allow for redemption for a certain period
  - ✦ effect on Fund valuation & cost to the Fund

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## R&T AGENT - ISSUES FOR REVIEW

- Disaster Recovery Plan
  - ✦ Systems Backup, Data Recovery And Re-entry
  - ✦ AMC's access to base data and systems
  - ✦ Insurance
  - ✦ Cost of recovery and re-entry of data

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14

## REVIEW OF SOP WITH CUSTODIAN

Compliance Officer to conduct periodic review of operating procedures at Custodian and AMC to ensure that these are being conducted in a Satisfactory manner

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## CUSTODIAN - ISSUES FOR REVIEW

- Adoption of Standard Operating Procedures
  - ✦ Data/Instructions Flow and Money Transfer Arrangements
  - ✦ Physical segregation of assets
  - ✦ Corporate Action Follow up
  - ✦ Periodic Reconciliation of assets
- Vaults location and Access controls
- Disaster Recovery And Insurance

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16

## ADVERTISING AND UNIT HOLDER COMMUNICATIONS

All Advertisements and Share Holder Communications must be cleared by the Compliance Officer

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17

## ADVERTISEMENTS

- ... "includes every form of advertising, whether in a publication, by display of notices, signs, labels or by means of circulars, catalogues or other documents, by an exhibition of pictures or photographic films, by way of sound broadcasting or television or in any other manner"

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18

## SALES LITERATURE

- ...“may contain only information, the substance of which is included in the Funds’ current advertisements...” Sales Materials should have the effect of resulting in sales of units
  - ♣ cannot be misleading
  - ♣ preceded or followed by “advertisements”
  - ♣ transmitted like an “advertisement”

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19

## SALES MATERIALS

- Factors to be considered in determining “misleading sales materials”:
  - ♣ absence of explanations
  - ♣ portrayal of past performance which imply that past results would be repeated in future
  - ♣ discussion of benefits without a discussion of limitations or risks
  - ♣ exaggerated or insubstantial claims

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## MISLEADING COMMUNICATIONS

- Factors that could be considered in judging misleading communications
  - ♣ overall context in which a statement is made
  - ♣ audience to which communications is addressed
  - ♣ clarity of communications
  - ♣ footnotes

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21

## MEDIA RELATIONS AND COMPLIANCE

- ROLE OF COMPLIANCE OFFICER TO ENSURE COMPLIANCE WITH REGULATIONS
  - ♣ Ensure that the AMC has necessary guidelines in force
  - ♣ Ensure that the AMC has a designated official (s) for Media Relations
  - ♣ Route Press Interviews through Media Relations Official

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22

## MEDIA RELATIONS AND COMPLIANCE

- AMCs seek to generate positive press coverage of their strengths
- CEOs and Fund Managers are increasingly tapped for their perspective on variety of issues
- Each Fund Complex is increasingly subjected to greater scrutiny
- Performance and Third Party Ranking
- Communications carry comparisons and forecasts

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23

## PERFORMANCE ADVERTISING - COMPLIANCE

- Uniform of time periods
- Clarity of chart or table used
- Standardized Formulae for Performance Measurements
- Adequacy of information and relevance of illustrations if any
- Fees and Expenses

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24

## A SUGGESTED OPERATING WORKFLOW FOR ADVERTISING COMPLIANCE

- "Compliance Review Form" to accompany advertising material
- Problems and Changes to be noted on the Review Form
- Retain a copy of the material before it is sent to Marketing Department
- Printed copies to be forwarded to Compliance department
- Notify Compliance when material is canceled, on hold or if changes made
- Compare printed material to the copy approved
- Ensure a copy of the advertisement is filed with SEBI

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25

## INVESTOR SERVICES - ISSUES FOR COMPLIANCE

- Prospectus Compliance
  - ✦ SOP to address routing and proper recording of investor complaints and service requests
  - ✦ Set in motion a good MIS including ageing reports
  - ✦ Periodical inspection to ensure adherence and quality control
- Standardization of communications

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26

## INVESTOR SERVICES - ISSUES FOR COMPLIANCE

- Regulatory Compliance
  - ✦ Aging Reports
  - ✦ Exception Reports
  - ✦ Litigation

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27

*Suggested  
Enhancements  
to the Profile  
Prospectus*

*Growth & Income Fund*

# Profile Prospectus

Growth & Income is a stock fund whose goal is to seek high total return through a combination of current income and capital appreciation.

May 1, 1996

XYZ COMPANY

This profile prospectus contains key information about the fund. If you would like more information before you invest, please consult the fund's long-form prospectus. For details about the fund's holdings or recent investment strategies, please review the fund's most recent financial reports. The long-form prospectus and reports may be obtained at no cost by calling 1-800-XXX-XXXX.

Investor alert  
concerning long-form  
prospectus and share-  
holder reports

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134

**Essential Questions Every Investor Should Ask**

**Suggested Enhancements to the Profile Prospectus**

**1. What is the Fund's Goal?**

Growth & Income Fund is a stock fund whose goal is to seek high total investment return.

**2. What is the Fund's Investment Strategy?**

The fund invests primarily in domestic and foreign stocks, but may also invest in other types of equity securities and debt securities. Although the fund has no limits on the amount of its assets that may be invested in any type of securities, the fund seeks to spread its holdings among many companies and industries. In selecting investments, the manager focuses on companies that pay current dividends while offering the potential for growth of earnings.

**3. What are the Significant Risks?**

You can lose money by investing in the fund.

The fund's share price changes daily based on the value of its holdings. Stock values fluctuate in response to the activities of individual companies and general market and economic conditions, both here and abroad. In the short term, stock prices can fluctuate dramatically in response to these factors. Bond values fluctuate based on changes in interest rates, market conditions, and announcements of other economic, political or financial information. Investments in foreign securities involve risks that are in addition to those of U.S. investments. These risks include increased political and economic risk of the countries in which the fund invests, and exposure to currency fluctuations. The performance of the fund will depend on how successful the manager is in pursuing the fund's investment strategy. When you sell your shares of the fund, they may be worth more or less than what you paid for them.

**4. Is the Fund Appropriate for Me?**

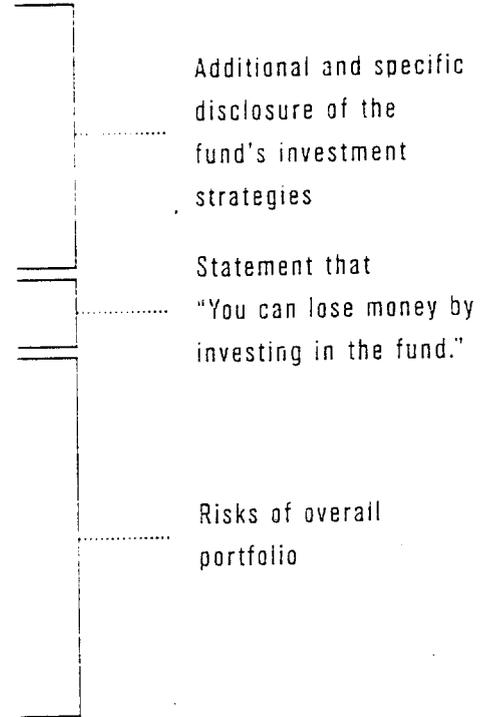
The fund may be appropriate for investors who are willing to ride out stock market fluctuations in pursuit of potentially high long-term returns. The fund is designed for those who seek a combination of growth and income from equity and some bond investments. The fund is not by itself a balanced investment plan.

**5. What are the Fund's Expenses?**

Shareholder transaction expenses are charges that may apply when you buy, sell or hold shares of a fund.

Maximum sales charge on purchases (as a % of offering price)	None
Maximum sales charge on reinvested distributions	None
Deferred sales charge on redemptions	None
Exchange fee	None
Annual account maintenance fee (for accounts under \$2,500)	\$12.00

Annual Fund operating expenses are the fund's operating expenses, including management fees, administrative expenses, and other expenses, expressed as a percentage of the fund's net assets. These expenses are deducted from the fund's assets and are not paid by the shareholder. The fund's operating expenses are disclosed in the fund's prospectus.



Management fee	5.2%
12b-1 fee	None
Other expenses	2.5%
<b>Total fund operating expenses<sup>1</sup></b>	<b>7.7%</b>

## Suggested Enhancements to the Profile Prospectus

**Examples:** Let's say, hypothetically, that the fund's annual return is 5% and that its operating expenses are exactly as just described. For every \$1,000 you invested, here's how much you would pay in total expenses if you close your account after the number of years indicated:

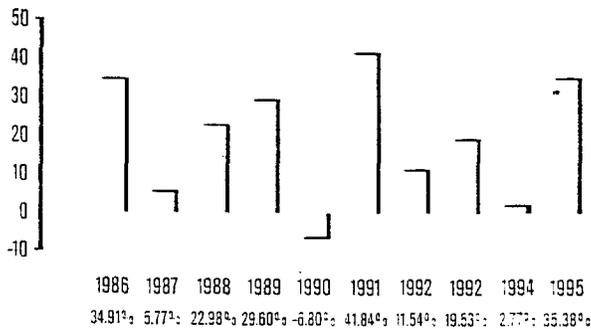
After 1 year	After 3 years	After 5 years	After 10 years
\$8	\$25	\$43	\$95

These examples illustrate the effect of expenses, but are not meant to suggest actual or expected costs or returns, all of which may vary.

### 6. How Has the Fund Performed?

The tables and chart below show the fund's past performance compared to different measures. Total returns are based on past results and are not an indication of future performance.

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Average Annual Total Returns for periods ended March 31, 1996

	Past 1 year	Past 5 years	Past 10 years <sup>2</sup>
<b>Growth &amp; Income</b>	32.75%	17.18%	16.25%
S & P 500	32.10%	14.67%	13.95%
Lipper Growth and Income Funds Average	27.73%	13.38%	11.79%
Salomon Brothers 3-Month U.S. Treasury Bill Index	5.63%	4.41%	5.72%

Comparison of 1, 5 and 10-year performance to an index or benchmark

The S&P 500<sup>®</sup> is the Standard & Poor's Composite Index of 500 Stocks, a widely recognized, unmanaged index of common stock prices. The Lipper Growth and Income Funds Average currently reflects the performance of over 350 mutual funds with similar objectives. The Salomon Brothers 3-Month T-Bill Index represents the return from short-term Treasury securities. Each measure assumes reinvestment of distributions.

### 7. Who is the Fund's Investment Manager?

NYF's investment and fund investment manager, Mark Starn, has managed the fund since its inception in 1985. Mr. Starn joined NYF in 1984 and held 1985.

Name and information describing the fund's portfolio manager

### 8. How Do I Buy Shares?

To complete the fund's application, all U.S. investors must open an account by exchange or bank way. The minimum initial investment is \$1,500. The minimum additional investment is \$25.

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9. How Do I Sell Shares?

You may redeem all or a portion of your shares on any business day by written request, telephone or wire transfer.

10. How Are Distributions Made and Taxed?

The fund distributes substantially all of its net income and capital gains to shareholders each year. Normally, dividends are distributed in March, June, September and December. Capital gains are distributed in September and December. Distributions are reinvested automatically in additional shares unless you elect another option. Your distributions are taxable when paid, whether you take them in cash or reinvest them. For federal tax purposes, income and short-term capital gain distributions are taxed as dividends, and long-term capital gain distributions, if any, are taxed as long-term capital gains.

Suggested Enhancements to the Profile Prospectus

The tax consequences of investing

11. What Services are Available?

XYZ Company provides a wide variety of services, including 24-hour telephone service providing information and assistance, periodic statements and reports, regular investment plans, and free exchanges among XYZ funds. XYZ Company reserves the right to modify or withdraw the exchange privilege.

1 Main Street, Yourtown, USA 00000

XYZ Growth & Income Fund Application

I do not wish to invest at this time, but wish to order the fund's long-form prospectus. (You also may call 1-800-xxx-xxxx to order the fund's long-form prospectus.)

I wish to invest at this time. My check is enclosed.

Equal prominence given to two options: ordering long-form prospectus or purchasing shares

Name \_\_\_\_\_
Name (if Joint Account) \_\_\_\_\_
Street Address \_\_\_\_\_
State/Zip \_\_\_\_\_
Type of Account:
Individual
Joint Tenant
Other (Please Call)
Social Security Number \_\_\_\_\_
Daytime Phone \_\_\_\_\_
Signature (Applicant) \_\_\_\_\_
Signature (Co-Applicant) \_\_\_\_\_

I am of legal age. My investment is subject to various conditions in the prospectus under penalty of perjury, I am NOT currently subject to IRS backup withholding because I have not been notified or if notification has been received, I cross out NOT. I am currently subject to withholding under penalty of perjury, the Social Security or Tax Identification Number given is correct. If I fail to give the correct number or sign this form, XYZ, its affiliates and agents will not be liable for any losses or expenses resulting from the use of these services.

If you choose to purchase, send this application with check payable to XYZ Growth and Income Fund, Mail to XYZ, 1 Main Street, Yourtown, USA 00000. We will send you a long form prospectus for the XYZ Growth and Income Fund with the confirmation of your investment. Applications received in good order by 4:00 P.M. ET on any business day will receive that day's closing N.A.V.

# **Session 6**

## **Preparing for an Inspection**

**Highlights of the remarks made by Mr. S. Haribhakti, Haribhakti & Co.:**

Relevant factors that a SEBI inspector would consider in the review of a mutual fund include the following:

- During an inspection, ensure that the mutual fund has created an environment wherein the broad promises made to investors has been kept.
- Prior inspection deficiencies should be followed up on. Ensure the deficiencies have been corrected and that controls have been put in place to ensure that deficiencies do not recur.
- Review items include: concentration of investors, concentration of investments, choice of broker/dealers, broker/dealer performance measurements, management and market practice, there should be no attempt at speculation - this is a serious issue with SEBI.
- Review inter-scheme transfers - the transaction should be in keeping with the purpose of each scheme.
- The role of the AMC should be reviewed as well as the way it relates to the Board of Trustees.
- The portfolio valuation procedure should be reviewed - this includes both debt as well as equities.
- Review special regulations and compliance with these.
- Review situations that can have an overall impact on the interests of the investor: back to back transactions and support group companies.
- Compliance officers should ensure that every aspect of SEBI regulations has been complied with and documented. Ensure that the compliance manual practices are actually implemented.
- The intent of the inspection is not to find faults but to provide assurance of compliance.
- Suggestions on making inspections more effective: there should be a SEBI Inspection Manual, training session for all firms to ensure standardization and post-inspection evaluation of inspectors.



## HOW TO PREPARE FOR A REGULATORY INSPECTION

Price Waterhouse 

### Why is it Important to Prepare for a Regulatory Inspection

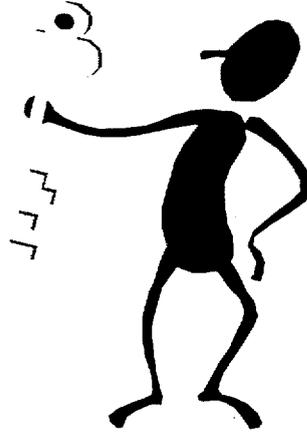
- Regulation is becoming serious business
  - misconduct noted can result in serious penalties
- Credibility and Reputation of the firm and industry at stake
  - loss of public trust and confidence
  - loss of business



## How to Prepare for a Regulatory Inspection

### Planning-the key to success

- Problems cannot be solved just before an inspection
- Firm must look at operations and controls on an ongoing basis
- Controls help you detect and resolve an issue before the regulator does
- A firm with good internal procedures is ready for an “any day” SEBI Inspection



### The First Day of a Regulatory Inspection

- Express intent to cooperate
- Designate point person whose responsibility is to facilitate the inspection process
- Find out agenda of inspection
  - anticipated length of inspection
  - any specific materials to be gathered
  - any specific areas of focus
- Find out persons the inspectors need to interview in order to schedule appointments
- Request a Closing interview to discuss any potential deficiencies the regulator has found

## How to Facilitate a Regulatory Inspection

### Promptness and Cooperation

- Quick completion of the examination is beneficial for you as well as for the regulator
- Give the inspectors what they need as promptly as is feasible



## How to Facilitate a Regulatory Inspection

### Control

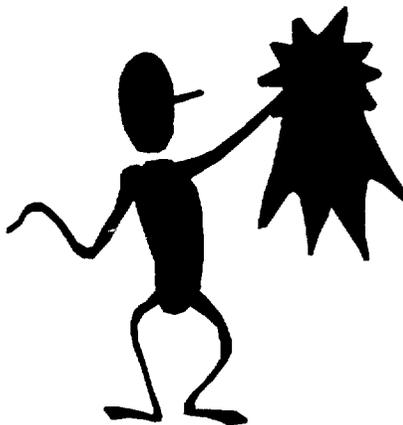
- Keep control over the inspection process
- Organize materials for the regulator prior to their arrival
- Designate a point person
  - to facilitate the inspection
  - to ensure that the regulator has all facts relating to an issue
  - to review all materials being presented to the regulator for accuracy
  - to minimize miscommunication



## How to Facilitate a Regulatory Inspection

### Advocacy

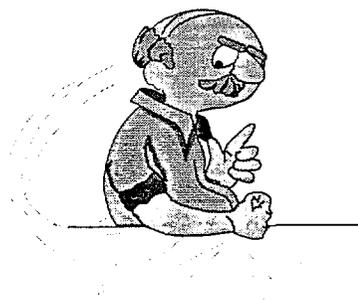
- Cooperate fully with the regulator
- Inform the regulator how seriously your firm takes compliance and about controls and procedures you have in place
- Maintain a dialogue with the regulator through out the inspection process



## How to Facilitate a Regulatory Inspection

### React and Resolve

- Acknowledge and resolve deficiencies noted during the inspection process
- Ensure that all prior deficiencies have been adequately addressed
- How to tackle serious deficiencies noted as a result of an internal control review



## Upon Conclusion of a Regulatory Inspection

- Closing Interview
  - Resolution of minor deficiencies on the spot
- Deficiency Letter
  - Clarify practices on deficiencies that appear to be cited as a result of miscommunication
  - Prompt Correction of deficiencies noted
  - Communicate to the Regulator how deficiencies were corrected
  - Enhance control systems in place to ensure that deficiencies that occurred do not reoccur

## Internal Controls

- Compliance starts with good internal controls or compliance systems
- The objective is to have policies and procedures in place within your firm that are reasonably designed to prevent, detect and minimize potential deficiencies or problems
- Policies are not enough, the firm must have an oversight function to ensure that policies are being complied with
- Oversight to be conducted by an “**independent**” person with appropriate qualifications
- Checklist for areas of review
- Internal Audit conducting “Internal Mock Inspections”

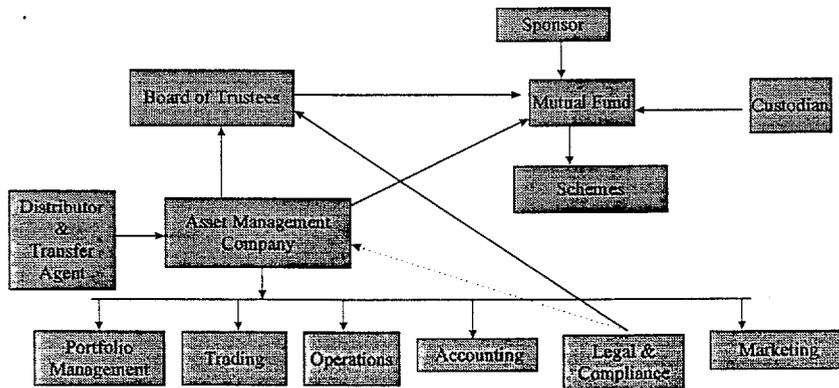


## “The man wearing too many hats”

- Segregation of functions is imperative in a control system with good checks and balances
  - Portfolio Management
  - Trading
  - Operations
  - Compliance
- Specified Responsibilities and Accountability
- The Issue of Limited Resources



## Segregation of Functions and Responsibilities in a Mutual Fund



145

## Characteristics of an Effective Internal Control Environment

- Document all functions of the firm's operations and underlying systems with written procedures that reflect the structure, functions and character of the organization
- Detail all functions of the firm to reflect the particular risk attributes of each function, with special emphasis on the functions perceived to pose greater risk to the fund, e.g., compliance with diversification and concentration requirements
- Attach specific responsibility and accountability to positions for performing functions and overseeing functions
- Conduct internal reviews to ensure that actual activities are in compliance with established procedures

## Characteristics of an Effective Internal Control Environment

- Document problems noted between practices and established procedures
  - Prompt correction of practices that do not follow procedures
  - Appropriate sanctions applied to persons responsible for the problem
- Periodic check of one's control system to ensure that controls adequate in light of the current structure and functions of your organization
- Train all employees in the purpose and function of control systems in place
- Top Management must recognize the importance of the control system and communicate its importance throughout the organization
- Periodic Evaluation of the control system and its effectiveness by an outside entity

## Areas of Concern for a Mutual Fund

### Role of the Board of Trustees

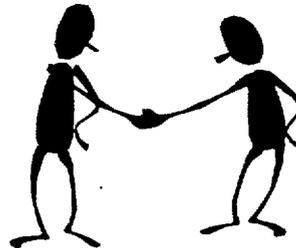
- Materials presented to the Board of Trustees
- Responsibility of Independent Trustees
- Review and Approval of the Advisory Agreement
- Review of Transactions with Affiliates
- Review of Valuation procedures
- Review of personal securities trades
- Customer Complaints and their Resolution



## Areas of Concern for a Mutual Fund

### Transactions with Affiliates

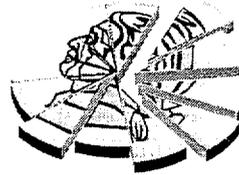
- Trades in securities where an affiliate is the underwriter
- Cross trades between schemes of a mutual fund
- Trades between schemes and affiliated persons
- Use of an affiliated broker



## Areas Of Concern for a Mutual Fund

### Composition of Mutual Fund Scheme Portfolios

- Review of objectives of the fund schemes as described in the offering document
- Ensure that portfolio managers review objectives, restrictions and disclosures made in the offering document
- Do the investments meet the objectives described?
- Diversification issues-monitoring the 5% and 10% diversification requirement
- Investors vs. Investments in portfolio



## Areas of Concern for a Mutual Fund

### Trading Issues

- Selection of Brokers to execute trades with
- Approved Broker list
- Best price and execution
- Portfolio turnover (Churning)
- Trade errors
- Personal trading



## Areas of Concern for a Mutual Fund

### Valuation of Mutual Fund Scheme Portfolios

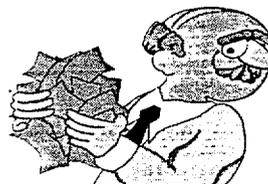
- Pricing of illiquid securities-trustee review of such valuation
- Independent portfolio valuation
- NAV calculation
  - Expenses incurred by the fund



## Areas of Concern for a Mutual Fund

### Personal Trading

- Reporting of personal trades-are all trades reported?
- Internal policy on personal trading
- Who is responsible for review of personal trades
- Resolution of conflicts arising out of personal trading
- Avoidance of front running, scalping, etc.



## Areas of Concern for a Mutual Fund

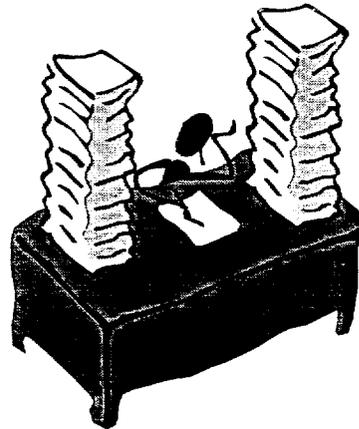
### Advertising and Performance

- Disclosures must be accurate and representative of practices
- Disclosure on Investment Strategy and Risks
- Disclosure on Fees and Expenses
- Disclosure on the type of scheme, e.g., “diversified”, etc.
- Performance numbers and the calculation of such numbers



### Maintenance of Books and Records

- Proper documentation is key to running an effective business
- Good documentation unlocks doors to the past



## Conclusion

- Make
  - Monitor
  - Maintain
- effective compliance systems and records to be ready for an “any day” regulatory inspection.



LORI RICHARDS

"The SEC's Exam Program for Investment Advisers:  
A More Targeted Approach"

Address to the Advisors' Education Group, Inc.  
Conference on Compliance Issues Affecting  
Investment Advisors of Discretionary Accounts  
June 14, 1996

Good Afternoon. I'm glad to be here to discuss the SEC's examination program, particularly our inspections of investment advisers. I was amused to learn from the brochure for last year's program, that one of the discussion topics was actually called "How to Survive an SEC Examination." While I know that regulatory examinations can sometimes be stressful, I don't think we've ever had any injuries or fatalities. The best reassurance I can give you is that, you may not enjoy it, but you will definitely live through it.

One thing you should all already know, is that the scope, the nature, the depth and the outcome of the examination -- all things which contribute to the relative pain of the exam experience -- depend not on our examiners, but on you. The most important variable in the whole process is entirely in your hands -- your own books and records and compliance systems, maintained, updated and implemented every day of the year, not suddenly thought of in the days before the SEC examiners arrive.

I know that the thought of a visit from our examiners in itself stimulates good compliance practices. This effect is intended -- when Congress gave the Commission the authority to conduct exams of investment advisers in 1960, the Senate Report stated that "the prospect of an unannounced visit of a Government inspector is an effective stimulus for honesty and bookkeeping veracity." I'd submit that there are lots of other, better, reasons to maintain absolute integrity and compliance, including the delicate franchise advisers maintain with their clients, but whatever contributes to the motivation, the result is what's important.

I'd like to update you on some of the changes to the exam program over the last year, and since this program was last held, particularly the new variable scope of our exams. I'd also like to describe the new selection process we use to decide who to examine, which is particularly relevant to this group, and finally, I'll describe some of the compliance issues and problems we're seeing with advisers. First, an overview of the new office. As you know, last spring Chairman Levitt created the Office of Compliance Inspections and Examinations to consolidate all of the SEC's examination activities. Through our staff in headquarters and in the eleven regional and district offices

throughout the country, we examine investment advisers, investment companies, transfer agents, broker-dealers and self-regulatory organizations.

Along with the creation of the new office came a mandate to take a fresh look at our process and priorities for examining investment advisers, and all of the entities we inspect. Among the other priorities of the Office, we're:

- increasing training for our examiners;
- creating more cross-disciplinary examination teams to examine multi-registered entities;
- doing all we can to ensure consistency in the approach and in the disposition of exams; and
- focusing our resources on firms and on the areas within firms that need our attention the most.

I think we have and we are making substantial progress towards modernizing the exam program.

During the last year or so, we've been extremely busy evaluating the program, and we've made some changes. Generally, I think our guiding philosophy is that we need to maximize our resources by ensuring that we're targeting our examinations to have the greatest possible effect. As a result, exams are increasingly becoming "risk-based," that is, our examiners are focusing on the registrants within the industry that need our attention the most, and also, in each exam we do, our examiners are focusing on the particular areas of the registrant's operations that deserve our attention the most. This is a shift for us, away from conducting cyclical, comprehensive examinations of every part of the adviser's operation, towards a more focused review in, perhaps, a handful of areas. We think that examiners should spend more time on the critical issues, and less time on the routine issues.

What are the critical issues and what are the routine issues? Well, they aren't the same for all registrants. Examiners' focus will vary, depending on the type of registrant they are examining. Generally, examiners will spend more time on the areas of the adviser's operations where deficiencies or violations have been noted in the past, areas of importance to the adviser, and areas where internal controls appear to be weak, and areas where clients appear to be most exposed to potential conflicts of interest. If we have a sense that the adviser has a strong control environment and is finding and correcting problems itself, the scope of our exam should reflect that. The more confidence examiners have in a registrant's own compliance and internal control system, the more they can waive routine

examination procedures. In essence this is an effort to apply, in the field, the Commission's frequent admonition that compliance professionals are the industry's "first line of defense" against fraud and abuse. So, depending on these factors, the exam could be very narrow and focused in scope, or quite inclusive and broad.

Why have we changed the scope of our exams? I think there are three reasons why it makes sense to do so.

First, and most practically: Given the size of the industry, with over 22,000 registered advisers, compared to the relative size of our exam staff, we need to make better use of our resources.

Second: We ought to recognize the development within the industry of institutionalized compliance systems. Many advisers have professional, state-of-the-art internal compliance systems that are accorded a high degree of institutional support in terms of resources and staff. Conversely, other money managers are still running on a shoestring and seem to be complying with the law day-to-day. Our exams ought to take these variables into account, and we ought to try to encourage good internal compliance systems.

Finally: I think that our resources are best utilized in finding fraud and serious compliance lapses. That means focusing our attention on true risk areas and firms.

Modifying our exams, from a one-size-fits-all approach to a variable scope approach is part of the shift towards what we call "smart exams." In implementation, this is how it works -- once the registrant is selected for examination, the examiner starts preparing for the exam. Advance preparation is essential for effective field work. Advance preparation includes research in SRO records and other automated data libraries, review of the registrant's filings with the Commission, review of any customer complaints received by the Commission, review of past inspection history and reports, and formulation of the problem areas likely to be found. I note for our mutual benefit, that registrants can often help speed the examination and eliminate any misunderstandings by quickly providing the staff with the documents they request, which include copies of the most current reports and other materials that explain their practices or place them in an appropriate context.

The scope of an examination is then determined by two variables: what the staff knows about an entity before they begin; and what they learn while the examination is in progress. An examination team could plan to cover only a limited area, and then rapidly expand the scope of their review as they discover problems. Similarly, they could plan a comprehensive

examination, and then waive in-depth testing procedures as they gain increasing confidence in the entity's internal controls. In other words, the scope of an examination is highly variable, and largely depends on the examiners' professional judgment of the advisers' own internal controls.

The areas which might be reviewed include: filings and reports; Form ADV, brochure disclosure and delivery; contracts; custody; books and records; financial condition; internal controls; advisory services; need for registration under other securities laws; portfolio management; prohibited transactions; limited partnerships; transactions with affiliates; brokerage and execution; wrap fee programs; marketing and performance calculations; compensation and client fees; client referrals; litigation and the catch-all, any other anomalies or issues that the examiners wish to resolve.

While we've not yet fully implemented this customized or "smart exam" approach, we expect to do so within the coming year.

As I mentioned, in addition to changing the scope of our exams, we've also made some changes in how we go about selecting advisers to examine, the second aspect of the "smart exam" approach. Rather than using a purely cyclical approach, where advisers are inspected on a regular schedule despite whether they need it more or less often than the cycle would require, we've overlaid other considerations onto our cycle. As I mentioned at the outset, our goal is to focus our attention on the firms which need it the most -- which we define as those firms presenting the most risk to investors. The question we pose is, "If all went awry with this adviser, how much damage could it do to investors?"

It is important to note that an examination based on risk factors is not necessarily for cause. The staff may have no indication of violations or other problems at the registrant. Instead, the selection factors are intended to highlight circumstances or activities that produce risk, not necessarily violations. Our first large scale application of a risk factors approach has been with respect to investment advisers.

As you know, in terms of sheer numbers, the investment adviser community has rapidly outgrown the Commission's examination resources. This led to a lengthening examination cycle until in 1995, it had grown to more than twenty years, an absurdly long time between exams. Actually, this "cycle" really meant no exam at all for most registrants. Using a risk factors approach, we've been able to cut that cycle in half for advisers deemed to possess certain factors indicating higher risk.

The single most important criteria in determining risk and therefore priority of examination for advisers is access to

client money. Advisers with discretionary authority over investments, or custody of assets, or, quite simply, large amounts of money under management, pose the greatest risk to investors. Of course, having discretion or custody of large amounts of money under management is perfectly appropriate, and most investment advisers accomplish all three with complete safety for their clients. Nonetheless, risk often accompanies discretionary authority, or access to large amounts of money. Approximately 9,000 registered investment advisers fall into this higher risk category.

To ensure better examination oversight for these advisers, we've divided our inspection program into two parts. Advisers in the higher risk category are now the responsibility of the regional offices. The regional offices will usually conduct inspections of advisers with discretion, custody, or non-discretionary management of \$100 million or more. By focusing resources on this group, all of these advisers are examined, on average, once every eight to ten years, significantly more often than the previous twenty year cycle.

In addition, earlier this year, the Commission allocated additional agency resources to our adviser exam program. With the new staff being made available, we hope to reduce the examination cycle for higher risk advisers to once every five years. Thus, through an application of risk factors when selecting registrants, and additional support within the agency, the examination cycle for higher risk advisers will be reduced to one quarter of its previous length.

Of course, focusing resources on areas of higher risk means that there will be fewer resources available for areas of lower risk. The 13,000 registered advisers who do not qualify for the higher risk category are now being inspected in joint sweep examinations conducted with state securities regulators. We've conducted 8 such joint sweeps so far, and expect to conduct many more through the remainder of 1996 and in 1997. Through this program, the lower risk advisers will be examined, on average, approximately once every forty years, or for cause when appropriate. I note that there is currently legislation pending in the Senate, the Securities Investment Promotion Act, which would call for States to assume a primary role for regulating these advisers, and the SEC supports that concept.

We think that this new system for examining advisers represents an appropriate weighting of resources towards providing protection for those investors who need it most.

If you're an investment adviser, it's important for you to know that risk-based selection will not replace cyclical examinations. Rather, thoughtful application of risk factors will assist examiners in determining whether a registrant should

be examined more frequently than allowed by the cycle. Outside examination cycles still exist, and as noted, our cycle for discretionary managers will be 5 years.

\* \* \*

So, everyone in this room falls within the "higher risk" category, and is likely to see our examiners much more often than in the past.

What will determine whether a higher risk adviser is examined more often than every five years? Lots of factors, including: the size of the adviser; and the number of clients; the adviser's business; the length of time the adviser has been registered; the adviser's prior examination history and results; its disciplinary history; its customer complaints; its affiliated persons; its advertising and performance claims; and information obtained from other regulators, including, among others, SROs and state securities regulators.

I'd like to focus for a minute on just one of those factors: the adviser's advertising and performance claims. I don't need to tell you how important it is to ensure that advertising and performance figures are accurate and not misleading. You're already well-aware of that, it's required by law. There are some advisers out there though, who I think deserve to have their performance claims verified by us, particularly advisers who claim to have generated large short-term profits for clients that are substantially in excess of their peer group. These are the advisers that are winning frequently in selection contests, and are rapidly growing their money under management. Performance claims are, as you know, one of the most important criteria used by clients in selecting a money manager. With so much riding on performance, there are great temptations to shade the truth in calculating the numbers. Not only is this not fair to clients or to the other money managers, it's not legal.

So, beginning this summer, we'll be conducting examinations of some of the more successful money managers to focus on their performance claims. I hope that we'll find nothing out of order in these exams, and I'll consider them a success whether we do or we don't. I think that this is an area that deserves our attention. Of course, all advisers have always been subject to our examinations and to a review of their performance calculations. In the past, however, we examined advisers through a process of random selection among the 22,000 registered advisers. Now, the winningest advisers will be specifically targeted for examination, and in addition, we'll be paying a lot more attention to verifying performance claims in every exam we do. We'll also be working closely with the NASD to ensure that mutual fund advertising claims are scrutinized carefully.

I'd like to turn to some of the other topic areas we're focusing on in our adviser exams.

Under the broad rubric of "trading practices," there are several areas that the staff is paying particular attention to this year.

We continue to look at allocation of trades among advisory clients, and whether allocation decisions seem fair, or are benefiting certain clients or accounts. Relatedly, we're also looking at allocation of bunched orders. Based on a recent no-action letter, advisers are now able to include proprietary accounts in bunched orders under certain conditions. The staff, generally, has no problem with an adviser bunching orders. However, because of the potential for unfair allocations of bunched trades, the staff will usually take a close look at an adviser's bunching procedures and practices.

We're also looking at how much individualized treatment an adviser is providing, and looking at whether the common and similar management of a large number of small accounts is really an investment company. To gain economies of scale, advisers of small accounts may make the services provided to all participating clients as similar as possible, including the investment advice. Once a client's assets are assigned to a particular investment objective, the composition of one client's account will then be very similar or identical to every other client with that same objective. In these circumstances, the staff is likely to ask some questions to evaluate whether these accounts are, in fact, being managed like an investment company.

We're also looking closely at soft-dollar arrangements, and have found that advisers sometimes forget that commissions and mark-up dollars belong to clients and not the adviser. Because the adviser has control over soft dollars and over disclosure of soft dollar practices, we're seeing problems when advisers use this money for their own benefit. The staff continues to take a hard look at soft dollar expenditures.

We're also looking at principal transactions, and making sure that the adviser obtains client consent before completing the transaction. Recently, we found one adviser who executed over 8,000 orders for advisory clients on a principal basis or by crossing clients' orders with orders of other brokerage customers, without notice to and consent of the clients, and contrary to the adviser's disclosure in its ADV. This adviser had lots of other problems too, and provided a real-life answer to the question I described earlier, which examiners always ask, "If everything went awry with this adviser, how much harm could it do to clients?"

Finally, we're always looking for personal trading conflicts of interest, not just among portfolio managers of mutual funds as you might assume from recent press reports. Conflicts of interest in personal trading by advisers of discretionary accounts are just as possible, and are being reviewed just as carefully.

If you've noticed a theme here, it's that, consistent with the risk-based approach to examinations that I've described, all these things, performance advertising, trade allocations, individualized treatment to clients, principal trades, soft dollars, personal trading, are all areas either where there have been problems or enforcement actions in the past or where, if problems did occur, they could have a serious impact on clients.

So, I've given you all the critical information here about our exams of investment advisers -- who are we going to examine? when will we examine you? and what will we be looking for when we examine you? I can't think you'd have any questions at all after all this information. I'll come full circle though by saying that all these things, the scope, the nature, the depth and the outcome of the exam will depend on you and your hopefully excellent, compliance systems.

Thank you.

- \* The SEC, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or the staff of the Commission.

**Appendix C:**

**Results of the Participants' Evaluations from the  
AMFI Mutual Fund Compliance Workshop**

**December 4 - 5, 1997**

**Mumbai, India**

**Seminar on "Mutual Fund Compliance"**

**December 4 - 5, 1997**

**Participant Evaluation: Results**

**Total Responses: 33**

	Question	Category/ Percentage of Respondents	Category/ Percentage of Respondents	Category/ Percentage of Respondents
1.	<b>Overall, to what extent are you satisfied with the workshop you have just completed?</b>	Very Satisfied 67	Satisfied 27	Not Satisfied 6

**Comments:**

- This workshop has given an overall view of the industry as such and the areas of concern were highlighted
- The workshop highlighted the role of compliance officer, his responsibilities towards compliance with regulations in a very satisfied manner
- The workshop have been addressing practical issues/problems that are common to the industry and suggest solutions
- Some more solutions to problems which occur in the Indian context would have made the workshop more useful
- Scope of subjects is very vast as compared to the time allotted
- The programme was very good especially the inaugural session and case study session where a top person from the regulator was present
- Very well presented
- Detailed discussion is required on topics like periodical reports sent to trustees, SEBI & standardisation of the same
- Scheme launch, investor services and preparing for SEBI inspection was well covered and made interesting
- Well conducted, topics chosen with care, covering all matters relating to compliance and clearing doubts in attendees minds
- Topics chosen were very well conducted and discussed completely and effectively
- The discussion was more of a theoretical nature, rather than specific on practical experiences
- Compliance problems encountered by Compliance Officers should be discussed among participants
- Much more in detail could have been covered

2.	To what extent were the objectives of this workshop relevant to your role and responsibilities?	Very Relevant 82	Somewhat Relevant 18	Not Relevant 0	
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**Comments:**

- It gives great help and knowledge about the importance and role of a Compliance Officer
- As NAV supervisor, I have to take care to see that all SEBI Guidelines are complied with so the objectives were very relevant to my role & responsibilities
- This workshop has cleared the role and responsibilities of a Compliance Officer
- The notes & material need to be studied in detail and applied to real-life situations. Probably, after this exercise, a clearer picture will emerge.
- Compliance as a serious business is a new trend and helps us to think more clearly and schedule accordingly
- It will help me to develop my role & responsibilities in the organisation and improve the system
- It has helped me in understanding my role as an assistant to Compliance Officer of the Trust
- It threw a lot of light on the areas and the responsibilities the Compliance Officer should look into. The objectives and areas covered were very relevant to my responsibilities.
- As I am involved also involved in deciding of the issues for compliance, the objectives of this workshop were relevant in suggesting certain issues which we had not yet covered
- Investor services is of paramount importance and the experience was done keeping in mind the investors interest in mind. Compliance regarding accurate & timely services to investors were the main objectives pertaining to my responsibility.
- I suppose it is only after this workshop that the onus & responsibility lying on the shoulder of Compliance Officer has been highlighted not only to the Compliance Officers, but also the other employees, CEOs & SEBI. This would provoke thought among CEOs to give more powers & authority to Compliance Review Team.

3.	<b>To what extent were these objectives met?</b>	To a great extent 70	Somewhat 27	Not at all 3	
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**Comments:**

- It definitely has helped us to make a better team of compliance and not just sign off all documents without proper evidence of documentation
- The objectives have been met to great extent by way of hammering the seriousness involved in compliance in respect of all areas which have significant impact on unitholders
- Expected more guidance in performing my role - a practical approach to the responsibility with the available Indian setup
- After attending the seminar and listening to the participants and fellow members, I know my responsibilities very clearly and how to go around ensuring those objectives
- To a great extent I have understood and would try to bring these to the notice of the Compliance Officer
- To meet this objective fully, the importance of compliance should be fully informed at the highest level
- In making me realize the great importance of my role and an internal need to educate myself & enhance my learning
- Doubts relating to SEBI Guidelines were cleared & the talk by Mr. Pradip Kar, Mr. Vaidyanathan & Mr. S.V. Prasad was very informative

4.	<b>Which of the following discussion topics were most helpful in assisting you to better understand the subject matter, and why?</b>	
	Topic	Number of Acknowledgments
	a) Session 1 : Compliance as the Foundation for Industry	7
	b) Session 2 : Case Study	4
	c) Session 3 : The Role of the Compliance Officer	9
	d) Session 4 : Investment Management	0
	e) Session 5 : Scheme Launch and Investor Services	8
	f) Session 6 : Preparing for an Inspection	3

5.	<b>Which discussion topics were least effective in assisting you to understand the subject matter, and why?</b>	
	Topic	Number of Acknowledgments
	a) Session 1 : Compliance as the Foundation for Industry	3
	b) Session 2 : Case Study	3
	c) Session 3 : The Role of the Compliance Officer	1
	d) Session 4 : Investment Management	4
	e) Session 5 : Scheme Launch and Investor Services	6
	f) Session 6 : Preparing for an Inspection	2

6. Any additional comments on the workshops?

- A detailed Compliance checklist/procedure on each and every aspect of Indian MF/Asset Management activities will go a long way in avoiding repetition of efforts at the individual company level
- Workshop was very well conducted and has done proper justice to all areas related to compliance
- Was very well conducted, the speakers chosen were the best in the industry & hence provided valuable advice on the subject
- It would be appreciated if there is extensive training offered to the compliance officer regarding how the role can be met effectively rather than weigh he/she down by putting down the responsibilities. The way to achieve the purpose may only be the training either by AMFI or SEBI
- Certain topics such as money laundering, taxation issues should be involved in future workshops
- Workshop should be conducted in at least two batches so if certain dates are not convenient to a Compliance Officer he/she can attend another batch
- The general view or for that matter my view is that the workshop devoted on all its areas and emphasized that the Compliance Officer is in cation on all the areas under the sun of the fund. From a practical point of view, this is a difficult task to achieve. Probably, it may take some time before the industry takes it shape to accept the Compliance Officer's functions as indispensable.
- This seminar points many roles of the Compliance Officer which have not been coded in SEBI Regulations by comparing with International standards, expectations and practice. This may be concentrated on Indian climate
- It is better that the AMFI to write a letter to the members clarifying the role and responsibilities of the Compliance Officer. Freedom, power and the protection that is to be given to the Compliance Officer is to be clarified by the AMFI/SEBI to discharge the duties faithfully and meaningfully
- There is a lot of ambiguity in regulations. There may be different interpretations of different regulations. As such there should be Advance Ruling Committee in SEBI to avoid non compliance detected at a future date.
- It is told that Compliance Officer is in the business of keeping you in business. But at the same time his/her reporting should be taken in the right perspective. It is as such suggested that Compliance Report should also be signed by CEO, Chairman of Board & Sponsor.
- Should invite questions on the actual problems/debatable sections of the functions and try and arrive at a common industry practice which may keep the regulations and reconsider any/some of the existing regulations.
- An excellent opportunity to understand compliance as the foundation for industry.
- More than Compliance Officers, I suppose SEBI & AMFI should make it heard to the CEOs that proper authority & powers are given to Compliance Officers. Hence such workshops in future should give such messages to CEOs.

7. **What additional comments/ suggestions do you have for on-going workshops and training and development programs related to Mutual Funds?**

- More workshops of this kind should be organized
- Maybe we should have such meets on exchange holidays to ensure better preparations & minimum disruptions of our office responsibilities
- SEBI representatives at a high level should be available throughout the sessions
- There could be a workshop/seminar on the role of the trustees to coax the existing trustees into playing a more active role
- A sort of workshop/seminar where issues which are ambiguous are sorted out and a consensus on how they shall be treated by all the funds.
- The importance of compliance needs to be explained to operations personnel also.
- A few more people from SEBI should be called to speak next time
- Certain provisions in the regulations are vague. A separate workshop or meeting should be organized to clarify these issues.
- We need more case studies, in depth analysis of compliance vis-a-vis critical areas like fund accounting through illustrations with numbers.
- There should be more seminars in the future to update the Indian Mutual Fund industry about the development takes place in United States and other countries in the world.
- There should be interface workshop of Compliance Officers with SEBI Officers at operating level to appraise them/clarify practical problems & brainstorm solutions & also standardize such procedures arrived at.
- Please arrange to supply/send copies of transparencies/material presented by way of projection, so that the contents are properly disseminated down the line by the participants in their organization