

PN-ACC-020

**SEBI Mutual Fund Inspection Workshop:
“Quality Control and Consistency in Mutual
Fund Inspections: Insights from the US SEC
Inspection Process”**

**Financial Institutions Reforms and
Expansion (FIRE) Project**

**Contract #386-0531-C-00-5010-00
Project #386-0531-3-30069**

December 23, 1997

**Financial Institutions Reform and Expansion (FIRE) Project
US Agency for International Development (USAID/India)**

**Price Waterhouse LLP
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Price Waterhouse LLP



December 18, 1997

Mr. Pratip Kar
Executive Director
Securities and Exchange Board of India ("SEBI")
Mittal Court 'B' Wing
Nariman Point
Mumbai - 400 021

Dear Mr. Kar:

**Subject: Results of the SEBI Mutual Fund Inspection Workshop,
December 15, 1997 "Quality Control and Consistency in Mutual
Fund Inspections: Insights from the US SEC Inspection Process"**

At the request of the Securities and Exchange Board of India, Price Waterhouse LLP (PW) presented a workshop on Mutual Fund Inspections entitled "Quality Control and Consistency in Mutual Fund Inspections: Insights from the US SEC Inspection Process." This workshop was delivered on December 15, 1997, for SEBI inspection officials and representatives of chartered accounting firms who conduct mutual fund inspections on SEBI's behalf. The workshop was sponsored by the USAID-Price Waterhouse Financial Institutions Reform and Expansion (FIRE) project.

The objective of the workshop was to aid in creating greater quality control and consistency to SEBI inspections of Indian mutual funds. To that end, the workshop highlighted the structure and best practice of the United States Securities and Exchange Commission in order to apply lessons learned and common tools to SEBI inspections. Ms. Anjali Kamat, a former US SEC inspector and current Price Waterhouse consultant serving in the New York-based Regulatory Compliance practice, served as the workshop's main presenter. In particular, Ms. Kamat presented an overview of the SEC highlighting the role of the inspection department and provided a comprehensive outline and discussion of the structure of the SEC inspection process.

Ms. Kamat was joined by FIRE Project consultants Mr. Lewis Mendelson, Mr. RNK Prasad, Ms. Sandhya Bahate and Ms. Mariann Kurtz to lead discussion on key inspection issues such as best price and execution, personal trading and front running, trade allocation, transaction with associates, portfolio review, accounting and valuation, and customer servicing.

December 18, 1997
Mr. Pratip Kar
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Based on participant evaluations, the workshop was very well received. Nearly all participants (94%) were satisfied with the workshop and all (100%) reported that it was relevant to their roles and responsibilities. Of the 34 participants, 12 were SEBI officers. The balance represented 21 chartered accounting houses.

A complete summary of participant evaluations and their suggestions 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,

A handwritten signature in black ink, appearing to read 'W. Dennis Grubb'.

W. DENNIS GRUBB
PRINCIPAL CONSULTANT CAPITAL MARKETS

Enclosure

1. RESULTS FROM THE SEBI MUTUAL FUND INSPECTION WORKSHOP

Quality Control and Consistency in Mutual Fund Inspections: Insights from the US SEC Inspection Process

The Price Waterhouse FIRE Project in conjunction with SEBI sponsored a workshop on Mutual Fund Inspections entitled "Quality Control and Consistency in Mutual Fund Inspections: Insights from the US SEC Inspection Process" on December 15, 1997, at the Taj Mahal Hotel in Mumbai. The objective of the workshop was to foster greater quality control and consistency in SEBI inspections of Indian mutual funds. To that end, the workshop highlighted the structure and best practice of the United States Securities and Exchange Commission in order to apply lessons learned and common tools to SEBI inspections.

1.1 Workshop Participants

The workshop was designed for SEBI officers working with mutual funds or more broadly in the inspections and surveillance divisions. In addition, professionals from chartered accounting firms who conduct mutual inspections on SEBI's behalf were invited. In total, 34 professionals attended the workshop including 12 SEBI officers. The balance of the participants represented 21 chartered accounting houses (out of the 28 firms invited at SEBI's request). A full list of participants is provided in Appendix A.

1.2 Workshop Content and Materials

The workshop combined both presentations and working groups to cover a variety of topics and discussion points. The main topics included:

- Why inspect: Goals philosophy and responsibilities
- Overview of the US SEC
- Structure of the inspection process
- Review of documentation given to the board of trustees
- Overview of key inspection issues including: best price and execution, personal trading and front running, trade allocation, transaction with associates, portfolio review, accounting and valuation, and customer servicing.

Each topic was addressed through presentation / lecture with time allowed for question and answers. Course materials were prepared on each topic and were given in a binder to participants and displayed on screen during the presentations. A complete set of course materials is provided in Appendix B. Participants were also given a copy of the AMFI Compliance Manual.

Working groups were also formed among the participants to discuss in greater detail inspection issues related to best price and execution, transaction with associates, and front running and personal trading. Each group was asked to discuss and present tools currently used to inspect these areas, limitations to affecting thorough investigations in these areas and spheres of regulation which required further clarification by SEBI. The findings of the working groups are captured below in section 1.5 Recommendations.

1.3 Trainers

Ms. Anjali Kamat, a former US SEC inspector and current Price Waterhouse consultant serving in the New York-based Regulatory Compliance practice, served as the workshop's main presenter. In particular, Ms. Kamat presented the overview of the SEC highlighting the role of the inspection department and provided a comprehensive outline and discussion of the structure of the SEC inspection process.

FIRE Project director Dennis Grubb gave opening remarks and Mr. Lewis Mendelson, a 30 year veteran of the SEC and current FIRE Project consultant, set the tone for the workshop discussion the goals, philosophy and responsibilities of the inspection process and the inspector. FIRE Project consultants Mr. RNK Prasad, and Ms. Sandhya Bhate gave presentations on key inspection issues and Ms. Mariann Kurtz facilitated the working groups and their subsequent discussions.

1.4 Evaluations Results

Each participant was asked to complete an evaluation at the conclusion of each workshop. Tabulated and summarized results from each of the three sessions are attached in Appendix C. All (100%) participants reported that the objectives of the workshop were relevant to their roles and responsibilities and nearly all (94%) were satisfied with the workshop.

Participants particularly acknowledged the benefit of bringing together the disparate group which performs SEBI inspections. Among the comments to this point were:

It was useful and thought-provoking. It is the first interchange of ideas between auditors.

An excellent opportunity to share our experience of inspection with others and gain more from the other inspectors.

Good exposure, broadening the perspective, sharing the global experiences was very satisfying.

The specific topics deemed most useful by the participants were Structure of the Inspection Process and the Overview of Key Inspection Issues which covered seven specific areas of inspection. Still participants noted a desire for more detail and the application of such detailed discussions to the Indian context. Thus participants reported their desired to participate in additional training workshops.

Topics most cited for inclusion in future workshops are transactions with associates, front running and personal trading, structure of the inspection process and the use of actual case studies encapsulating such issues. Participants endorsed using a variety of workshop formats including a series of half day workshops each devoted to a single topic, one or two large workshops covering many topics and the establishment of working groups / committees devoted to improving procedures and testing methodologies.

1.5 Recommendations

The participants almost unanimously (94%) endorsed the need for a standardized routine inspection structure. They cited increased transparency and accountability as benefits of standardization. Participants also noted areas which should be included in a standardized routine inspection (in addition to those covered in the workshop). Among these areas are investment decisions and NAV calculation coupled with the authority to inspect brokers' books.

Related recommendations resulted from the working group discussions. As noted above, each group was asked to consider current limitations to effective testing and related areas needing further clarification/interpretation from SEBI. Results of each group are presented below.

1.5.1 Transactions with Associates

Participants reported difficulty in defining and gaining information on group companies. They believed the term "associate" is not clearly defined by SEBI regulations. Additionally, they cited the need to extend the definition to related parties and to cover associates of associates. Furthermore, participants would like SEBI to review the definition of associate for consistency with other regulations. Participants commented on the difficulty to gain accurate information on a firm's affiliates since they rely on the firm to provide such a list.

1.5.2 Front Running and Personal Trading

Common limitations cited by participants in this group include the inability to identify all key personnel. Participants suggested that firms should be required to maintain a register listing key personnel similar to the requirement in the Companies Act. Additionally, participants discussed their inability to obtain all transactions for key personnel and their relatives due to the lack of cooperation and disclosure from key persons and the inability to affect third-party checks on trades of key persons. Also, the outside inspectors noted that they do not have within their purview the right to inspect brokers' books for any transactions of key personnel. This limits their ability to fully track trades and test for front running.

1.5.3. Best Price and Execution

Testing for best price and execution is most hindered by the inability of inspectors to access information on intra-day positions taken by brokers. They do not have convenient access to trading data on exchanges other than the NSE and BSE and will look to SEBI to help in obtaining it. Additionally, since off market deals are not properly documented by mutual funds, it is difficult to check for best price and execution with respect to such deals.

Workshop on 'Inspection of Mutual Funds' - December 15, 1997
at the Taj Mahal Hotel, Gateway Room

Sr. No.	Name of Participant	Designation	Name of Organisation
1.	Mr. Santosh Parab	Principal	B. K. Khare & Co.
2.	Mr. Sanjay Panse	Partner	M. P. Chitale & Co.
3.	Mr. Sohan Chaturvedi	Partner	Chaturvedi & Shah
4.	Mr. Nandkishor Bafna	Sr. Partner	Lodha & Co.
5.	Mr. Pradeep Shetty	Partner	N. B. Shetty & Co.
6.	Mr. Vilas Rane	Partner	Dalal Desai & Kumana
7.	Mr. Anil Chaturvedi	Partner	Chaturvedi & Co.
8.	Mr. Naren Sheth	Partner	Mayra & Khatri
9.	Mr. Vinayak Padwal	Manager	Kalyaniwala & Mistry
10.	Mr. Atul B. Desai	Partner	G. P. Kapadia & Co.
11.	Mr. H. H. Parmar	Partner	H. H. Parmar & Associates
12.	Mr. L. Ravi Shankar		Brahmayya & Co.
13.	Mr. Chetan S. Kothari	Partner	Mahta Kothari & Associates
14.	Mr. Pravin Thakur	Partner	Chandabhoy & Jassoobhoy
15.	Mr. Ketan Vikamsey		Khimji Kunverji & Co.
16.	Mr. Ashok Mewawala		M. M. Nissin & Co.
17.	Mr. D. P. Thakkar		Chhajed & Joshi
18.	Mr. A. Y. Kably	Partner	Habib & Co.
19.	Mr. Oturkar	Sr. Employee	Singhavu, Oturkar & Kelkar
20.	Mr. Pankaj Gupta	Jr. Partner	Shah, Gupta & Co.
21.	Mr. G. Sankar	Consultant	V. Sankar Aiyar & Co.
22.	Mr. N. Sampath Ganesh	Consultant	V. Sankar Aiyar & Co.

Sr. No.	Name of Participant	Designation	Name of Organisation
23.	Mr. Anupam Tandon	Officer	SEBI
24.	Mr. Suddipto Bhattacharya	Officer	SEBI
25.	Mr. Suresh Rajagopal	Officer	SEBI
26.	Mr. Umesh Damle	Officer	SEBI
27.	Mr. Uday Diwale	Officer	SEBI
28.	Mr. N. Maru	Officer	SEBI
29.	Mr. P.K. Nagpal	Division Chief	SEBI
30.	Mr. Sanjay Chandy	Officer	SEBI
31.	Mr. Praveen	Officer	SEBI
32.	Ms. Anukriti Upadhyay	Officer	SEBI
33.	Ms. Sonali Sen	Officer	SEBI
34.	Mr. M.H. Saiyed	Officer	SEBI

Workshop on "Inspection of Mutual Funds"
December 15, 1997

Participant Evaluation: Results

Total Responses: 32

	Question	Category/ Percentage of Respondents	Category/ Percentage of Respondents	Category/ Percentage of Respondents
1.	Overall, to what extent are you satisfied with the workshop you have just completed?	Very Satisfied 78	Satisfied 16	Not Satisfied 6

Comments:

- An excellent opportunity to share our experience of inspections with others and gained more from the other inspectors
- Good exposure, broadening the perspective, sharing the global experiences was very satisfying
- Very comprehensive
- It covered very general topics. More detail discussion is essential.
- The workshop has brought out salient features of the US SEC and partially covered the scenario in the Indian context. The emphasis may be the other way round unless SEBI wants to go the SEC way.
- It was useful and thought provoking. It is the first inter exchange of ideas between auditors.
- Needs to be more interactive. The quality of slides needs to be improved. More examples need to be narrated.
- The workshop has cleared a lot of misconceptions.
- All the major aspects of Mutual Fund inspection came up for discussion.
- Very informative and full of new ideas.
- Mutual Fund inspection is fairly new to me.
- Workshop was very informative and will be useful for our future inspections.
- The workshop should not discuss slides, but talk on practical issues and problems faced in the US, which could be a good insight to participants.
- The whole programme was very well structured & designed and the presentations were excellent.
- It might have been useful to get AMFI in as well.
- Very satisfactory. Excellent opportunity to understand US Mutual Fund inspections.

2.	To what extent were the objectives of this workshop relevant to your role and responsibilities?	Very Relevant 75	Somewhat Relevant 25	Not Relevant 0
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Comments:

- It helped in analyzing the subject at a macro level.
- The objectives of this workshop were very much relevant to our roles & responsibilities.
- Being in Surveillance Division, we do not inspect many Mutual Funds.
- All the recommendations, if implemented, will ease the task of fault finding and consequently reforming the securities market.
- Investigations mainly hinge on the role of Stock Exchanges/Brokers to detect abnormal price movements. Hence, Mutual Funds are inspected by us only if they are found involved in any of the above activities.
- It will help in future inspections very much.
- The overview was general and so not much has been achieved by wasting a whole day.
- The Indian context was not very widely discussed.
- Although it is of great importance, the workshop failed to provide any such value addition.
- The workshop helped in understanding the system of inspections carried out in the US. The detailed discussions of various amendments & Mutual Fund Regulation was also helpful.
- Though I am not currently handling any work related to the topic of today's workshop, I am confident that it would be useful in the future.
- Substantially relevant regarding procedures used for inspections.
- The practical difficulties which we face while doing inspections have been discussed at length.

3.	To what extent were these objectives met?	To a great extent 72	Somewhat 19	Not at all 9
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Comments:

- Up to my satisfaction.
- The objectives were met to a very large extent. It was good exposure and overview of the Mutual Fund industry in a developed market like the US market.
- Yes. Almost.
- Need to be more specific. Rather than explaining initial nitigrities the stress should be on a more in-depth fundamental discussion.
- The Indian context was not very widely discussed.
- The overview was general and so not much has been achieved by wasting a whole day.
- By providing a better understanding of the role of Mutual Fund inspectors.
- The regulatory laws are in the process of evolution & with new ideas & information gathered, the task will be easy for future amendments in laws & regulations.
- This workshop has given me some insight about the Mutual Fund inspections.
- We gained tremendous amount of knowledge.

4. Please rank from 1 to 8 the following discussion topics. "1" should represent the topic most useful in assisting you better understand the subject matter and "8" should represent the least useful.

	<u>Topic</u>	<u>Rank</u>
a)	Why Inspect: Goals, Philosophy and Responsibilities	7
b)	Overview of US Securities and Exchange Commission	8
c)	Structure of the Inspection Process	1
d)	Role of the Board of Trustees	5
e)	Overview of Key Inspection Issues (Panel)	2
f)	Working Group I: Affiliated Transactions	3
g)	Working Group II: Best Price and Execution	4
h)	Working Group III: Front Running and Personal Trading	6

Comments:

- Discussion among the group were relevant to the Indian context.
- More emphasis should be placed on Indian market conditions and market practices.
- Working in a group was interactive.
- Structure of the Inspection Process helped the most in reviewing our own Inspection program.

5.	Would you like to participate in additional workshops related to inspections ?	Yes (in percentage) 97	No (in percentage) 3
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List of topics that should be discussed during these workshops (no. of responses):

- Action by SEBI in case of negative reporting
- Enforcement - Limitations & the ways to overcome them (2)
- Affiliated Transactions (5)
- Front Running and Personal Trading (5)
- Valuation of Investments
- Investor Protection / Transparency
- Structure of the Inspection Process (4)
- Issues/Problems encountered in the process of inspection
- Inspection Process of the SEC
- Actual case studies (3)
- Some more practices that need checking
- Overview of Key Inspection Issues (2)
- Role of Trustees (2)
- Type of Mutual Funds in the US - their features
- Distribution of Mutual Fund products
- Pension Fund products in the US
- Best Price and Execution (2)
- Accounting Procedures
- Organisational Controls & Procedures
- Checking of off market deals / unlisted securities
- Inspection of funds so as to be more effective
- Tools of Inspections
- Suggestions to SEBI for assisting the Inspector in their work
- Planning and conducting the inspection
- Detailed Guidelines to follow during inspection
- Inspection of R&T Agents and Custodian Operations
- Inspection of other intermediaries
- Compliance with Regulations
- Adequacy of Records available for Inspection

What form should potential future workshops follow ?	A series of half day workshops, each devoted to a single topic 15	One or two large workshops covering many topics 13	Small working groups /committees devoted to improving procedures & testing methodologies 12
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Other formats for future workshops:

- Series of half day workshops comprising of working groups/committees
- Topic specific presentations and interactive sessions

6.	Do you believe routine inspections of Indian Mutual Funds should follow a standardized structure ?	Yes (in percentage) 94	No (in percentage) 6
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Comments:

- But will also depend on the size of fund and complexities/issues involved.
- Needs further standardization and elaboration.
- Inspection Reports should be structured taking into consideration the size of the Mutual Fund and number of schemes.
- This will ensure uniformity in Mutual Fund performance evaluation.
- Standardisation of Inspection routine will make the whole exercise meaningful and not just a technical procedure.
- This would ensure greater transparency in the system.
- A standardised structure, on the lines followed by NSE for inspecting its trading members would be a good beginning.
- The format in which inspections are conducted should be common across Mutual Funds.
- Only in certain areas.
- Routine Inspection will help Mutual Funds in bringing accountability because level of compliance is low in India.
- Let the imagination of Inspectors be given a free-hand.

Areas (in addition to those covered in this workshop) which should be included in a "standard" Routine Inspection:

- Investment Decisions (2)
- Inspectors should incorporate points pertaining to changes in market conditions, changes in the policies of the government etc.
- Standard Checklists
- Standardised, Reporting Formats (Illustrative)
- It may be useful to have some standardized method of evaluation of auditors work
- NAV Computation (2)
- Inter fund Transfer
- Front Running
- Structure of Inspection Process
- A detailed Inspection Manual
- Authority to inspect brokers books (3)
- Role of the Sponsor
- Associate Transactions
- Broker Dealings
- Market Operations
- Investment Restrictions.
- Associates of AMC - Indirect Control
- Trade Timings
- Motive of buying or selling by AMC at a particular timing
- Examining of guarantor's books in case of assured return schemes

7.

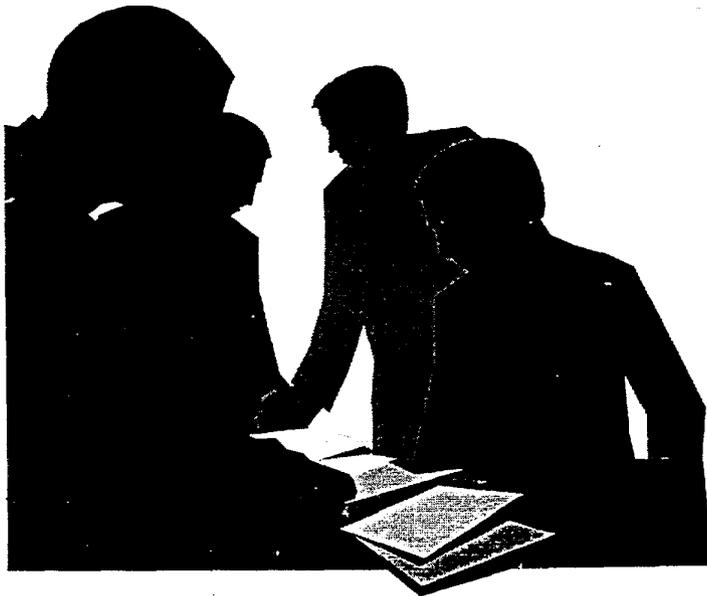
Any additional comments on the workshop ?

Comments:

- It would have been useful to devote more time to working group discussions.
- An overview on the Mutual Fund industry in the US may have been useful.
- Very boring; monotonous speakers like Mendelson.
- Has been very informative and useful.
- AMFI contribution would have been of additional use.
- Good presentations were made.
- Discussion/Workshop on Key Inspection Issues for Mutual Funds needs to intensify.
- SEBI has to act very fast on all communications relating to subject discussed.
- More workshops may be arranged.

SEBI INSPECTION WORKSHOP

**Quality Control and Consistency in Mutual Fund Inspections:
Insights from the U.S. SEC Inspection Process**



December 15, 1997
Hotel Taj Mahal Gateway Room

Sponsored by the USAID - Price Waterhouse FIRE Project

15

SEBI Inspection Workshop

“Quality Control and Consistency in Mutual Fund Inspections:” Insights from the U.S. SEC Inspection Process

Monday, December 15, 1997
Hotel Taj Mahal, Gateway Room

Workshop Objectives: This workshop will focus on bringing greater quality control and consistency to SEBI inspections of mutual funds. To that end, the structure and best practices of the United States Securities and Exchange Commission will be highlighted in order to apply lessons learned and common tools to SEBI inspections in India. Additionally, participants will form working groups to identify and discuss key inspection issues in India, share local best practices, and target obstacles to quality control and consistency arising out of their experiences within the India Mutual Fund environment.

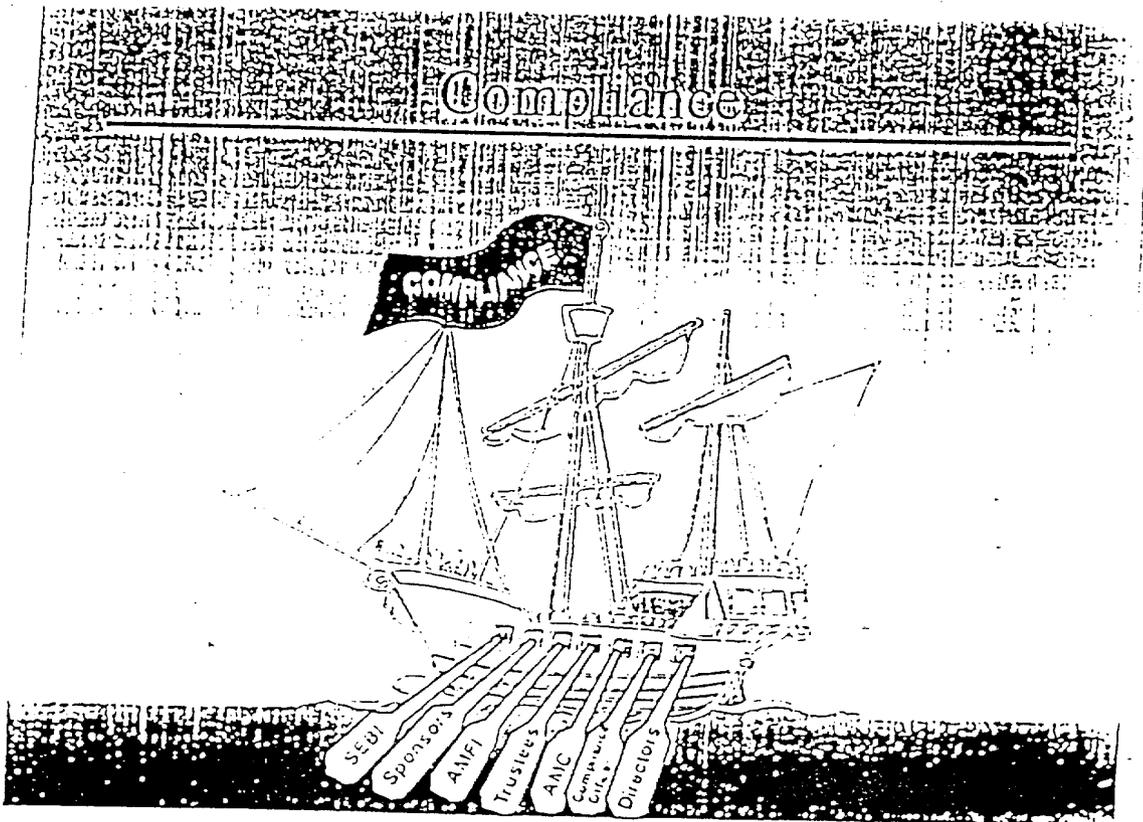
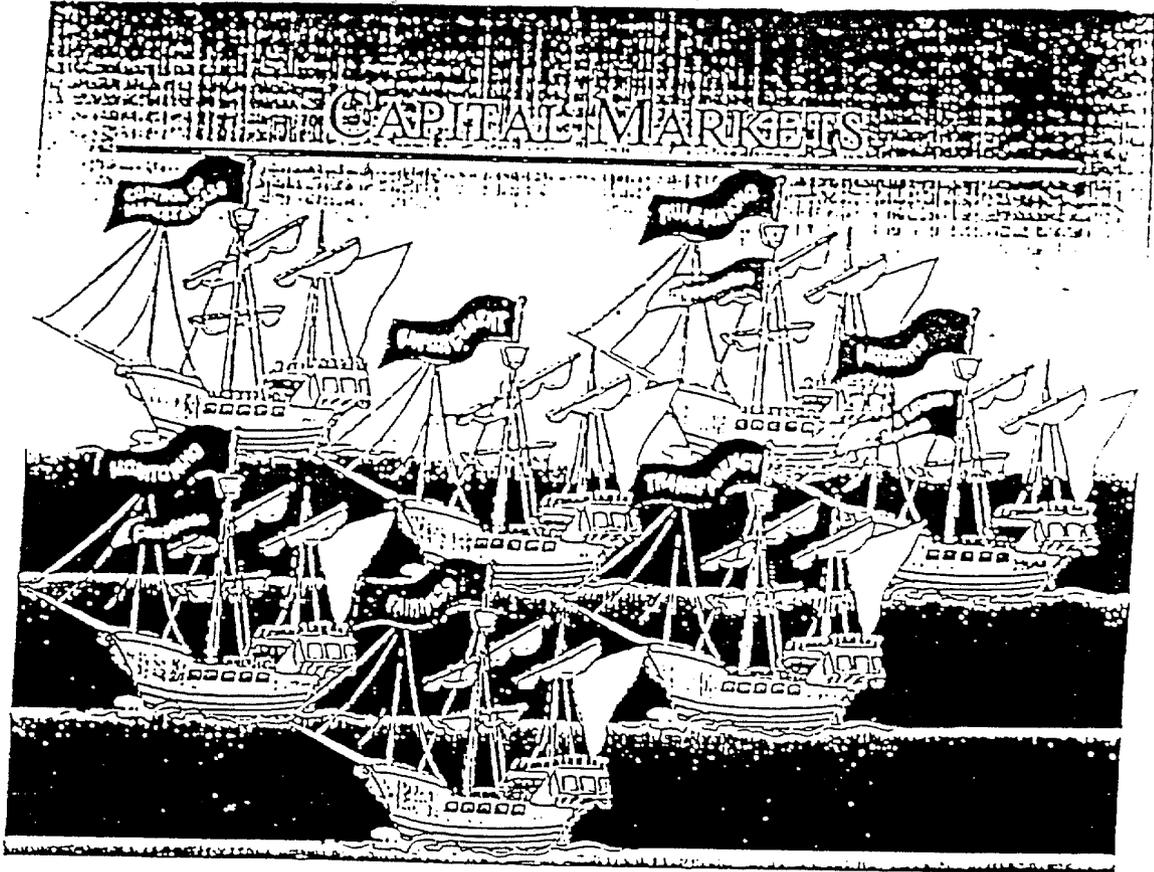
Schedule of Activities:

- 09:15-09:45 Welcome: Mr. Dennis Grubb, PW FIRE Project
Opening Remarks: Mr. Pratip Kar, Executive Director, SEBI
- 09:45-10:15 Why Inspect: Goals, Philosophy and Responsibilities
Lewis Mendelson, PW FIRE Project
- 10:15-10:45 Overview of US Securities and Exchange Commission
Ms. Anjali Kamat, PW New York
- Structure of the SEC
 - Role of Inspection Department and training for inspectors
 - Routine and 'For Cause' inspections
- 10:45-11:00 Break
- 11:00-12:15 Structure of the Inspection Process
Ms. Anjali Kamat, PW New York
- Pre-inspection preparations
 - Conducting the inspection and interview protocols
 - Preparing the inspection report
 - The deficiency letter
 - Response by inspection target
 - SEC follow-up
 - Industry tracking
- 12:15-12:45 Documentation Provided to the Board of Trustees
Ms. Sandhya Bhate, PW FIRE Project
- 12:45-1:45 Lunch

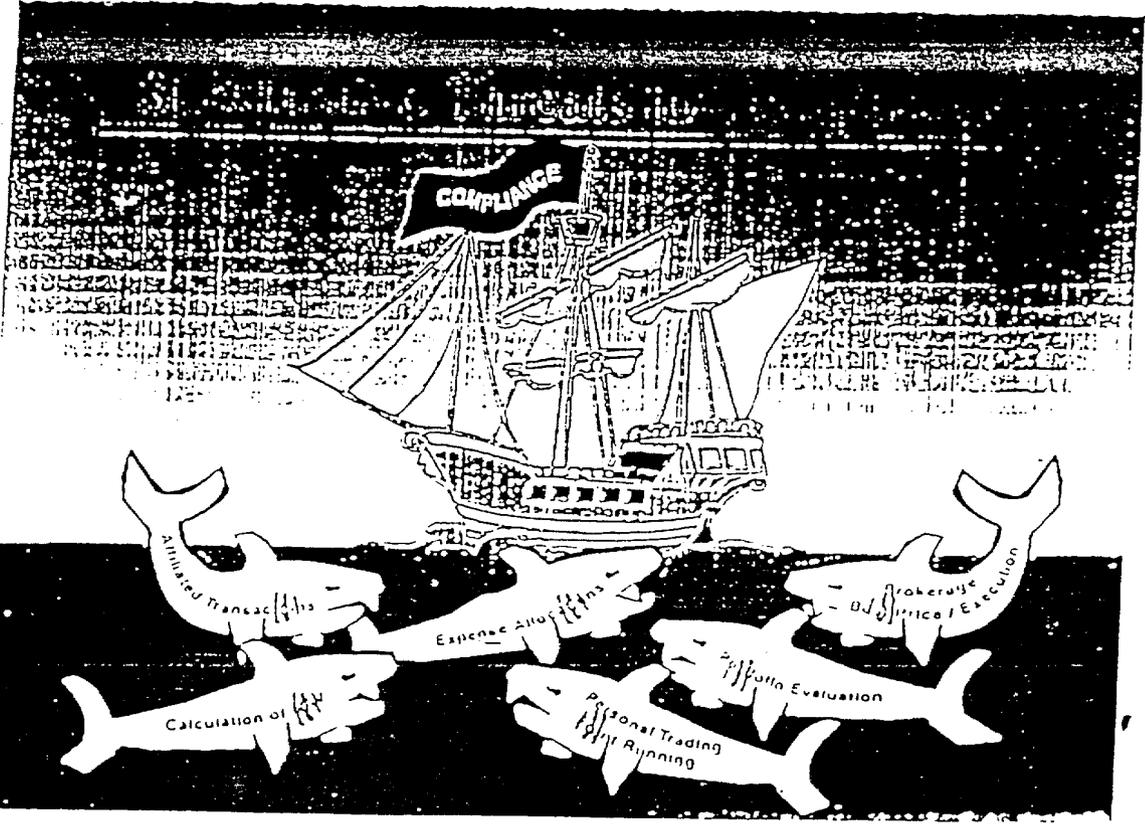
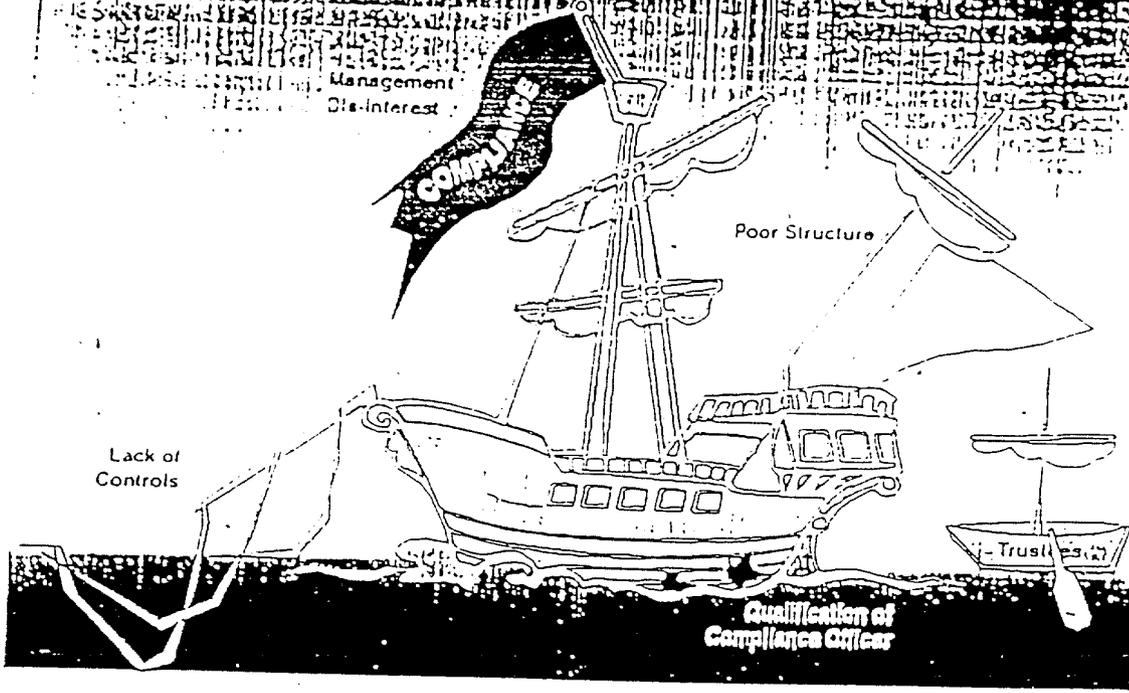
SEBI Inspection Workshop
Monday, December 15, 1997

- 1:45-3:30 Overview of Key Inspection Issues: Common inspection objectives, tools for discovery and testing, and typical findings (compliance with prospectus, internal controls and regulatory requirements)
- Panel: Ms. Anjali Kamat, PW New York
Ms. Sandhya Bhate, PW FIRE Project
Mr. R.N.K. Prasad, PW FIRE Project
- 3:30-3:45 Break
- 3:45-3:50 Introduction to Working Groups
Facilitator: Mariann Kurtz, PW FIRE Project
- 3:50-4:05 Working Groups: Key Inspection Issues of Investment Management
- 4:05-4:30 Findings and Discussion
Working Group I: Transactions with Associates
- 4:30-4:55 Findings and Discussion
Working Group II: Best Price and Execution
- 4:55-5:20 Findings and Discussion
Working Group III: Front Running and Personal Trading
- 5:20-5:30 Closing remarks and evaluations

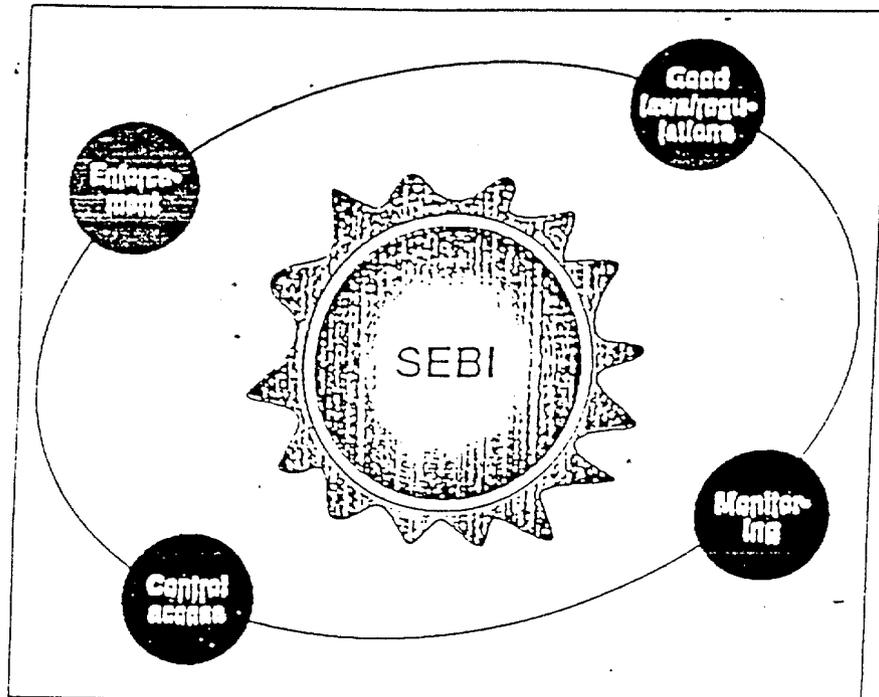
Why Inspect: Goals, Philosophy and Responsibilities



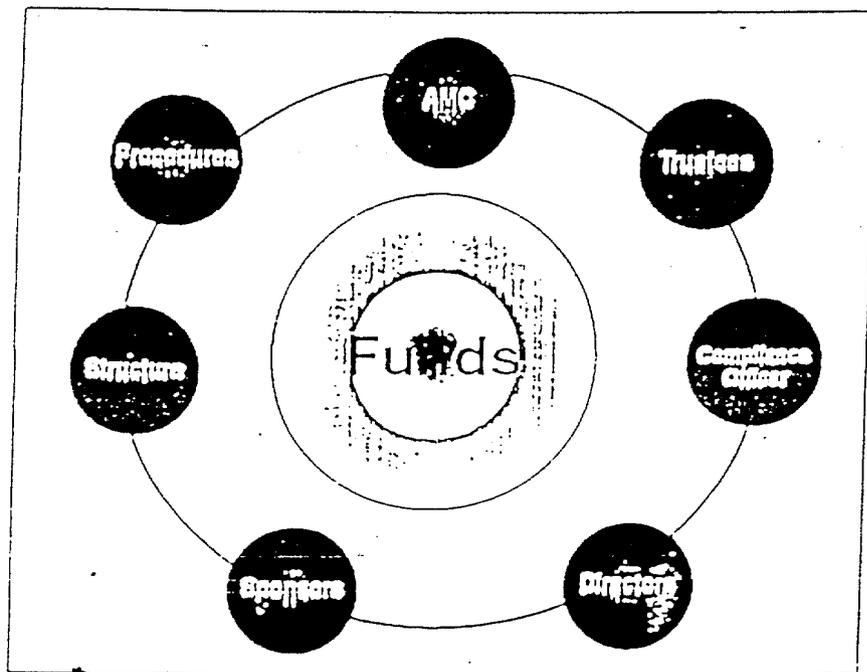
Structural Pitfalls to Compliance



SEBI



Fund Compliance



Quality Control and Consistency in Mutual Fund Inspections

Workshop for SEBI Inspectors

Monday, 15 December, 1997

USAID/Price Waterhouse FIRE Project

INSPECTING MUTUAL FUNDS

- Efficient mutual fund inspections
 - focus
 - consistency
 - » techniques
 - » interpretations
 - » standardized methods, procedures and forms

EFFICIENT MUTUAL FUND INSPECTIONS

- structure
 - » training
 - » review
 - » feed back
- application and utilization of inspection information

PURPOSES OF SEBI INSPECTIONS

- To maintain a high level of compliance among all AMC's and throughout the mutual fund industry
 - Through activities of SEBI and its inspectors
 - » Deter
 - » Detect
 - » Discourage violations
 - By strengthening internal fund compliance mechanisms, systems and procedures

PURPOSES OF SEBI INSPECTIONS

■ To provide SEBI, legislative and rule-making bodies with information necessary for:

- designing regulatory policy
- making more effective laws, rules and regulations and
- requiring more meaningful disclosures

PURPOSES OF SEBI INSPECTIONS

■ Help SEBI better

- to understand
 - » mutual fund and AMC operations
 - » industry practices and norms
 - » new products
- to discover industry trends

ALTERNATIVE INSPECTION PHILOSOPHIES

■ Newly Registered Funds (Schemes)

- **Objective** – assure that newly registered funds are properly organized and all compliance mechanisms are functioning.
- **Method** - - inspect new funds within three to six months of launch. Assure that compliance, systems are in place and operational and that everyone, *including the trustees*, understands his or her role.

ALTERNATIVE INSPECTION PHILOSOPHIES

■ Largest Funds (Schemes)

- **Objective** – assure that funds or AMCs that manage the largest amounts of money and have the most unit holders are inspected
- **Method** – Inspect largest funds first and regularly

ALTERNATIVE INSPECTION PHILOSOPHIES

■ Unique Funds

- Objective -- assure that funds that operate in the most unique manner (or like UTI are subject to different regulatory standards) fully meet those SEBI standards to which they are subject or that the standards that apply to them are adequate to protect their unit holders.
- Method – Inspect unique funds:

ALTERNATIVE INSPECTION PHILOSOPHIES

■ Broad Based Inspections

- Objective – Cover many small funds, increase range and variety of inspections
- Method - Prioritize and inspect accordingly

ALTERNATIVE INSPECTION PHILOSOPHIES

- **Red Flags - Suspicious Practices**
 - **Objective** -- assure that suspicious practices that raise *red flags* are covered. Conduct a full inspection of those funds with investment practices or related problems which could easily be subject to abuse
 - **Method** -- Prioritize *red flags* and conduct inspections

RED FLAGS

- weak internal controls
 - lack of procedures
 - poor documentation
 - failure to segregate responsibilities
 - insufficient authority in compliance officer
 - lack of trustee involvement
 - lack of commitment by AMC

RED FLAGS

- affiliated transactions (unlisted unquoted securities)
- affiliated brokers
- high portfolio turnover ratios
- back to back practices
- relationship with NBFC's
- questionable guarantees

RED FLAGS

- unreasonable advertisements
- highest expense ratios per asset size class
- worst/ best performing funds (risk adjusted)
- sponsor or affiliate business problems
- unresolved difficulties uncovered in prior inspections

RED FLAGS

- transfer agent/registrar issues
- custodial issues
- improbable valuation and NAV calculation
- indications of front running

ALTERNATIVE INSPECTION PHILOSOPHIES

- **Risk Inspections – Focused, Limited Purpose**
 - **Objective** – Focused (*smart*) inspections, determine an area of risk, focus inspections solely on that risk and closely related issues, inspect many funds, but only as to the major issue raised.
 - **Method** – Identify risk, prioritize funds and inspect accordingly.

RISK INSPECTIONS

- Provide a broad industry view of an area of major concern. Helpful in controlling an identified problem or providing information which could form the basis for a legislative or rule-making solution



OPERATIONAL CHECKS

- Segregation of functions (see organization chart)
- Compliance Manual
- Code of Ethics
- Compliance Officer
- AMC
- Controls over Service Providers
- Documentation (paper/computer trails)
- Employee trading limitations and reporting provisions

OPERATIONAL CHECKS

■ Trustees Involvement

- Background
- Information provided
 - » Source
 - » Quality and Adequacy
 - » Timeliness
 - » Frequency

Trustees Involvement

- Alternative Sources of Objective Information
- Relationship with Compliance Officer
- Availability of Third Party Verification/ Evaluation
- Understanding role of Trustees (interview)
- Trustee Initiatives

Overview of US Securities and Exchange Commission



“THE EAGLE IS
WATCHING”

THE SEC AND ITS
MUTUAL FUND
INDUSTRY
OVERSIGHT

Topics of Discussion

- Overview of the SEC
 - Role
 - Organization
- Inspector Training and Resources
- Types of Inspections
 - Routine and For Cause



Mission

“The U.S. Securities and Exchange Commission’s mission is to administer federal securities laws that seek to provide protection for investors. The purpose of these laws is to ensure that the securities markets are fair and honest and to provide the means to enforce the securities laws through sanctions where necessary”

The Importance of Inspections



- One of the key functions of a regulator is to monitor the market in order to ensure a fair and honest environment
- Inspections are an important and effective tool to monitor the market
- Inspectors play a vital role in protecting the interests of the investors since they make important judgments about the firms they inspect and indirectly on the industry as a whole

How does the SEC address Industry Growth and Change?

- No-Action Letters

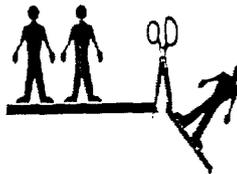
- A no-action letter is a request from the investment management firm that the SEC staff react to a particular set of circumstances or facts
- Other firms with similar circumstances can rely on an existing no-action letter



How does the SEC address Industry Growth and Change?

- Exemptive Orders

- An Exemptive order permits the applicant to engage in an activity that is otherwise prohibited by the act.
- reviewed on a case by case basis by the SEC
- a number of similar requests for exemptive orders may result in adopting new regulation





Industry Role in Rule Making

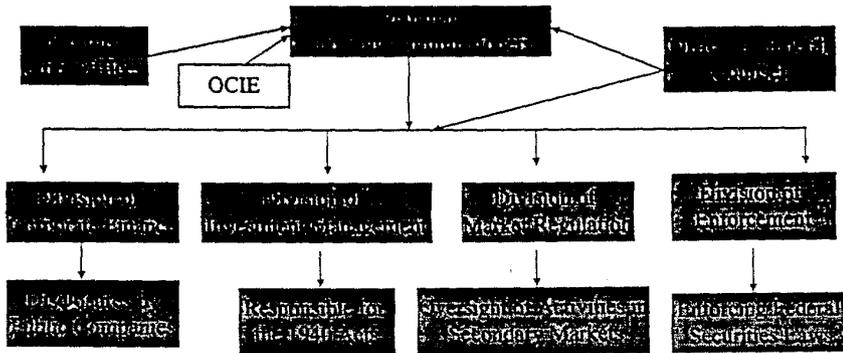
- SEC consults with Industry Representatives
- Advanced Public Notice of Proposed or Amended Regulations with Comment Period to solicit Public Opinion
 - Comments analyzed and summary prepared for Commissioners
 - Commissioners determine if modifications to proposed regulation is warranted
 - Final rule adopted within a specified time period from proposal

How does the SEC Maintain Uniformity in Interpreting Regulations

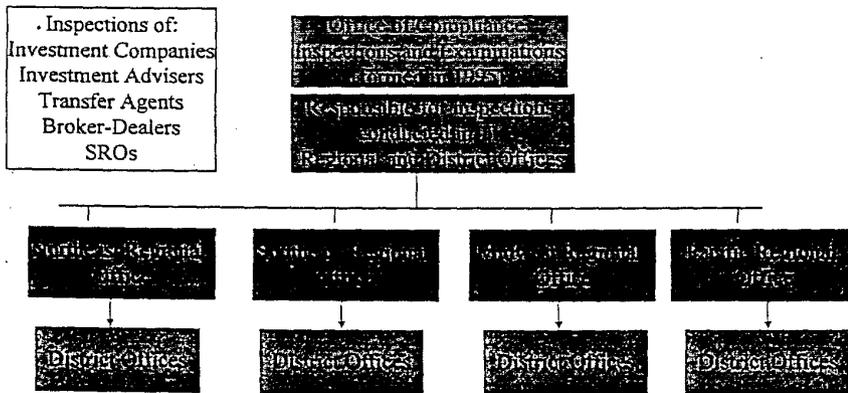
- No-Action Letters to the Industry
- Internal Written Interpretive Positions circulated in Regional and District Offices
- OCIE assists Regional and District Office to resolve “gray areas” when specific issues are noted in a firm



Organization of the SEC



Office of Compliance Inspections & Examinations



Office of Compliance Inspections and Examinations ("OCIE")

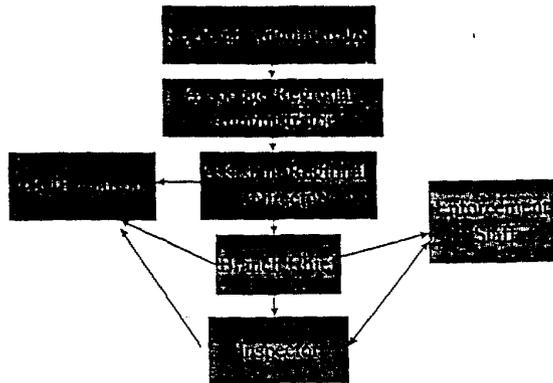
- Created in May 1995 to consolidate all of the SEC's Inspection Activities
- Each Regional and District Office has a liaison within OCIE to who provides guidance to Inspectors
- Conducts focused Inspections on particular topics of interest to Washington
- Accompany Regional Office Inspectors from time to time

1996 Inspections of Mutual Fund Complexes

- 308 Fund Complex Inspections conducted in 1996
- Approximately 5000 deficiencies noted during such mutual fund inspections
- Approximately 82% of Inspections resulted in Deficiency Letters
- Approximately 5% of Inspections referred to Enforcement



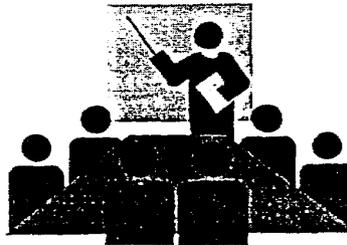
Who does an Inspector deal with?



Training

Maintaining Quality Control and Consistency in the Inspection Process

- The Inspection Manual
- On the Job Training
- Team Leaders
- Formal Training
- Talks from Industry Experts



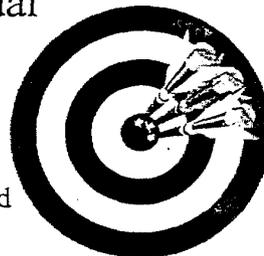
The Inspection Manual

- The Inspection Manual serves a vital function for the Inspection Staff
 - Detailed guide providing the “road map” of an Inspection
 - Highlights the concerns the SEC has in the particular area and the red flags that the inspector should look for
 - Checklists in Q&A form that walk Inspectors through the basics of what should be covered in that area



The Inspection Manual

- The Inspection Manual:
 - Ensures Uniformity
 - Ensures that key concerns are addressed
 - Critical Tool for new Inspectors
 - Inspectors complete the checklist for each area of review thereby creating a standard document which forms an important part of the work papers
 - Checklists create accountability





On the Job Training

- A significant part of an Inspector's Training is "on the job"
- Typically Junior Inspectors with 0-1.5 years of experience are trained by Senior Inspectors
- On the job training enables the junior inspector to work with real documents and real scenarios
- On the job training can be overwhelming because typically the inspector has no background in conducting inspections

Team Leaders

- Each Branch has a "Team Leader" who provides guidance to the Inspectors in the branch
- Team Leaders:
 - Take new inspectors on inspections
 - Ensure that new inspectors are provided appropriate reading material needed to understand the regulation and the investment management activity conducted
 - Provide ongoing guidance on issues that an inspector wants to "bounce off" of someone
 - Keep branch members apprised of new no-action interpretations, changes in the industry and areas of particular interest



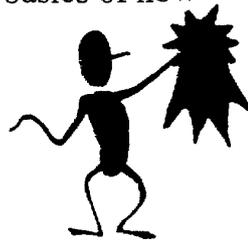
Formal Training



- Purpose of the Formal training sessions are in order to provide Inspectors a basic understanding of Inspection procedures, regulations, etc.
- Formal Training sessions typically last 5 days and are intensive
- Formal Training session conducted by Inspectors and Branch Chiefs that are involved on a day to day basis with the Inspection Process
- Extensive use of case studies

Talks from Industry Experts

- Regional and District Offices often invite industry experts that talk to the inspectors
- The intent is for inspectors to learn basics of how the industry works
- Examples of topics discussed are:
 - Derivative Instruments
 - How a trade is processed and settled
 - How does the NYSE work
- Understanding these areas helps in the conduct of better inspections





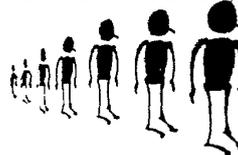
“Routine and For Cause Inspections”

- SEC Inspections are either “routine” or “for cause”
- Routine Inspections are conducted as part of regular inspection cycle in order to inspect funds on a regular basis
- Cause Inspections occur because the SEC is concerned that violations of the law are occurring
- The SEC does not typically disclose if an Inspection is routine or for cause



Routine Inspection

- The SEC typically gives the firm advance notice (5 days) of the date on which the inspection will begin
- Less likely to become an enforcement referral
- Follow a standardized format involving a review of all functions/areas of the firm
- A fund is typically inspected at least once in every three years





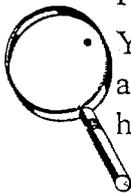
For Cause Inspection

The SEC does not give notice - Inspectors show up at the firm's doorstep

- More likely to become an enforcement referral
- For Cause Inspections tend to be more focused on the area where violative conduct is anticipated
- For Cause Inspections can be as a result of:
 - A tip received by the SEC
 - Complaint letters from Customers indicating violative conduct

Techniques to Handle a Cause Inspection

- Do not disclose to the firm that a cause inspection is being conducted
- More than one Inspector should be present at all points of time
- Diligent notes on all Observations and Interviews
- Have a normal dialogue with firm personnel
- Your objective is to find out as much as you can about the firm's practices - you do not want to have the firm "clam up"



Structure of the Inspection Process



THE SEC INSPECTION PROCESS

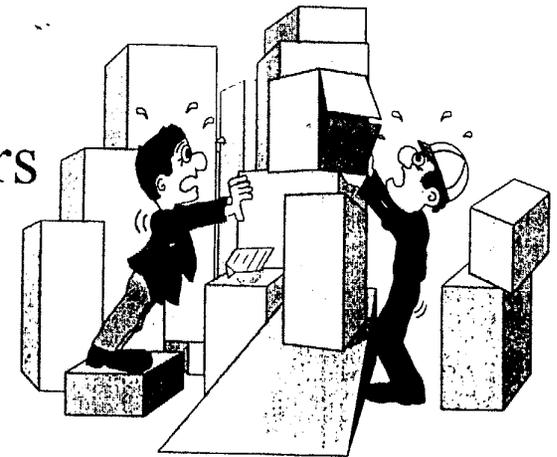
Price Waterhouse



4/6

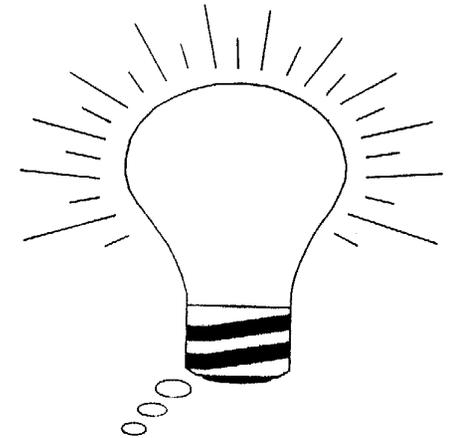
Why is the Structure of an Inspection Important?

- Ensures a Consistent, Uniform Approach to Inspections
- Quality Control Assured
- Ensures maximum utility of the Inspection Process and Findings
- Provides Guidance to the Inspectors during the Inspection Process



The Role of the Inspector

- Inspectors are Fact Finders
- Inspectors and the Inspection Program assists in promoting an “investor friendly” environment
- Inspectors provide the link between the Rule making body and the Industry



Which Mutual Funds to Inspect?

- General Guidelines set by OCIE
- District and Regional Offices have primary responsibility to select funds for Inspection
- Prospect Selection Process -Inspector Involvement
 - Frequency of Inspections (once in 3-5 years)
 - Prior Deficiencies
 - Enforcement Proceedings
 - New Funds
 - Risk Areas noted



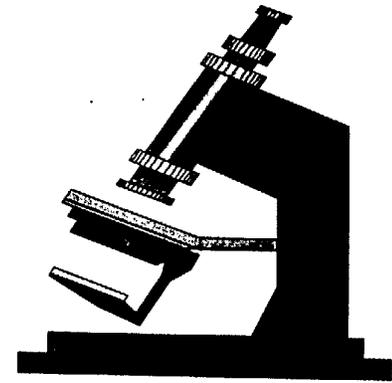
The Inspection

- Branch Chief and Assistant Regional Director determine which mutual fund to be inspected at what point of time during the fiscal year
- Branch Chief selects the Inspectors to be sent on the Inspection
- Inspection team size and capability
 - At least two Inspectors
 - Senior lead Inspector with junior Inspector
 - Fund Complex-multiple senior and junior Inspectors
 - Branch Chief Accompanies



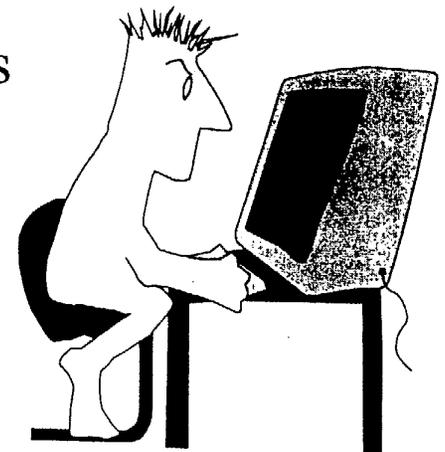
Pre-Inspection Process

- Review of filings with the SEC
 - Note any delay in filings
 - Note any areas of focus that can be established
- Review of the prior Inspection Report, Deficiency Letter and Response to the Deficiency Letter
- Background check of principal persons within the AMC
 - Review work history
 - Review of disciplinary history



Pre-Inspection Process

- Entry in Database to Inform staff that the mutual fund is being inspected
 - Avoids Washington from sending its team of Inspectors to the same fund
- Administrative
 - Sign Out with contact phone and Address
 - Take copies of filings with the SEC on the Inspection



The First Contact

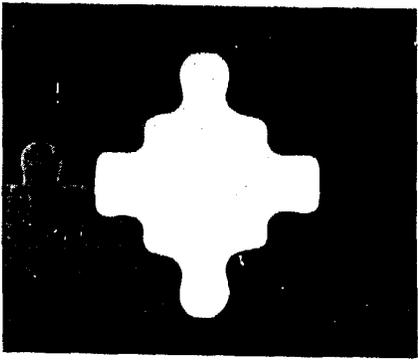


- Inspector contacts designated contact person (listed on Form ADV)
 - Request for delay of Inspection
- Standard Request List faxed to Registrant 5 days prior to Inspection
 - Typically period covered by the inspection 1-2 years
 - Allows Registrant to gather documentation in advance
 - Clarification of items on the request list

First Day of the Inspection

- Privacy Act Notice
- Inspection Information Brochure
- Opening Interview
 - Overview of the firm and its affiliates
 - Overview of departmental structure
 - The “Walk Through” - Tour of Office
 - Designation of contact person
- Questions and Clarifications





The Inspection

- Objective of the Inspection - “Look at the Big Picture”
 - The Inspection should not be a compartmentalized process of reviewing issues and conducting test checks
 - Utilize the facts learned from the inspection process to ensure that the fund is operating for the benefit of its investors and not for the benefit of the sponsor or any other affiliates

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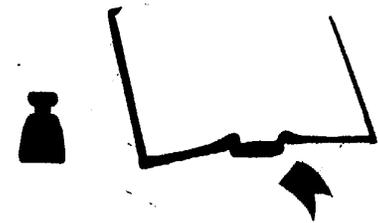
The Inspection

- Determine if the firm's practices are operating in accordance with disclosures made to Investors
- Compliance with the securities laws and regulations
- Adequacy and Effectiveness of a fund's internal controls
 - Ensure that AMC has adequate structure to function effectively in its role
 - Segregation of Responsibilities
 - Identification of conflicts of Interest and controls to monitor them



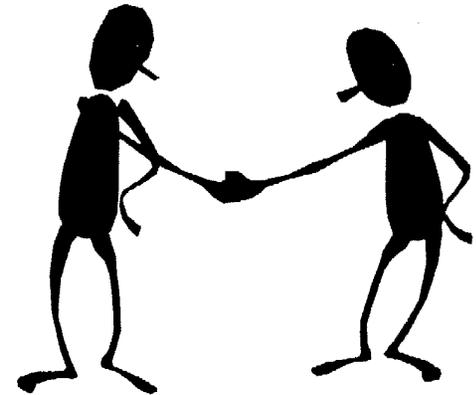
The Inspection

- Review of Internal Control Procedures including the Firm's Compliance Manual (Written policies)
- Interviews
 - Portfolio Management
 - Trading
 - Accounting
 - Compliance
 - Marketing



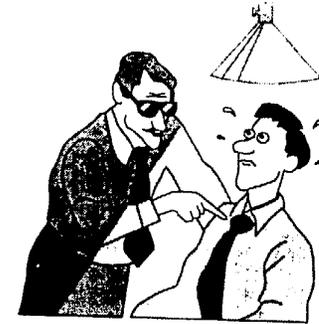
Interviews

- Interviews form an important part of the Inspection Process
 - Learn the reality of how things are done on a day to day basis from persons that actually perform the function
 - Do the persons that perform the functions understand the procedures and control mechanisms in place
 - Identify any discrepancies between verbal explanations and written procedures



8

Interviews .



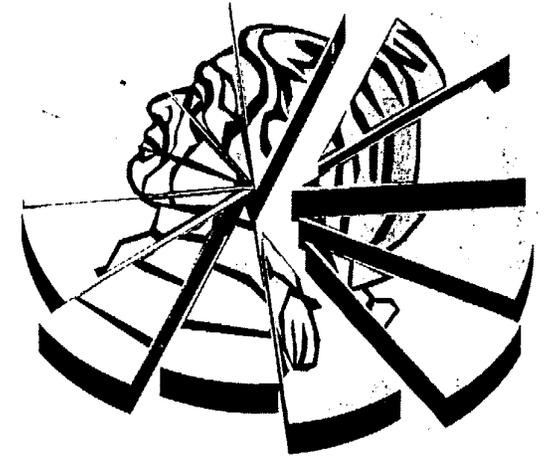
- Formal/Informal Interviews
 - At least two inspectors to be present during an interview
 - Explain the purpose of the Interview
 - Documenting what is mentioned during the interview
 - Dialogue not a Statement
 - Interviews are tools to learn from firm personnel how the firm actually is run

Testing

- The Importance of Testing
 - Verbal Explanations and Review of Written Procedures are not adequate
 - Are described procedures actually implemented
 - Do the described procedures appear adequate when dealing with day to day issues
 - The magnitude of a potential deficiency



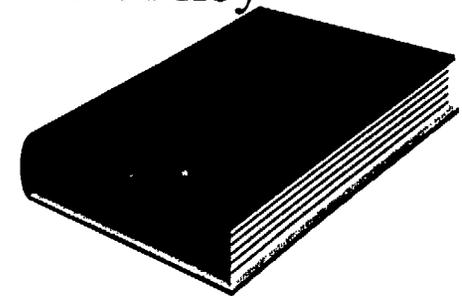
Sample Sizes



- How much to test
 - Although the request list covers a period of 1-2 years all issues are reviewed on a sample basis
 - The sample size is contingent on the size of the firm and the volume of trading activity conducted
 - One does not require to take a large sample size to identify a deficiency
 - Once a problem is noted the sample size can be readjusted

Tools that Assist the Inspector in the Inspection Process

- Inspection Manual
 - Checklists that guide the Inspector through the Inspection Process
 - Highlights the red flags that lead to detection of key issues
- Dialogue with Branch Chief
 - Provides guidance through the Inspection Process
 - Inspector keeps the Branch chief appraised of key issues noted
- Dialogue with fellow Inspectors

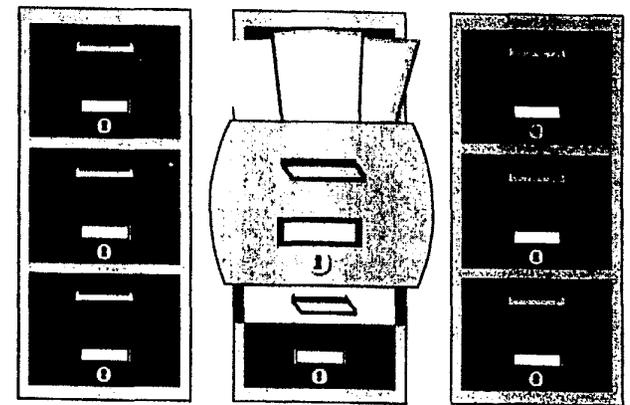


Work Papers

- Work Papers document the work done during the inspection
- Assists in the Preparation of the Inspection Report
- Document the time period tested and the test checks conducted
- Includes a summary page with list of all potential deficiencies noted

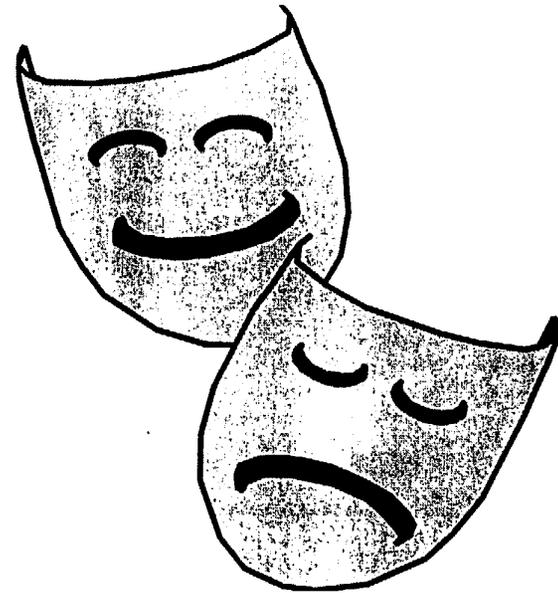
Work Papers

- Include all supporting documentation needed to verify that the firm is deficient in a certain area
- Branch Chief review relies on adequacy and accuracy of work papers
- Valuable resource for next Inspection

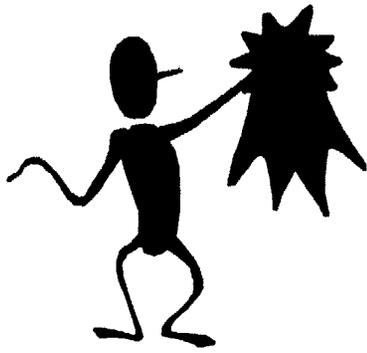


Closing Interview

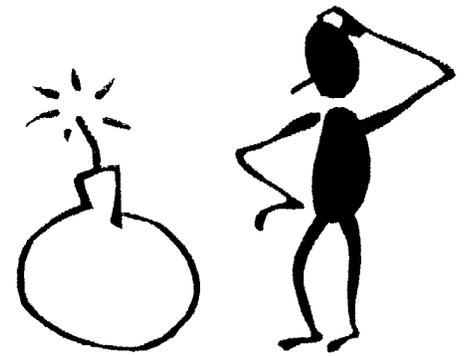
- What to discuss during a Closing Interview
 - Technical violations vs. Fraud
 - Onsite Inspection completed
 - Further contact or questions
 - What to expect
 - When to expect it



5



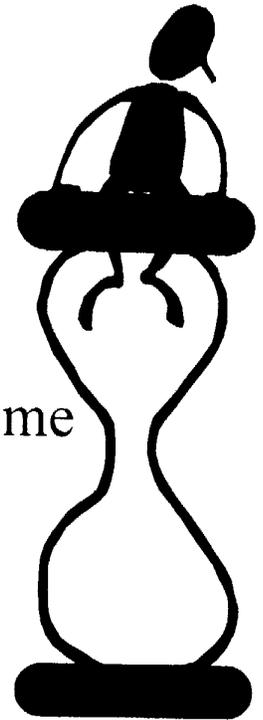
Closing Interview



- The Pros of a Closing Interview
 - Clarifies procedures/practices which may have been misunderstood by the inspectors
 - Gives a chance for the firm to explain themselves
- The Cons of a Closing Interview
 - The firm may argue and disagree with what may be a potential deficiency
 - The SEC chiefs may disagree with what the inspector thinks is a deficiency

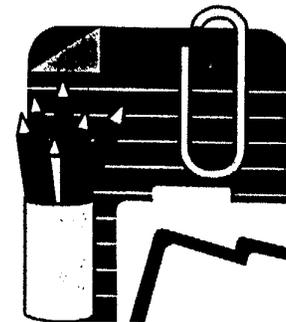
Inspection Report

- Intent to provide feed back to the firm within 90 days of the completion of the on-site inspection
- Inspection Report drafted by Inspector
 - Significant Contact with the firm to verify facts
 - Refer to documents in work papers to draft the deficiencies
 - Deficiencies identified specifically, referring to time period, etc.



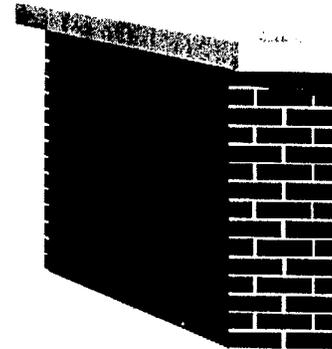
Inspection Report

- Branch Chief Review-First Level Review
 - Review of Draft Inspection Report
 - Review of Work Papers
 - Discussion Session between the Branch Chief and Inspector-additional information may be requested from firm
 - Report and deficiencies modified based on materiality



Inspection Report

- Assistant Regional Director Review-Second Level Review
 - Not as detailed a review as Branch Chief Review
 - Discussion of Broad Concerns and Firm Practices
 - Finalization of Deficiencies
 - Review of Deficiency Letter
- Associate Regional Administrator Review-Third Level Review
 - Final Sign Off



Inspection Report



- Introduction
 - An Overview of the Firm and its Affiliates
- Summary Page of Deficiencies in pre-determined categories
- Discussion of the Firm's Deficiencies
 - Cite the Regulation
 - Details of the Deficiency including the time period that the Deficiency was noted in
 - Cause of Deficiency if known
 - Any Explanations offered by the firm with regard to the Deficiency

Possible Outcomes of the Inspection

- No Further Action/No Comment
 - Does not occur frequently
- Oral Notice of Deficiencies
 - When very minor deficiencies are noted
- Deficiency Letter
 - Most Common Action
- An Office Reprimand from the SEC Staff
- A Referral to the SEC Enforcement Staff



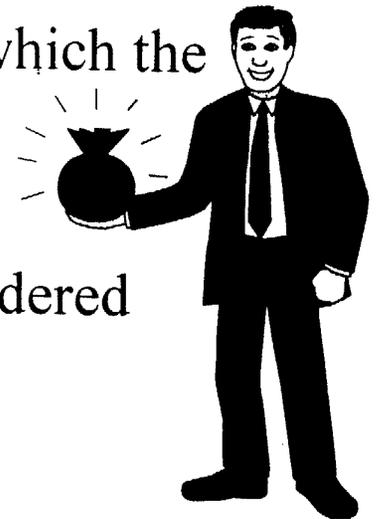
Deficiency Letter



- Attempt to send the Deficiency Letter to the Firm within 90 days of the Inspection
- Deficiency Letter typically the same as “Discussion of Deficiencies” in the Inspection Report
 - Similar details provided so that the firm knows exactly what you looked at
 - Not all deficiencies make it to the deficiency letter

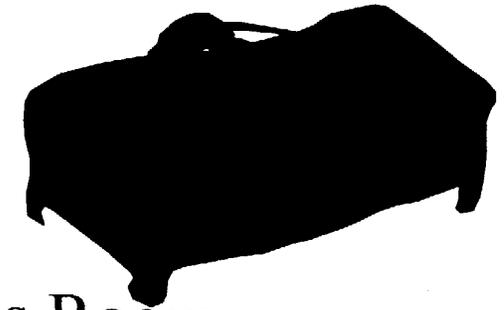
Materiality of Deficiencies

- Insignificant Deficiencies do not appear in the Deficiency Letters
- No Quantitative Measure of what is considered Insignificant/Material
 - Based on the deficiency
 - Number of times and period of time during which the deficiency occurred
 - Determined on a case by case basis
 - If an investor suffers financial loss it is considered material
 - NAV - penny materiality



Closing an Inspection

- Create a File with the Inspection Report and Deficiency Letter
 - For the Branch
 - For the District Office Records
 - Send a copy to Washington
- File the Work Papers in the Records Room
- Circulate the Report with the Deficiency Letter to all Branch Chiefs and Key individuals within the the District Office
 - Gives the Opportunity for all Branches to share findings



11

Response to the Deficiency Letter

- Response to the Deficiency Letter required within 30 days from the receipt of the letter
 - Firm must respond to each deficiency noted in the deficiency letter and inform the SEC what corrective action will be taken or what controls will be put in place
 - If Firm does not agree with the deficiency, they refute the deficiency in their response by providing details



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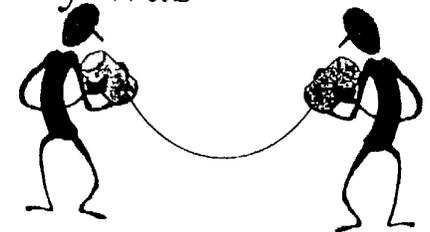
Follow Up to the Response

- Response received by the Associate Regional Director
- Reviewed by Branch Chief and Inspector
- If Response is Adequate - Filed
 - With Branch records
 - With Regional Records clipped to Inspection Report and Deficiency Letter
 - Copy Provided to Washington



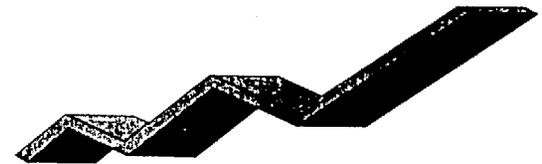
Follow Up to the Response

- SEC Follow up if Response is not received within 30 days
 - Extensions are granted on a case by case basis
- SEC Follow up if the Response is not Adequate
 - Contact Firm personnel and discuss what deficiencies were not addressed
 - Second Response will be expected
- SEC Follow up if Firm refutes SEC findings
 - Discussion of what documents the deficiency was based on
 - Agreement reached

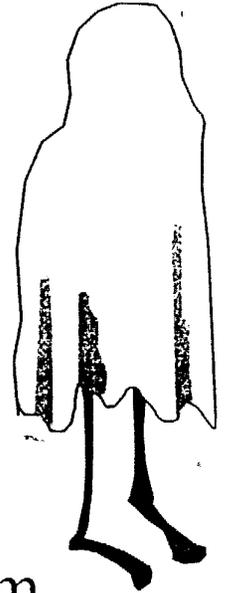


SEC Tracking of Deficiencies

- Summary Page of the Inspection Report has a table with Pre-determined Deficiency Categories
- The number of Deficiencies in each Category inputted into a database that is common to all Regions
- This Information is tabulated
 - Utilized by the SEC for determining and publishing the number of deficiencies in any particular area
 - Provides a resource for determining any focus areas during an Inspection
 - Rule making



Confidentiality of the Inspection



- Any Inspection conducted by the SEC is kept Extremely Confidential
- Inspectors are not allowed to discuss which Firm they are inspecting nor the issues that are found with personnel outside the SEC
- Inspectors are encouraged to Inform the Firm what level of Confidentiality is maintained by the SEC in order to alleviate any concerns of the firm

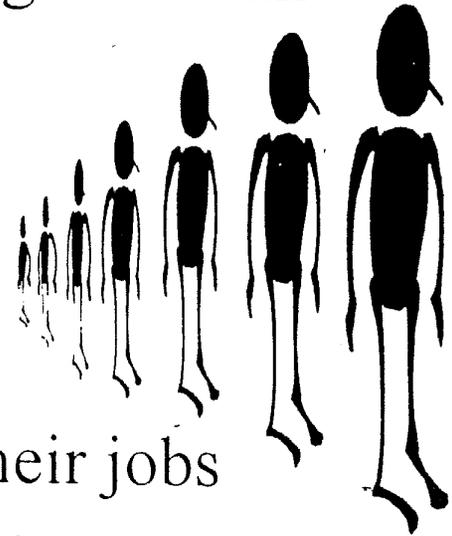
When does an Enforcement Case Become Public

- If an Inspection leads to potentially Serious Violations, the Issues discovered are turned over to the Enforcement Staff
- Enforcement Staff will make an individual determination about the seriousness of the issues
- If the issues are considered serious, the assigned SEC Lawyer will get in touch with the Firm
- The Matter is not public until a settlement is reached or a case is brought by the SEC



Conclusion

- Structure assists in achieving your goals of an effective inspection program
- Structure assures quality
- Structure assures uniformity
- Structure limits questions
- Structure helps the Inspectors do their jobs
- Structure gives you focus from beginning to end



**Documentation Provided to
the Board of Trustees**

REVIEW OF DOCUMENTATION PROVIDED TO THE BOARD OF TRUSTEES

PURPOSE

- The Board of Trustees is ultimately responsible and needs to be informed of all key areas
- To determine if this has been done
- To determine if the briefing was accurate, complete and timely
- To verify the trustees' involvement in the strategic decisions made in the management of funds

SAMPLE LIST OF REVIEW ITEMS:

- Board minutes
- Quarterly/ monthly Board package
- Materials filed with SEBI
- Scheme/fund portfolio briefing packages
- Fair valuations (internal valuation)
- Board approved procedures
- Personal Securities Transaction reports

SAMPLE REVIEW LIST cont.

- All contracts including but not limited to:
 - Advisory
 - Custodian
 - Transfer Agent
 - Brokers
 - Marketing
 - Legal
- Appointment of trustees

SAMPLE BOARD PROCEDURES

- Brokerage allocation
- Trade allocation
- Personal Securities Transactions/ Code of Conduct
- Diversification

SAMPLE BOARD PROCEDURES cont.

- Interfund transactions
- Money market fund valuations
- Repurchase transaction guidelines
- Securities lending guidelines
- Counterparty credit review standards

MISCELLANEOUS ITEMS

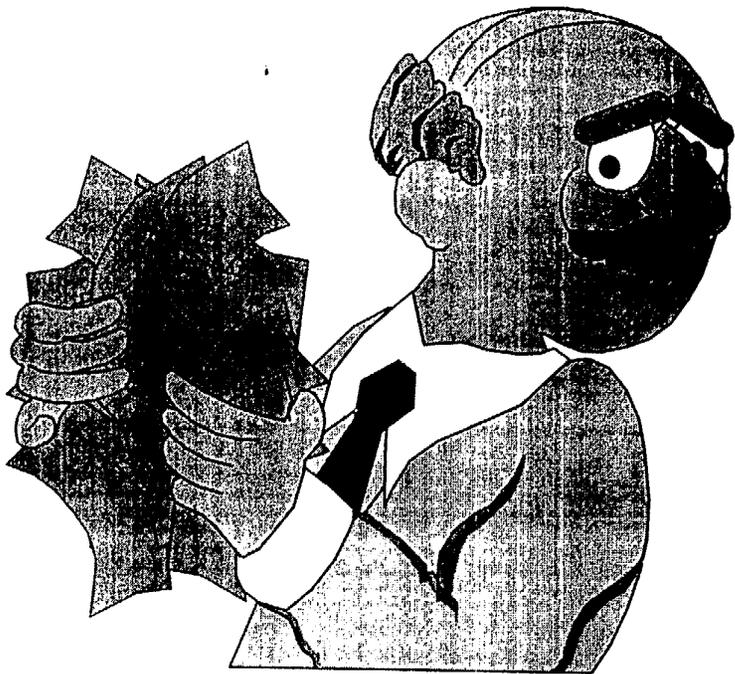
- Queries raised by the trustees
- Responses by the AMC
- Resolutions of the trustees
- Interviews to understand the process of preparing the Board of Trustees package

Board Package Review

Conclusion

Overview of Key Inspection Issues

- Personal Trading and Front Running
- Trade Allocation
- Best Price and Execution



PERSONAL TRADING AND FRONT RUNNING

Price Waterhouse



bb

SEBI Regulation

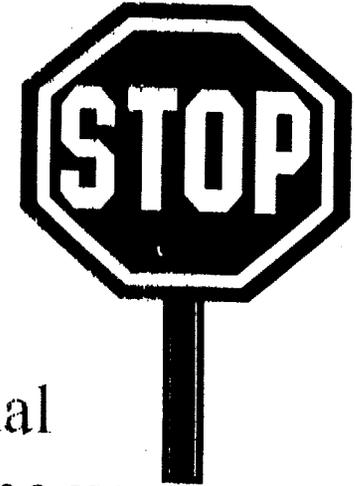
- Rights and Obligations of Trustees
 - 18 (8)
 - 18 (11)
 - 18 (23)(b)
 - 18 (22) Code of Conduct
- Rights and Obligations of AMC
 - 25 (3)
 - 25 (9)
 - 25 (16)

Areas of Concern to SEBI

- Are the firm's employees and/or relatives of such employees utilizing material non-public information to benefit themselves personally?
- Are employee (and relatives) personal trades receiving better prices than client accounts?
- Are profitable investment opportunities being taken away from clients in order to benefit employees (and relatives) personally?



Areas of Concern to SEBI



- Does the firm have reasonable organizational structures and controls in place to contain the use of material non-public information
- Does the firm adequately monitor the personal trades of its employees (and relatives)?
- Does the firm resolve any conflicts between employee/relative and client trades appropriately?

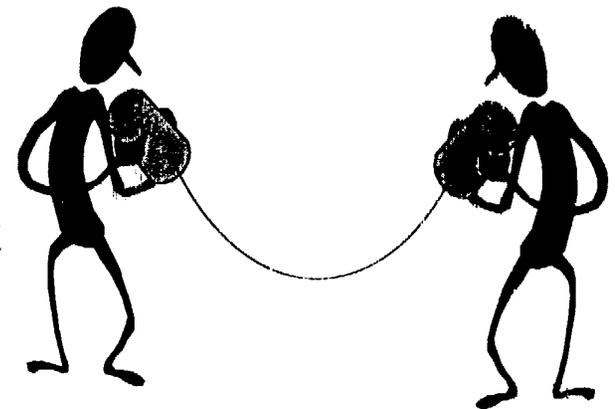
Front running



- A Practice whereby a person takes a position to capitalize on knowledge of an upcoming transaction that is expected to influence the market
- Example : A person has knowledge of a upcoming buy order for a fund in a security that is thinly traded. The person places a buy order for his/her own account prior to the fund and sells the shares after the fund order thus making a profit as a result of possessing material non-public information

Access to Privileged Information

- Access to privileged inside information can occur in several ways:
 - Investment Banking and Underwriting activities
 - Analysts' contact with Corporate Insiders
 - Firm sponsored LBOs, Takeovers, etc.
 - Firm sits on Creditors Committees of Bankrupt Companies
 - Third-party Tip

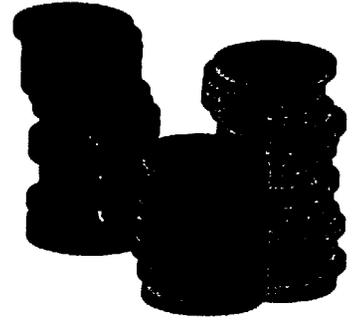


What Documents to Request

- Organization Chart with the organization of the firm and all affiliated entities
- Pre-Inspection Process should give you an idea of the affiliations firm personnel may have, e.g., a person may be sitting on the Board of Directors of a company
- Also, formally request Affiliations/positions with other corporations or partnerships and shares or interests held in each.



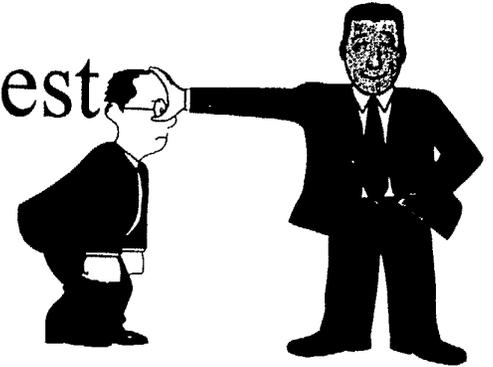
What Documents to Request



- A list of firm personnel that are required to report their personal securities transactions due to their involvement in or knowledge of investment decisions being made for clients, e.g., officers, partners, directors, portfolio managers (debt and equity accounts), traders (debt and equity securities) and research analysts (debt and equity securities).
- Statements of the firm's or affiliates' proprietary trading account (objective to test firm or affiliate proprietary trading vs. client trading)



What Documents to Request



- Chinese Wall Policies
 - Internal policies that are designed to prevent the dissemination of non-public information from one department to another. Typically a wall exists between the Investment Banking side of a firm and the Investment Management side
- Insider Trading Policies
 - Policies that are designed to educate an individual as to what is considered material non-public information and what firm personnel must do when in possession of such material non-public information

What Documents to Request

- Employee Personal Trading Policy
 - Policy that lay down internal rules to be followed when trading for personal accounts or accounts of relatives
 - Will specify what to report to the firm on personal trades
 - Any Pre-approval requirements will be described here
 - Holding Period Requirements
 - Will describe how conflicts between personal and client trades will be resolved

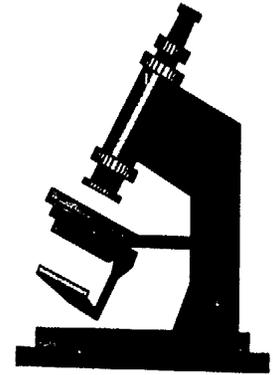




What Documents to Request

- Firm's Trade Blotter/Deal Sheet (Chronological Purchase and Sales Journal that shows trades placed for all clients managed by the firm)
- Any materials presented to the Board of Trustees on personal trade policies and personal trades of employees and relatives
- Personal Trades for a sample of personal accounts of firm personnel.
- Exception reports that list trades in conflict with client trades

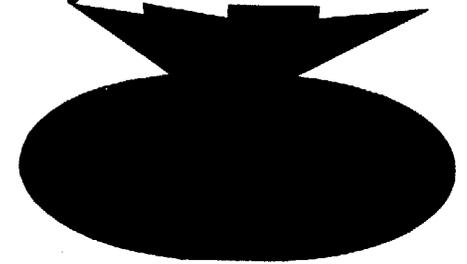
Process of Testing



- Test sample of personal and proprietary account trades vs. client trades on trade blotter
 - Do any of the personal trades get a better price on the same day trading in the same security as the fund?
 - Personal trades with better price before fund trades?
 - Is a proprietary account getting better prices than client accounts?
 - Ensure that firm requires employees to report trades in private placements in addition to trades in listed securities

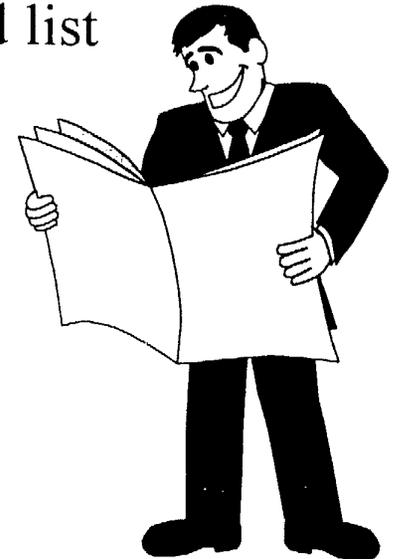
Process of Testing

- Note trades in which a firm personnel has made a significant profit in a relatively short amount of time
 - Would the investment have been suitable for any of the clients?
 - Do research files indicate that the security was being considered for client accounts?
 - Does it appear that an investment opportunity has been taken away from clients?



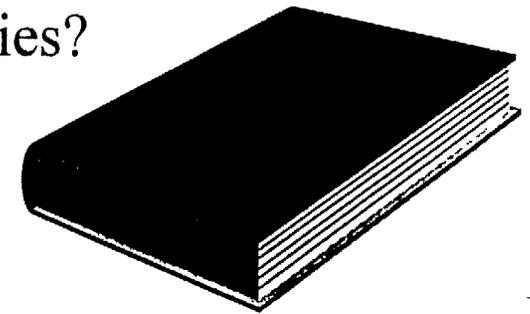
Process of Testing

- For employees that may have access to non-public information
 - Compare trading with news stories to detect if any trade was based on inside information
 - Compare personal trades against any restricted list created by the underwriting affiliate

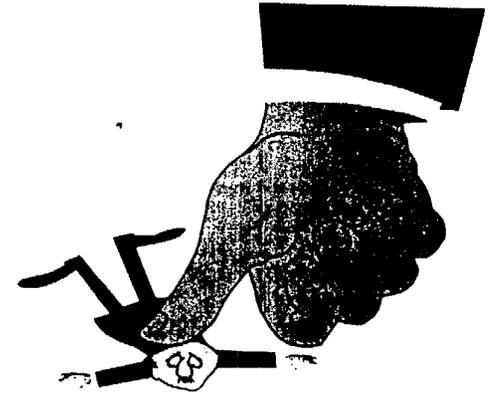


Process of Testing

- Test if personal trades are being filed according to internal policies created by the firm
 - If not, it may be an indication of poor internal controls
 - Does the firm require its employees to sign a statement representing they have reported all personal trades?
 - Does the firm provide copies of its internal policies relating to personal trading, etc. to its employees?
 - Does the firm get representation from its employees that they have read and understood such policies?

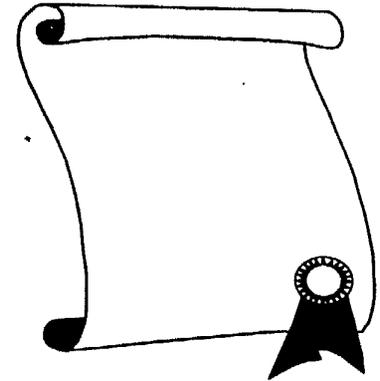


Process of Testing



- Request a sample of exception reports and review method in which any conflicts in personal trades get resolved
- Review minutes and ascertain if Board of Directors has been involved with the approval of personal trading, insider trading and Chinese Wall policies

Process of Testing



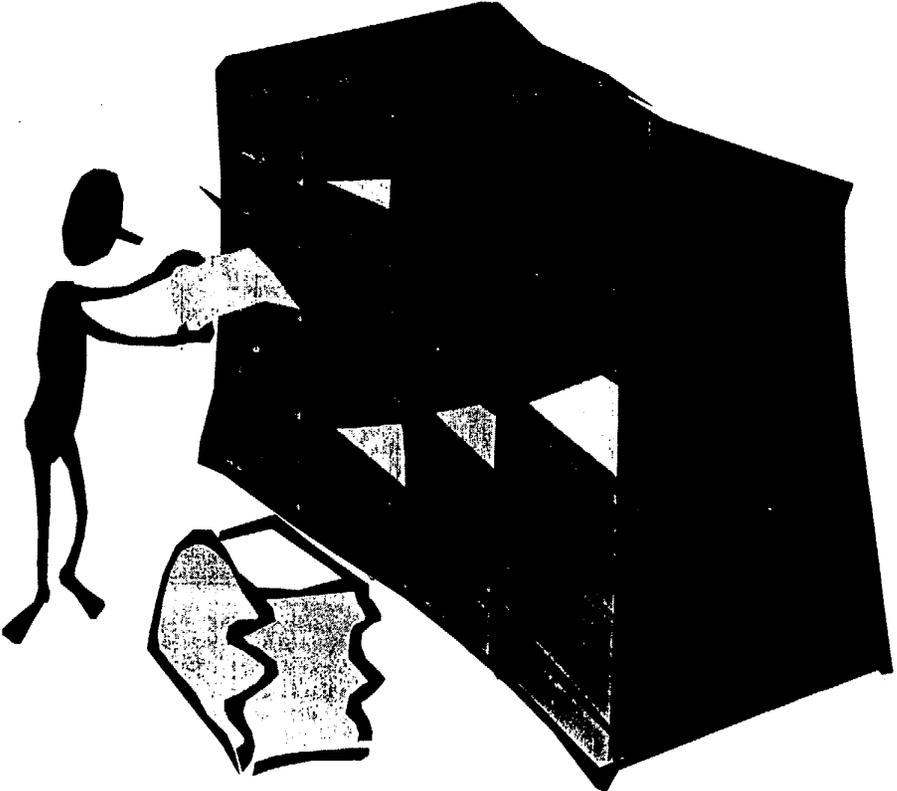
- Board of Trustees review of personal trades?
 - What review is conducted to ensure that the representations made to the Trustees regarding front running and self dealing is accurate
- Representation to SEBI that personal trades have been reviewed and are not in conflict with client trades
 - Who signs the representation?
 - What Documentation does the person review before making the representation?

Limitations



- Firms have to rely on the honesty of their employees to ensure that all personal trades have been reported
- Firms in India cannot get personal trades reported to the firm directly from an independent source- when that is feasible, it is considered a good internal control to have custodians/brokers directly report employee trades to the firm for review

TRADE
ALLOCATION

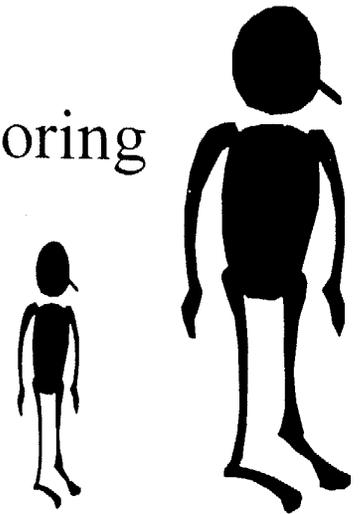


SEBI Regulation

- Rights and Obligations of the Trustees
 - 18 (5)
 - 18 (8)
- Rights and Obligations of the AMC
 - Code of Conduct

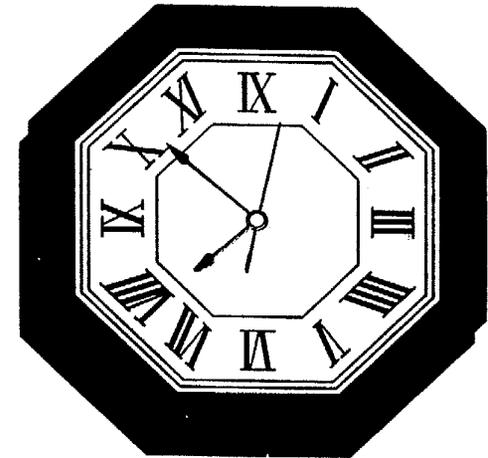
Areas of Concern to SEBI

- Is the firm favoring certain schemes over others by allocating profitable investment opportunities to only some of its schemes and/or personal accounts?
 - For example, is the firm allocating Hot IPOs to certain schemes?
- In allocating bunched orders, is the firm favoring certain schemes over others?



Areas of Concern to SEBI

- When is the firm determining allocations?
 - Pre-trade execution or Post trade execution
 - If allocations are occurring towards the end of the trading day or after trade date, the firm has the potential determine allocation based on any price movements that occur subsequent to the execution of the trade



What Documents to Request

- Any Written Department Trading Policies
 - Internal policy on how the trading desk should place and document trades
- Trade Blotter
- Order Tickets and any Pre-trade allocation documentation if maintained separate from order tickets
- Performance for a select time period of various schemes managed by the firm

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What Documents to Request

- A list of all IPOs that schemes and personal accounts have been invested in with:
 - Date of Purchase
 - Date of Sale
 - Price of Purchase
 - Price of Sale
 - Allocation

Typically Hot IPOs are flipped (sold within a short period of time) to take advantage of short term inflated prices that normally seen with Hot IPOs

Process of Testing



- Based on information provided on IPOs ascertain the profit/loss made by various clients
 - Do certain schemes consistently make a profit?
 - Do certain schemes consistently make a loss?
 - Does the firm document the allocation of IPOs prior to the date of the IPO?
 - If the firm does not get the number of shares it has indicated interest for how does it allocate the shares received among its schemes? Does the methodology seem fair?
 - Ask the firm to provide reasons why certain schemes were not allocated any IPOs

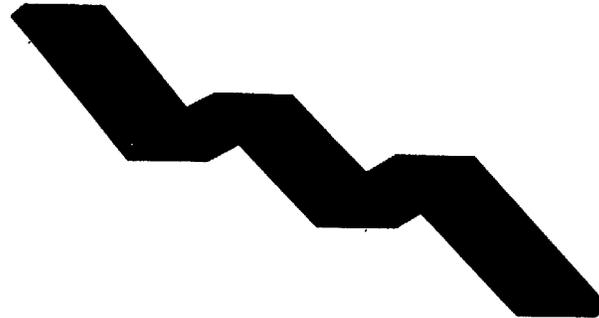


Process of Testing

- For a sample of bunched orders review the order tickets and ascertain when the allocation was determined
 - Time Stamps
 - Interview firm personnel and watch the trade placement and allocation procedures
 - Review pre-trade allocation tickets and question modifications to any allocations made post trade execution

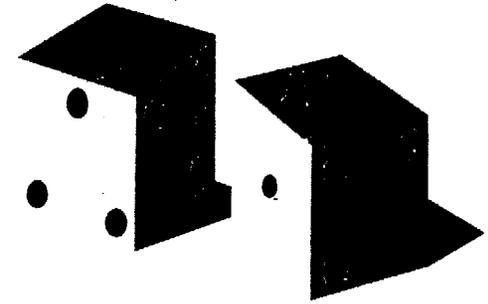
Process of Testing

- Allocation cont....
 - In reviewing the performance of all schemes managed by the firm pay particular attention to significant deviance in performance of schemes managed in a similar style - it may be indicative of schemes that are favored or disfavored by the firm
 - all accounts participating in a bunched order should get an average price



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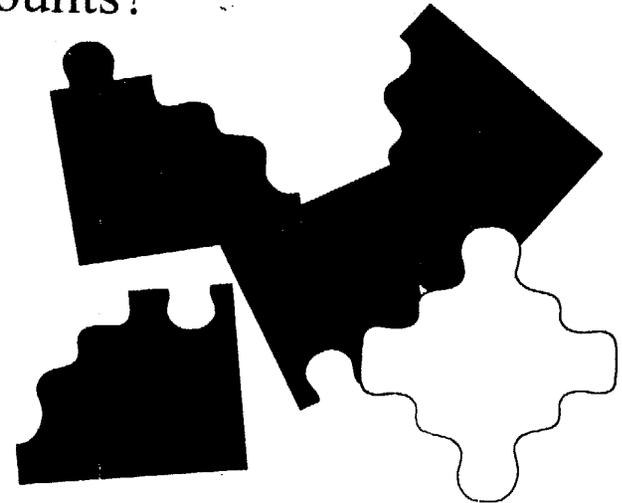
Process of Testing



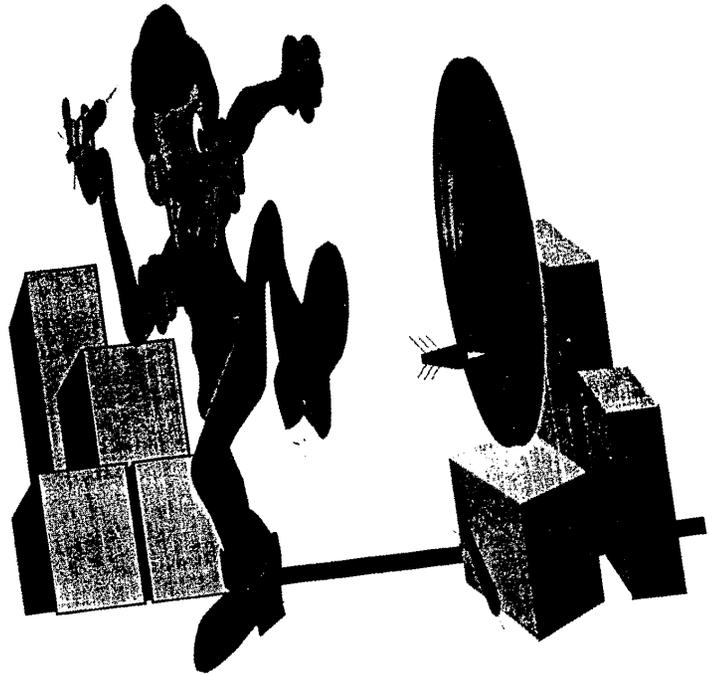
- Partially executed trades
 - If a trade is partially executed, how does the firm allocate the shares it has obtained (pro-rata basis, random allocation)
 - Does the methodology utilized seem fair and equitable to all schemes?
 - Is an employee account allocated any shares of a partially executed order?

Process of Testing

- If firm has an affiliate that manages brokerage accounts
 - Ascertain if fund trades and trades for brokerage accounts are being bunched
 - How are partially executed trades being allocated among brokerage and fund accounts?



BEST PRICE
AND
EXECUTION



SEBI Regulation

- Rights and Obligations of the Trustees
 - 18 (4)(g)
 - 18 (5)
 - 18 (6)
- Rights and Obligations of the AMC
 - Code of Conduct

Areas of Concern to SEBI

- A firm has the fiduciary responsibility of obtaining best price and execution for its clients
- Best Price and Execution - Client's total cost or proceeds in a trade is most favorable under the circumstances
- Is the firm selecting the broker based on the broker's execution capability?
- Is the firm negotiating commission rates?
- Is the firm using its brokerage affiliate without evaluating for best execution?



Best Execution

- Best Execution is based on various factors:
 - Execution Capability - brokers may have different execution capabilities based on the order size or type of security that is being traded
 - Commission Rates - are the commission rates being charged by the broker competitive?
 - Value of Research Provided - Is the broker providing research reports, etc. that are valuable in the portfolio management process?





What Documents to Request

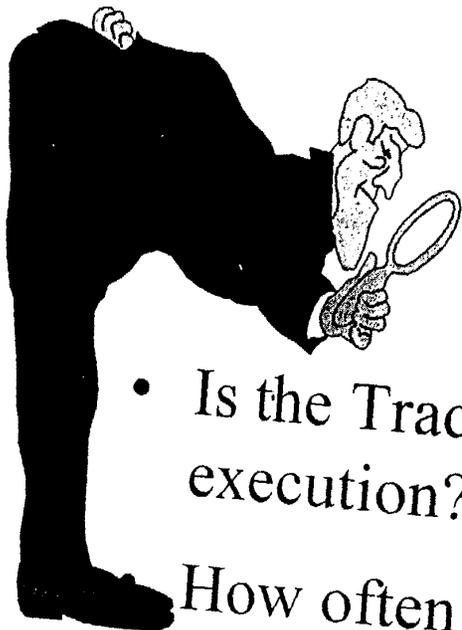
- Approved Broker List and the criteria utilized by the firm to select brokers
- Any internal documentation the firm maintains that documents best execution checks conducted by the firm
- Trade Blotter (showing the price and the commission charged for each trade)
- Any Documentation given to the Board which evaluates the execution of fund trades

Process of Testing

- Commissions charged
 - Ascertaining whether a competitive commission is charged is based in part on knowledge of what is considered a competitive commission rate in the market
 - Interview trading personnel and ascertain whether the firm negotiates a commission rate with brokers
 - Review commission per share paid by different schemes to ascertain whether certain schemes are receiving a better commission rate than others

Process of Testing

- Prices obtained
 - For a sample of securities check what the “high”, “low” and “close” for the day was - the price obtained by the fund should fall within the range
 - Also check whether purchases are occurring consistently at the high of the day and sales at the low of the day - if so, it would be indicative of a problem
 - If various schemes are executing trades in the same security on the same day - test to see whether prices obtained by the different schemes are disparate

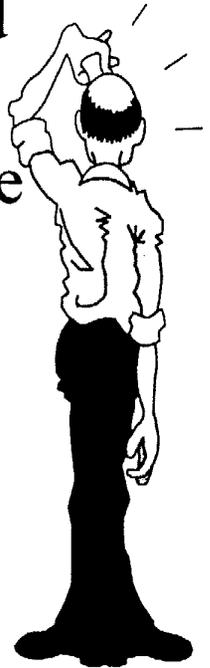


Process of Testing

- Is the Trading desk monitoring best price and execution?
- How often does the firm review best price and execution?
- Question whether the firm has stopped using a particular broker due to poor execution being offered

Limitations

- Since Best Price and Execution is based on several factors, including research capabilities of the brokerage firm, it is quite difficult to make a judgment on poor execution unless the prices and commissions obtained by the clients are consistently poor compared to other players in the market



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Overview of Key Inspection Issues

- Transactions with Associates
- Portfolio Review

Transactions with Associates

Relevant Regulations

SEBI (Mutual Funds) Regulations, 1996:

- Regulation 2. (c) - definition of associate
- Regulation 18. (6) - no unfair or undue advantage should be given to any associate in any manner detrimental to the interests of the unitholders
- Regulation 24 (3) - disclosure of intention of AMC to invest in its own schemes

Relevant Regulations cont.

SEBI (Mutual Funds) Regulations, 1996:

- Regulation 25 (7) - no more than 5% of daily gross business with an associated broker
- Regulation 25(8) - utilising the services of associates etc for any securities transaction and the distribution and sale of securities - disclosure in the half yearly and annual accounts

Relevant Regulations cont.

SEBI Press Release Sept. 5, 1997

Ref No. PR 100/97

- No investments in unlisted securities of associate/ group companies
- No investments in privately placed securities of associate/ group companies
- Aggregate investments in group companies not to exceed 25%

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Purpose

To protect the interests of the unitholders

To set limits to prevent conflicts of interest

Sample Documents to Request

- List of affiliates/ associates (individuals, firms, etc)
- List of sponsors and their other interests
- List of directors of the AMC and their other interests
- List of trustees and their other interests

Sample Documents to Request cont.

- Trade blotter for the sample period(s) selected
- Listed vs. unlisted transactions
- Transactions subjected to fair valuation procedures

Testing process

- Disclosure in the half-yearly and annual reports
- matching list of associates etc. and their interests with the (sample of) transactions selected and the firms executing those transactions (Note: the sample should include transactions subjected to fair valuation procedures.)
- review of reports to the trustees

Limitations

- Accuracy and completeness of the lists identifying all associates
- Identification of counterparties to a transaction
- Fraud potential

Transactions with Associates

Conclusion

PORTFOLIO REVIEW

RELEVANT REGULATIONS/ RESTRICTIONS

- SEBI (Mutual Funds) Regulations, 1996:
Seventh Schedule - Restrictions on
investments
- SEBI Press Release - dated Sept 5, 1997
Ref. No. PR 100/97
- Fund offer documents
- AMC's compliance manual
- AMC's internal policies and procedures

Purpose

- Investment regulations provide for the protection of unsophisticated investors
- The Offer document represents the promises made to potential investors
- Internal policies represent prudent norms established by the trustees to ensure orderly conduct of business

Documents to Request

- Offer documents
- Internal policies and procedures
- Compliance manual
- Download of transactions for sample period
- Databases used for routine monitoring

Types of Restrictions

- Regulatory
- Offer document
- Internal policies and procedures

Examples of Regulatory Restrictions

- Investments only in investment grade rated debt - else approval by board of AMC
- 10% of any company's paid up capital carrying voting rights for all schemes collectively
- Initial issue expenses limited to 6% of funds raised by the scheme

Examples of Offer Document Restrictions

- industry limits (definition)
- No more than 5% of net assets shall be in the securities of a single issuer (cost/market)
- Dedicated funds - standards for defining type (65%?)
- Limits set cash equivalents/ equities/ debt (unexpected market conditions)
- Underwriting limits

Examples of Internal Restrictions

- Internal valuation of securities
- Debt instruments only of the top three tiers
- Portfolio limits for illiquid securities (definition)
- Derivative trading

Testing process

- Sampling: period, point in time
- Identify all restrictions
- Independently verify compliance
- validate the databases used for routine testing
- Review reports submitted to SEBI
- I/C: portfolio, trading, accounting, compliance

Specific issues

- guarantees
- indicative returns
- other promises
- allowable fund expenses
- other review items: cancel/corrects, adjustments, pricing exception reports

Other issues

- Disclosures (deficiencies or litigation etc) in the annual reports or offer documents
- Prior audit/ inspection deficiency reports and their resolution

Limitations

- Sample size
- Period vs. point in time

Portfolio Review

Conclusion

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 donot 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?

Overview of Key Inspection Issues

- Accounting and Valuation
- Client Servicing

MUTUAL FUND INSPECTION

ACCOUNTING AND VALUATIONS

PRINCIPAL INSPECTION OBJECTIVES

- Compliance with Regulations and Prospectus Terms
 - Transactions are properly authorized and recorded
 - Reasonable assurance for compliance with investment objectives and policies
 - Fund's ownership of and accounting control over its assets

OBJECTIVES

- Compliance with Regulations and Prospectus Terms
 - Investments are correctly accounted and properly valued
 - Income and gains (losses) are properly accounted
 - Investments are not encumbered

INTERNAL CONTROLS

- Adequacy of internal controls to assure
 - reliability of financial reporting
 - efficiency and effectiveness of operations
 - efficiency of pricing process
 - compliance with rules and regulations
- *Size of Sample for test checks depends upon inspectors confidence on the fund's internal controls. Sizing is judgmental*

AREAS OF CONCERN

- Material Weaknesses in Internal Controls
- Maintenance of Proper Books of Accounts
- Segregation of Assets
- Recording of Corporate Actions
- Fair Valuation of Securities
- Reconciliation with Custodian Records
- Recording and Reconciliation of Capital Account Transactions

REVIEW OF DOCUMENTATION

- Board Approvals for:
 - internal control procedures and accounting policies
 - constitution of valuation committees and terms of reference
 - fair valuation procedures
 - ratification of fair valuation
- Offer Documents for valuation terms and procedures
 - Valuation dates and Pricing methodology
 - Valuation policies, if any

REVIEW OF DOCUMENTATION

- Minutes of the AMC
- Minutes of Valuation Committee
- Portfolio Holding Statements
- Custodian Reports
- Confirmation of Balances

PROCESS OF TESTING

- Test of Custody Securities
 - Confirmations from Custodian
 - Security Count Reports from Custodian's auditors
 - Physical Count of a representative sample
 - Reconciliation with portfolio holding statements

PROCESS OF TESTING

- Tests of Portfolio Transactions
 - select a representative sample of transactions
 - obtain brokers notes and delivery instructions
 - test for proper authorization, trade dates, broker, script detail, rates etc..
 - examine whether these have been properly recorded
 - test the prices with independent published sources
 - check corresponding entries in bank statements
 - check delays in booking of trades /delays in settlements

PROCESS OF TESTING

- Tests of Income accrued/received
 - Obtain Interest/Dividend schedules
 - select an interim period
 - test income earned for either the entire portfolio or a representative sample of securities
 - consult independent sources for dates/rates; dates, rates to agree with General Ledger

PROCESS OF TESTING

- Tests of Income accrued/received
 - check for the income included and those that could have been excluded
 - check whether excess received is properly accounted
 - review portfolio statements for non-income producing securities

PROCESS OF TESTING

- Test of NAV
 - Test on the first date of inspection, last date and select a few dates in the interim
 - compare balances with investment ledger
 - reconcile balances to the general ledger
 - trace a sample of corporate actions accounted to independent sources

PROCESS OF TESTING - Testing of NAV

- trace market price used to independent sources
 - check alerts for fair valuation when market quotes are not available
 - set tolerance levels - check out for securities whose prices fall out of tolerance limits for further test on valuation
 - identify securities whose prices have not changed for "x" no. days , for further tests
 - highlight securities sold at a price that is significantly higher than the most recent valuation

PROCESS OF TESTING

- Net Asset Value - Fair Valuation
 - inspector is not an appraiser
 - review board package for methods/procedures
 - review valuation committee minutes
 - review the methods used to determine and update prices and their consistency
 - review the sale proceeds to the value used several days before sale

PROCESS OF TESTING

- Net Asset Value - Fair Valuation
 - inspect the underlying documentation to ensure reasonableness of procedures
 - review the procedures used to assess credit risk

PRINCIPAL ISSUES IN FAIR VALUATION PROCEDURES

- Controls to alert for significant price deviations
- Board to satisfy that surrogate securities are truly "comparable" to the security being valued
- Regular cross checking of prices with that of actual sales of comparable securities
- Board review of material pricing errors and approval of corrective action

MUTUAL FUND INSPECTION

CAPITAL ACCOUNTS

PRINCIPAL INSPECTION OBJECTIVES

- Number of Units and their Value are properly stated
- Satisfactory procedures for determination of no. outstanding units for calculation of NAV
- Receivable and Payable are properly stated
- Distributions and Reinvestments are properly accounted for
- Record keeping is appropriate

REVIEW OF DOCUMENTATION

- Review Offer Document policies for sales, redemptions, switches, reinvestments
- Review Contractual responsibilities of Transfer Agents to test controls
 - Accounting and Arithmetical controls
 - System access controls
 - cash control procedures
- Review the internal controls for:
 - Sales, Redemptions, Reinvestments
 - Cancellation of units, cheque writing

PROCESS OF TESTING

- Testing of Sale & Repurchase
 - select a sample of applications. Trace them from receipt to processing and to allotment
 - check the NAV transfer mechanism between AMC & R&T; Ensure that NAV used is appropriate
 - conform with Prospectus for eligibility
 - test the details on application agree with unitholder account statements

PROCESS OF TESTING

- Check all rejections have the Management explicit approval
- Test check totals of daily sales & repurchases and compare their daily postings to related books
- reconcile the balances with general ledger
- check corresponding entries in bank statements
- as on the first date of inspection obtain confirmations from transfer agent for shares outstanding

DIVIDENDS AND REINVESTMENTS

- Review board minutes for dates/amounts
- test for reconciliation of units outstanding on xd to the transfer agent records
- recompute the dividend-payable and compare it against R & T report
- check that correct NAV is used for reinvestment

MUTUAL FUND INSPECTION

CLIENT SERVICING

CUSTOMER COMPLAINTS

- Check SOP for recording & redressal
- Obtain aging reports
- Review Offer Document for service standards
- Randomly select sample correspondence and do an indepth check
 - check for proper recording and data entry
 - check for non-inclusions in aging reports

Working Group Findings

- Transactions with Associates
- Best Price and Execution
- Front Running and Personal Trading

Transactions with Associates



What are the key tools you use to inspect this area?



What are the current limitations to effective testing in this area?



In what areas of regulation related to this area would you like further clarifications/interpretation by SEBI?

Best Price and Execution



What are the key tools you use to inspect this area?



What are the current limitations to effective testing in this area?



In what areas of regulation related to this area would you like further clarifications/interpretation by SEBI?

Front Running and Personal Trading



What are the key tools you use to inspect this area?



What are the current limitations to effective testing in this area?



In what areas of regulation related to this area would you like further clarifications/interpretation by SEBI?

Reference Materials

- The Work of the SEC:
A Public Bulletin
- The SEC's Exam Program for
Investment Advisers
- The SEC Document Request
List for Mutual Fund Inspections
- GAO Report on Mutual Fund
Inspections 5/28/97

The Work of the SEC

A Public Bulletin published by the
SEC

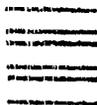
The Work Of The SEC



United States Securities
and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, \$300
RETURN AFTER FIVE DAYS



SEC 2171 (11-04)

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The Work of the SEC

A publication of the
Office of Public Affairs, Policy Evaluation and Research
United States Securities and Exchange Commission
November 1994

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I Introduction

The U.S. Securities and Exchange Commission's mission is to administer federal securities laws that seek to provide protection for investors. The purpose of these laws is to ensure that the securities markets are fair and honest and to provide the means to enforce the securities laws through sanctions where necessary. Laws administered by the Commission are the:

- Securities Act of 1933;
- Securities Exchange Act of 1934;
- Public Utility Holding Company Act of 1935;
- Trust Indenture Act of 1939;
- Investment Company Act of 1940; and
- Investment Advisors Act of 1940.

The Commission also serves as advisor to federal courts in corporate reorganization proceedings under Chapter 11 of the Bankruptcy Reform Act of 1978 and, in cases begun prior to October 1, 1979, Chapter X of the National Bankruptcy Act. The Commission reports annually to Congress on administration of the securities laws.

Under the Securities Exchange Act of 1934, Congress created the Securities and Exchange Commission (SEC). The SEC is an independent, nonpartisan, quasi-judicial regulatory agency.

The Commission is composed of five members: a Chairman and four Commissioners. Commission members are appointed by the President, with the advice and consent of the Senate, for five-year terms. The Chairman is designated by the President. Terms are staggered; one expires on June 5th of every year. Not more than three members may be of the same political party.

Under the direction of the Chairman and Commissioners, the staff ensures that publicly held entities, broker-dealers in securities, investment companies and advisers, and other participants in the securities markets comply with federal securities laws. These laws were designed to facilitate informed investment analysis and decisions by the investing public, primarily by ensuring adequate disclosure of material (significant) information. Conformance with federal

Securities laws and regulations does not imply merit. If information essential to informed investment analysis is properly disclosed, the Commission cannot bar the sale of securities which analysis may show to be of questionable value. It is the investor, not the Commission, who must make the ultimate judgment of the worth of securities offered for sale.

The Commission's staff is composed of lawyers, accountants, financial analysts and examiners, engineers, investigators, economists, and other professionals. The staff is divided into divisions and offices (including twelve regional and district offices), each directed by officials appointed by the Chairman.

This brochure describes the work of the SEC by discussing the laws it administers, the organization of the Commission, the ways in which it carries out its statutory mandates, and the sanctions it can bring to bear to enforce federal securities laws.

Securities Act of 1933

This "truth in securities" law has two basic objectives:

- To require that investors be provided with material information concerning securities offered for public sale; and
- To prevent misrepresentation, deceit, and other fraud in the sale of securities.

A primary means of accomplishing these objectives is disclosure of financial information by registering offers and sales of securities. Securities transactions subject to registration are most offerings of debt and equity securities issued by corporations, limited partnerships, trusts and other issuers. Federal and certain other government debt securities are not. Certain securities and transactions qualify for exemptions from registration provisions; those exemptions are discussed below.

PURPOSE OF REGISTRATION

Registration is intended to provide adequate and accurate disclosure of material facts concerning the company and the securities it proposes to sell. Thus, investors may make a realistic appraisal of the merits of the securities and then exercise informed judgment in determining whether or not to purchase them.

Registration requires, but does not guarantee, the accuracy of the facts represented in the registration statement and prospectus. However, the law does prohibit false and misleading statements under penalty of fine, imprisonment, or both. And, investors who purchase securities and suffer losses have important recovery rights under the law if they can prove that there was incomplete or inaccurate disclosure of material facts in the registration statement or prospectus. If such misstatements are proven, the following could be liable for investor losses sustained in the securities purchase: the issuing company, its responsible directors and officers, the underwriters,

controlling interests, the offers of the securities, and others. These rights must be asserted in an appropriate federal or state court (not before the Commission, which has no power to award damages).

Registration of securities does not preclude the sale of stock in risky, poorly managed, or unprofitable companies. Nor does the Commission approve or disapprove securities on their merits; it is unlawful to represent otherwise in the sale of securities. The only standard which must be met when registering securities is adequate and accurate disclosure of required material facts concerning the company and the securities it proposes to sell. The fairness of the terms, the issuing company's prospects for successful operation, and other factors affecting the merits of investing in the securities (whether price, promoters' or underwriters' profits, or otherwise) have no bearing on the question of whether or not securities may be registered.

THE REGISTRATION PROCESS

To facilitate registration by different types of companies, the Commission has special forms. These vary in their disclosure requirements but generally provide essential facts while minimizing the burden and expense of complying with the law. In general, registration forms call for disclosure of information such as:

- Description of the registrant's properties and business;
- Description of the significant provisions of the security to be offered for sale and its relationship to the registrant's other capital securities;
- Information about the management of the registrant; and
- Financial statements certified by independent public accountants.

Registration statements and prospectuses on securities become public immediately upon filing with the Commission. After the registration statement is filed, securities may be offered orally or by certain summaries of the information in the registration statement as permitted by Commission rules. However, it is unlawful to sell the securities until the effective date. The act provides that most registration statements shall become effective on the 20th day after filing (or on the 20th day after filing the last amendment). At its discretion, the Commission may advance the effective date if deemed appropriate considering the interests of investors and the public, the ad-

equacy of publicly available information, and the ease with which the facts about the new offering can be disseminated and understood.

Registration statements are subject to examination for compliance with disclosure requirements. If a statement appears to be materially incomplete or inaccurate, the registrant usually is informed by letter and given an opportunity to file correcting or clarifying amendments.

However, the Commission may conclude that material deficiencies in some registration statements appear to stem from a deliberate attempt to conceal or mislead, or that the deficiencies do not lend themselves to correction through the informal letter process. In these cases, the Commission may decide that it is in the public interest to conduct a hearing to develop the facts by evidence and determine if a "stop order" should be issued to refuse or suspend effectiveness of the statement. The Commission may issue stop orders after the sale of securities has been commenced or completed. A stop order is not a permanent bar to the effectiveness of the registration statement or to the sale of the securities. If amendments are filed correcting the statement in accordance with the stop order decision, the order must be lifted and the statement declared effective.

Although losses which may have been suffered in the purchase of securities are not restored to investors by the stop order, the Commission's order precludes future public sales. Also, the decision and the evidence on which it is based may serve to notify investors of their rights and aid them in their own recovery suits.

EXEMPTIONS FROM REGISTRATION

In general, registration requirements apply to securities of both domestic and foreign issuers, and to securities of foreign governments (or their instrumentalities) sold in domestic securities markets. There are, however, certain exemptions. Among these are:

- Private offerings to a limited number of persons or institutions who have access to the kind of information that registration would disclose and who do not propose to redistribute the securities;
- Offerings restricted to residents of the state in which the issuing company is organized and doing business;
- Securities of municipal, state, federal, and other governmental instrumentalities as well as charitable institutions and banks;

- Offerings not exceeding certain specified amounts made in compliance with regulations of the Commission; and
- Offerings of "small business investment companies" made in accordance with rules and regulations of the Commission.

Whether or not the securities are exempt from registration, anti-fraud provisions apply to all sales of securities involving interstate commerce or the mails.

Among the special exemptions from the registration requirement, the "small issue exemption" was adopted by Congress primarily as an aid to small business. The law provides that offerings of securities under \$5 million may be exempt from the full registration, subject to conditions the Commission prescribes to protect investors. The Commission's Regulation A permits certain domestic and Canadian companies to make exempt offerings. A similar regulation is available for offerings under \$5 million by small business investment companies licensed by the Small Business Administration. The Commission's Regulation D permits certain companies to make exempt offerings under \$1 million with only minimal federal restrictions; more extensive disclosure requirements and other conditions apply for offerings exceeding that amount.

Exemptions are available when certain specified conditions are met. These conditions include the prior filing of a notification with the appropriate SEC regional office and the use of an offering circular containing certain basic information in the sale of the securities. For a more complete discussion of these and other special provisions adopted by the Commission to facilitate capital formation by small business, please request a copy of the small business packet, available from the Office of Public Affairs, Policy Evaluation and Research or the public reference rooms of the Commission.

Securities Exchange Act of 1934

By this Act, Congress extended the "disclosure" doctrine of investor protection to securities listed and registered for public trading on our national securities exchanges. Thirty years later, the Securities Act Amendments of 1964 extended disclosure and reporting provisions to equity securities in the over-the-counter market. This included hundreds of companies with assets exceeding \$1 million and shareholders numbering 500 or more. Today, securities of thousands of companies are traded over-the-counter. The Act seeks to ensure fair and orderly securities markets by prohibiting certain types of activities and by setting forth rules regarding the operation of the markets and participants.

CORPORATE REPORTING

Companies seeking to have their securities registered and listed for public trading on an exchange must file a registration application with the exchange and the SEC. If they meet the size test described above, companies whose equity securities are traded over-the-counter must file a similar registration form. Commission rules prescribe the nature and content of these registration statements and require certified financial statements. These are generally comparable to, but less extensive than, the disclosures required in Securities Act registration statements. Following the registration of their securities, companies must file annual and other periodic reports to update information contained in the original filing. In addition, issuers must send certain reports to requesting shareholders. Reports may be read at the Commission's public reference rooms, copied there at nominal cost, or obtained at reasonable rates from a copying service under contract to the Commission.

PROXY SOLICITATIONS

Another provision of the law governs soliciting proxies (votes) from holders of registered securities, both listed and over-the-counter, for the election of directors and/or for approval of other corporate action. Solicitations, whether by management or minority groups, must disclose all material facts concerning matters on which holders are asked to vote. Holders also must be given an opportunity to vote "yes" or "no" on each matter. Where a contest for control of corporate management is involved, the rules require disclosure of the names and interests of all "participants" in the proxy contest. Thus, holders are enabled to vote intelligently on corporate actions requiring their approval. The Commission's rules require that proposed proxy material be filed in advance for examination by the Commission for compliance with the disclosure requirements. In addition, the rules permit shareholders to submit proposals for a vote at the annual meetings.

TENDER OFFER SOLICITATIONS

In 1968, Congress amended the Exchange Act to extend its reporting and disclosure provisions to situations where control of a company is sought through a tender offer or other planned stock acquisition of over ten percent of a company's equity securities. Commonly called the Williams Act, this amendment was further amended in 1970 to reduce the stock acquisition threshold to five percent. These amendments, and Commission rules under the act, require disclosure of pertinent information by anyone seeking to acquire over five percent of a company's securities by direct purchase or by tender offer. This disclosure is also required by anyone soliciting shareholders to accept or reject a tender offer. Thus, as with the proxy rules, public investors holding stock in these corporations may make more informed decisions on takeover bids. Disclosure provisions are supplemented by certain other provisions to help ensure investor protection in tender offers.

INSIDER TRADING

Insider trading prohibitions are designed to curb misuse of material confidential information not available to the general public. Examples of such misuse are buying or selling securities to make profits or avoid losses based on material nonpublic information — or by telling others of the information so that they may buy or sell securities — before such information is generally available to all shareholders. The Commission has brought numerous civil actions in federal court against persons whose use of material nonpublic information constituted fraud under the securities laws. Additionally, the Commission supported legislation to increase the penalties that can be imposed by the courts on those found guilty of insider trading. The Insider Trading Sanctions Act, signed into law on August 10, 1984, allows imposing fines up to three times the profit gained or loss avoided by use of material non-public information.

Section 16 of the Exchange Act requires that all officers and directors of a company and beneficial owners of more than ten percent of its registered equity securities must file an initial report with the Commission, and with the exchange on which the stock may be listed, showing their holdings of each of the company's equity securities. Thereafter, they must file reports for any month during which there was any change in those holdings. In addition, the law provides that profits obtained by them from purchases and sales or sales and purchases of such equity securities within any six-month period may be recovered by the company or by any security holder on its behalf. This recovery right must be asserted in the appropriate U.S. District Court. Such "Insiders" are also prohibited from making short sales of their company's equity securities.

MARGIN TRADING

Margin trading in securities also falls under certain provisions of the act. The Board of Governors of the Federal Reserve System is authorized to set limitations on the amount of credit which may be extended for the purpose of purchasing or carrying securities. (The Federal Reserve periodically reviews these limitations.) The objective is to restrict excessive use of the nation's credit in the securities markets. While the credit restrictions are set by the Board, investigation and enforcement is the responsibility of the SEC.

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TRADING AND SALES PRACTICES

Securities trading and sales practices on the exchanges and in the over-the-counter markets are subject to provisions designed to protect the interests of investors and the public. These provisions seek to curb misrepresentations and deceit, market manipulation, and other fraudulent acts and practices. They also strive to establish and maintain just and equitable principles of trade conducive to maintaining open, fair, and orderly markets.

These provisions of the law establish the general regulatory pattern. The Commission is responsible for promulgating rules and regulations for its implementation. Thus, the Commission has adopted regulations which, among other things:

- Define acts or practices which constitute a "manipulative or deceptive device or contrivance" prohibited by the statute;
- Regulate short selling, stabilizing transactions, and similar matters;
- Regulate hypothecation (use of customers' securities as collateral for loans); and
- Provide safeguards with respect to the financial responsibility of brokers and dealers.

REGISTRATION OF EXCHANGES AND OTHERS

As amended, the 1934 Act requires registration with the Commission of:

- "National securities exchanges" (those having a substantial securities trading volume);
- Brokers and dealers who conduct securities business in interstate commerce;
- Transfer agents;
- Clearing agencies;
- Government and municipal brokers and dealers; and
- Securities information processors.

To obtain registration, exchanges must show that they are organized to comply with the provisions of the statute as well as the rules and regulations of the Commission. The registering exchanges must also show that their rules contain just and adequate provisions to ensure fair dealing and to protect investors.

Each exchange is a self-regulatory organization. Its rules must provide for the expulsion, suspension, and other disciplining of member broker-dealers for conduct inconsistent with just and equitable principles of trade. The law intends that exchanges shall have full opportunity to establish self-regulatory measures ensuring fair dealing and investor protection. However, it empowers the SEC (by order, rule, or regulation) to approve proposed rule changes of exchanges concerning various activities and trading practices if necessary to effect the statutory objective. Exchange rules and regulations, proposed by exchanges or by the Commission, generally reach their final form after discussions between representatives of both bodies without resort to formal proceedings.

By a 1938 amendment to the 1934 Act, Congress also provided for creation of a national securities association. The only such association, the National Association of Securities Dealers, Inc., is registered with the Commission under this provision of the law. This association is responsible for preventing fraudulent and manipulative acts and practices, and for promoting just and equitable trade principles among over-the-counter brokers and dealers. The establishment, maintenance, and enforcement of a voluntary code of business ethics is one of the principal features of this provision of the law.

BROKER-DEALER REGISTRATION

The registration of brokers and dealers engaged in soliciting and executing securities transactions is an important part of the regulatory plan of the act. Broker-dealers must apply for registration with the Commission and amend registrations to show significant changes in financial conditions or other important facts. Applications and amendments are examined by the Commission. Brokers and dealers must conform their business practices to the standards prescribed by the law and the Commission's regulations for protecting investors and to rules on fair trade practices of their association. Additionally, brokers and dealers violating these regulations risk suspension or loss of registration with the Commission (and thus the right to continue conducting an interstate securities business) or of suspension or expulsion from a self-regulatory organization.

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Public Utility Holding Company Act of 1935

Interstate holding companies engaged, through subsidiaries, in the electric utility business or in the retail distribution of natural or manufactured gas are subject to regulation under this act. Today, 14 systems are registered. These systems must register with the Commission and file initial and periodic reports. Detailed information concerning the organization, financial structure, and operations of the holding company and its subsidiaries is contained in these reports. However, if a holding company or its subsidiary meets certain specifications, the Commission may exempt it from part or all of the duties and obligations otherwise imposed by statute. Holding companies are subject to SEC regulations on matters such as structure of the system, acquisitions, combinations, and issue and sales of securities.

INTEGRATION AND SIMPLIFICATION

The most important provisions of the act were the requirements for physical integration and corporate simplification of holding company systems. Integration standards restrict a holding company's operations to an "integrated utility system." Such a system is defined as one:

- Capable of economical operation as a single coordinated system;
- Confined to a single area or region in one or more states; and
- Not so large that it negates the advantages of localized management, efficient operation, and effective regulation.

The capital structure and continued existence of any company in a holding company system must not unnecessarily complicate the corporate structure of the system or distribute voting power inequitably among security holders of the system.

The Commission may determine what action, if any, must be taken by registered holding companies and their subsidiaries to comply with act requirements. The SEC may apply to federal courts for orders compelling compliance with Commission directives.

Voluntary reorganization plans for many divestments of nonretainable subsidiaries and properties, recapitalizations, dissolutions of companies, and other adjustments may be used to satisfy act requirements. The SEC may approve voluntary plans it finds to be fair and equitable to all affected persons and to be necessary to further the objectives of the act. If the company requests, the Commission will apply to a federal district court for an order approving the plan and directing its enforcement. All interested persons, including state commissions and other governmental agencies, have full opportunity to be heard in proceedings before the Commission and before the federal courts.

ACQUISITIONS

To be authorized by the SEC, the acquisition of securities and utility assets by holding companies and their subsidiaries must meet the following standards:

- The acquisition must not tend toward interlocking relations or concentrating control to an extent detrimental to investors or the public interest;
- Any consideration paid for the acquisition (including fees, commissions, and other remuneration) must not be unreasonable;
- The acquisition must not complicate the capital structure of the holding company system or have a detrimental effect on system functions; and
- The acquisition must tend toward economical, efficient development of an integrated public utility system.

ISSUANCE AND SALE OF SECURITIES

Proposed security issues by any holding company must be analyzed and evaluated by the staff, and approved by the Commission, to ensure that the issues meet the following tests under prescribed standards of the law:

- The security must be reasonably adapted to the security structure of the issuer and of other companies in the same holding company system;
- The security must be reasonably adapted to the earning power of the company;
- The proposed issue must be necessary and appropriate to the economical and efficient operation of the company's business;
- The fees, commissions, and other remuneration paid in connection with the issue must not be unreasonable; and
- The terms and conditions of the issue or sale of the security must not be detrimental to the public or investor interest.

OTHER REGULATORY PROVISIONS

Other provisions of the act concern regulating dividend payments (in circumstances where payments might result in corporate abuses); inter-company loans; solicitation of proxies, consents, and other authorizations; and insider trading. "Upstream" loans from subsidiaries to their parents and "upstream" or "cross-stream" loans from public utility companies to any holding company in the same holding company system require Commission approval. The act also requires that all services performed for any company in a holding company system by a service company in that system be rendered at a fair and equitably allocated cost.

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Trust Indenture Act of 1939

This act applies to bonds, debentures, notes, and similar debt securities offered for public sale and issued under trust indentures with more than \$7.5 million of securities outstanding at any one time. Even though such securities may be registered under the Securities Act, they may not be offered for sale to the public unless the trust indenture conforms to statutory standards of this act. Designed to safeguard the rights and interests of the purchasers, the act also:

- Prohibits the indenture trustee from conflicting interests which might interfere with exercising its duties on behalf of the securities purchasers;
- Requires the trustee to be a corporation with minimum combined capital and surplus;
- Imposes high standards of conduct and responsibility on the trustee;
- Precludes, in the event of default, preferential collection of certain claims owing to the trustee by the issuer;
- Provides that the issuer supply to the trustee evidence of compliance with indenture terms and conditions (such as those relating to the release or substitution of mortgaged property, issue of new securities, or satisfaction of the indenture); and
- Requires the trustee to provide reports and notices to security holders.

Other provisions of the act prohibit impairing the security holders' right to sue individually for principal and interest, except under certain circumstances. It also requires maintaining a list of security holders for their use in communicating with each other regarding their rights as security holders.

Applications for qualification of trust indentures are examined by the SEC's Division of Corporation Finance for compliance with the law and the Commission's rules.

In 1967 the Commission sent a legislative proposal to Congress which would modernize procedures under the act to meet the public's needs in view of novel debt instruments and modern financing techniques. This legislative proposal was adopted and enacted into law in 1990.

Investment Company Act of 1940

The Public Utility Holding Company Act of 1935 required Congress to direct the SEC to study the activities of investment companies and investment advisers. The study results were sent to Congress in a series of reports filed in 1938, 1939, and 1940, causing the creation of the Investment Advisers Act of 1940 and the Investment Company Act of 1940. The legislation was supported by both the Commission and the industry.

Activities of companies engaged primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public, are subject to certain statutory prohibitions and to Commission regulation under this act. Also, public offerings of investment company securities must be registered under the Securities Act of 1933.

Investors must understand, however, that the Commission does not supervise the investment activities of these companies and that regulation by the Commission does not imply safety of investment.

In addition to the registration requirement for such companies, the law requires they disclose their financial condition and investment policies to provide investors complete information about their activities. This act also:

- Prohibits such companies from substantially changing the nature of their business or investment policies without stockholder approval;
- Bars persons guilty of securities fraud from serving as officers and directors;
- Prevents underwriters, investment bankers, or brokers from constituting more than a minority of the directors of such companies;
- Requires that management contracts (and any material changes) be submitted to security holders for their approval;

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SECURITIES DIVISION

UNITED STATES DEPARTMENT OF JUSTICE

- Prohibits transactions between such companies and their directors, officers, or affiliated companies or persons, except when approved by the SEC;
- Forbids such companies to issue senior securities except under specified conditions and upon specified terms; and
- Prohibits pyramiding of such companies and cross-ownership of their securities.

Other provisions of this act involve advisory fees, not conforming to an adviser's fiduciary duty, sales and repurchases of securities issued by investment companies, exchange offers; and other activities of investment companies, including special provisions for periodic payment plans and face-amount certificate companies.

Regarding reorganization plans of investment companies, the Commission is authorized to institute court proceedings to prohibit plans that do not appear to be fair and equitable to security holders. The Commission may also institute court action to remove management officials who have engaged in personal misconduct constituting a breach of fiduciary duty.

Investment companies must not only register securities under the Securities Act, but also must file periodic reports and are subject to the Commission's proxy and "insider" trading rules.

Investment Advisers Act of 1940

This law establishes a pattern of regulating investment advisors. In some respects, it has provisions similar to the Securities Exchange Act provisions governing the conduct of brokers and dealers. With certain exceptions, this act requires that persons or firms compensated for advising others about securities investment must register with the Commission and conform to statutory standards designed to protect investors.

The Commission may deny, suspend, or revoke investment adviser registrations if, after notice and hearing, it finds that grounds for a statutory disqualification exist and that the action is in the public interest. Grounds for disqualification include conviction for certain financial crimes or securities law violations, injunctions based on such activities, conviction for violating the mail fraud statute, willfully filing false reports with the Commission, and willfully violating the Advisers Act, the Securities Act, the Securities Exchange Act, the Investment Company Act, or the rules of the Municipal Securities Rulemaking Board. In addition to the administrative sanction of denial, suspension, or revocation, the Commission may obtain injunctions prohibiting further violations of this law. The SEC may also recommend criminal prosecution by the Department of Justice for fraudulent misconduct or willful violation of the law or Commission rules.

The law contains antifraud provisions and empowers the Commission to adopt rules defining fraudulent, deceptive, or manipulative acts and practices. It also requires that investment advisers:

- Disclose the nature of their interest in transactions executed for their clients;
- Maintain books and records according to Commission rules; and
- Make books and records available to the Commission for inspections.

C

orporate Reorganization

Reorganization proceedings in the U.S. Courts under Chapter 11 of the Bankruptcy Code are begun by a debtor, voluntarily, or by its creditors. Federal bankruptcy law allows a debtor in reorganization to continue operating under the court's protection while it attempts to rehabilitate its business and work out a plan to pay its debts. If a debtor corporation has publicly issued securities outstanding, the reorganization process may raise many issues that materially affect the rights of public investors.

Chapter 11 of the Bankruptcy Code authorizes the SEC to appear in any reorganization case and to present its views on any issue. Although Chapter 11 applies to all types of business reorganizations, the Commission generally limits its participation to proceedings involving significant public investor interest - protecting public investors holding the debt or securities and participating in legal and policy issues of concern to public investors. The SEC also continues to address matters of traditional Commission expertise and interest relating to securities. Where appropriate, it comments on the adequacy of reorganization plan disclosure statements and participates where there is a Commission law enforcement interest.

Under Chapter 11, the debtor, official committees, and institutional creditors negotiate the terms of a reorganization plan. The court can confirm a reorganization plan if it is accepted by creditors for:

- At least two-thirds of the amounts of allowed claims;
- More than one-half the number of allowed claims; and
- At least two-thirds in amount of the allowed shareholder interest.

The principal safeguard for public investors is the requirement that a disclosure statement containing adequate information be transmitted by the debtor or plan proponent in connection with soliciting votes on the plan. In addition, reorganization plans involving publicly held debt usually provide for issuing new securities to creditors and shareholders which may be exempt from registration under Section 5 of the Securities Act of 1933.

O

rganization of the Commission

The Commission carries out its work, in both Washington headquarters and the field offices around the country, through divisions and offices charged with specific responsibilities under the securities laws. Additionally, there are offices responsible for the smooth and effective administration of the Commission itself. Overall responsibility for carrying out the SEC's mission rests with the Commissioners.

THE COMMISSIONERS

The Securities Exchange Act of 1934 formally created the Securities and Exchange Commission on June 6, 1934. (The Securities Act of 1933 was administered by the Federal Trade Commission until creation of the SEC.) Among other provisions, this act set forth the composition of the Commission, which remains unchanged today.

A deliberative collegial body, the Commission meets numerous times monthly to debate and decide upon regulatory issues. Like other regulatory agencies, the Commission has two types of meetings. Under the Government in the Sunshine Act, meetings must be open to the public and to members of the press. However, if necessary to protect the Commission's ability to conduct investigations and/or protect the rights of individuals and entities which may be the subject of Commission inquiries, meetings may be closed.

Commission meetings are generally held to deliberate on and resolve issues the staff brings before the Commissioners. Issues may be interpretations of federal securities laws, amendments to existing rules under the laws, new rules (often to reflect changed conditions in the marketplace), actions to enforce the laws or to discipline those subject to direct regulation, legislation to be proposed by the Commission, and matters concerning administration of the Commission itself. Matters not requiring joint deliberation may be resolved by procedures set forth in the Code of Federal Regulations.

Resolution of the issues brought before the Commission may take the form of new rules or amendments to existing ones, enforcement actions, or disciplinary actions. The most common activity is rulemaking. Rulemaking is generally the result of staff recommendations made to the Commissioners.

THE COMMISSION STAFF

The staff is organized into divisions and offices with specific areas of responsibility for various segments of the federal securities laws.

Divisions serving under the Commission are Enforcement, Corporation Finance, Market Regulation, and Investment Management. The Office of General Counsel serves as the chief source of general legal advice for the Commission. As such, it is responsible for appellate and other litigation as well as certain other legal matters.

The offices include those of Chief Accountant, International Affairs, Legislative Affairs, Economic Analysis, Administrative Law Judges, Secretary and Inspector General.

Other offices provide administration and carry out certain necessary functions for the Commission. These include the offices of Executive Director, Comptroller, Filings and Information Services, Administrative and Personnel Management, Information Technology, and Public Affairs, Policy Evaluation and Research.

THE DIVISIONS

The Division of Corporation Finance

Corporation Finance has the overall responsibility of ensuring that disclosure requirements are met by publicly held companies registered with the Commission. Its work includes reviewing registration statements for new securities, proxy material and annual reports the Commission requires from publicly held companies, documents concerning tender offers, and mergers and acquisitions in general.

This division renders administrative interpretations of the Securities Act, the Securities Exchange Act and regulations thereunder to the public, prospective registrants, and others. It is also responsible for certain statutes and regulations pertaining to small businesses and for the Trust Indenture Act of 1939. Applications for qualification of trust indentures are examined for compliance with the applicable requirements of the law and the Commission's rules. Corporation

Finance works closely with the Office of the Chief Accountant in drafting rules and regulations which prescribe requirements for financial statements.

The Division of Market Regulation

Market Regulation is responsible for oversight of activity in the secondary markets — registration and regulation of broker-dealers, oversight of the self-regulatory organizations (such as the nation's stock exchanges), and oversight of other participants in the secondary markets (such as transfer agents and clearing organizations).

Financial responsibility of these entities, trading and sales practices, policies affecting operation of the securities markets, and surveillance fall under the purview of this division. In addition, it carries out activities aimed at achieving the goal of a national market system set forth in the Securities Act Amendments of 1975. Market Regulation develops and presents market structure issues to the Commissioners for their consideration. The division also oversees the Securities Investor Protection Corporation and the Municipal Securities Rulemaking Board.

The Division of Investment Management

Investment Management has basic responsibility for the Investment Company Act of 1940 and the Investment Advisers Act of 1940. In 1985, it assumed responsibility for administering the Public Utility Holding Company Act of 1935.

The division staff ensures compliance with regulations regarding the registration, financial responsibility, sales practices, and advertising of mutual funds and of investment advisers. New products offered by these entities also are reviewed by staff in this division. They also process investment company registration statements, proxy statements, and periodic reports under the Securities Act.

The division's Office of Public Utility Regulation oversees the activities of the twelve active registered holding company systems, ensuring that their corporate structures and financings are permissible according to certain tests set up in the Holding Company Act. The staff analyze legal, financial, accounting, engineering, and other issues arising under the Act. The office participates in hearings to develop the factual records where necessary, files briefs and participates in oral arguments before the Commission, and makes

recommendations regarding the Commission's findings and decisions in cases which arise in administration of the law. All hearings are conducted in accordance with the Commission's Rules of Practice.

The Division of Enforcement

Enforcement is charged with enforcing federal securities laws. The division's responsibilities include investigating possible violations of federal securities laws and recommending appropriate remedies for consideration by the Commission. Possible violations may come to light through the division's own inquiries, through referrals from other divisions of the Commission, from outside sources such as the self-regulatory organizations, or by other means, including review of investor complaints and inquiries.

When possible violations of federal securities laws warrant further investigation by the staff, the Commission is consulted before proceeding. The Commission's decisions may result in issuing subpoenas, formal orders of investigation, or other means of proceeding with actions. At the conclusion of investigations, the Commission may authorize the staff to seek injunctions or other court ordered remedies, institute administrative proceedings in the case of entities directly regulated by the Commission, or pursue other action as appropriate.

ACTIVITIES OF DIVISIONS

The Commission's work is remedial, not punitive. Its primary activities are to ensure investor protection through full disclosure of material information and to ensure that the securities markets are fair and honest in compliance with federal securities laws and rules under those laws. Interpretations, counseling, rulemaking, and similar activities are all aimed at ensuring compliance with the law.

The Commission, however, does have civil authority to enforce federal securities laws and does so when it has reason to believe that the laws have been, or in some cases are about to be, violated. The Commission also works closely with criminal authorities in matters of mutual interest.

Finance works closely with the Office of the Chief Accountant in drafting rules and regulations which prescribe requirements for financial statements.

The Division of Market Regulation

Market Regulation is responsible for oversight of activity in the secondary markets — registration and regulation of broker-dealers, oversight of the self-regulatory organizations (such as the nation's stock exchanges), and oversight of other participants in the secondary markets (such as transfer agents and clearing organizations).

Financial responsibility of these entities, trading and sales practices, policies affecting operation of the securities markets, and surveillance fall under the purview of this division. In addition, it carries out activities aimed at achieving the goal of a national market system set forth in the Securities Act Amendments of 1975. Market Regulation develops and presents market structure issues to the Commissioners for their consideration. The division also oversees the Securities Investor Protection Corporation and the Municipal Securities Rulemaking Board.

The Division of Investment Management

Investment Management has basic responsibility for the Investment Company Act of 1940 and the Investment Advisers Act of 1940. In 1985, it assumed responsibility for administering the Public Utility Holding Company Act of 1935.

The division staff ensures compliance with regulations regarding the registration, financial responsibility, sales practices, and advertising of mutual funds and of investment advisers. New products offered by these entities also are reviewed by staff in this division. They also process investment company registration statements, proxy statements, and periodic reports under the Securities Act.

The division's Office of Public Utility Regulation oversees the activities of the twelve active registered holding company systems, ensuring that their corporate structures and financings are permissible according to certain tests set up in the Holding Company Act. The staff analyze legal, financial, accounting, engineering, and other issues arising under the Act. The office participates in hearings to develop the factual records where necessary, files briefs and participates in oral arguments before the Commission, and makes

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ACTIVITIES OF DIVISIONS

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Interpretation and Guidance

On the basis of responsibilities and powers assigned under federal securities laws, each division provides guidance and counseling to registrants, prospective registrants, the public, and others. This information is provided to help determine the application of the law and its regulations and to aid in complying with the law. For example, this advice might include an informal expression of opinion about whether the offering of a particular security is subject to the registration requirements of the law and, if so, advice on compliance with disclosure requirements of the applicable registration form. These interpretations of the rules and laws help ensure conformity on the part of the registrants. Also, most divisions occasionally issue "no action" letters which indicate whether the division would recommend Commission action on matters regarding registrants in certain circumstances.

Rulemaking

One of the most common activities engaged in by the divisions is rulemaking.

The Commission's objective of requiring regulated entities to provide effective disclosure, with a minimum of burden and expense, calls for constant review of practical operations of the rules and registration forms adopted. If experience shows that a particular requirement fails to achieve its objective, or if a rule appears unduly burdensome in relation to the resulting benefits, the staff presents the problem to the Commission. The Commission then considers modifying the rule or other requirement. Based on their particular area of expertise, the divisions and offices are often asked to contribute specific analyses.

Many suggestions for rule modification follow extensive consultation with industry representatives and others affected. The Commission normally gives advance public notice of proposals to adopt new or amended rules or registration forms and affords the opportunity for interested members of the public to comment on them.

The Commission decides, generally in open meetings, whether or not the new rules or amendments to existing rules are warranted. Proposals approved by the Commission become mandatory, usually within a specific time period after publication in the Federal Register.

Under the laws it administers, the Commission has a duty to investigate complaints and other indications of possible law violations in securities transactions. Most arise under the Securities Act and the Securities Exchange Act. (Fraud prohibitions of the Securities Act are similar to those contained in the Securities Exchange Act.) Investigation and any subsequent enforcement work is conducted primarily by the Commission's field offices and the Division of Enforcement.

Most of the Commission's investigations are conducted privately. Facts are developed to the fullest extent possible through informal inquiry, interviewing witnesses, examining brokerage records and other documents, reviewing trading data, and similar means. The Commission is empowered to issue subpoenas requiring sworn testimony and the production of books, records, and other documents pertinent to the subject matter under investigation. In the event of refusal to respond to a subpoena, the Commission may apply to a federal court for an order compelling obedience.

Inquiries and complaints by investors and the general public are primary sources of leads for detecting law violations in securities transactions. Another source is inspections by field offices and Investment Management or Market Regulation of the books and records of regulated persons and organizations to determine whether their business practices conform to the prescribed rules. Still another means is conducting inquiries into market fluctuations in particular stocks which do not appear to result from general market trends or from known developments affecting the issuing company.

Investigations frequently concern the sale without registration of securities subject to the registration requirement of the Securities Act. Misrepresentation or omission of material facts concerning securities offered for sale, whether or not registration is required, is another common subject of investigation. The antifraud provisions of the law also apply to the purchase of securities, whether involving outright misrepresentations or the withholding or omission of pertinent facts to which the seller was entitled. For example, it is unlawful in certain situations to purchase securities from another person while withholding material information which would indicate that the securities have a value substantially greater than that at which they are being acquired. These provisions apply not only to transactions between brokers and dealers and their customers but also to the reacquisition of securities by an issuing company or its "insiders."

Other types of inquiries relate to manipulating market prices of securities; misappropriating or illegally hypothecating customers' funds or securities; conducting a securities business while insolvent; broker-dealers buying or selling securities from or to customers at prices not reasonably related to current market prices; and broker-dealers violating their responsibilities to treat customers fairly.

A common type of violation involves the broker-dealer who gains the customer's trust and then takes undisclosed profits in securities transactions with or for the customer over and above the agreed commission. For example, the broker-dealer may have purchased securities from customers at prices far below, or sold securities to customers at prices far above, their current market prices. In most of these cases, the broker-dealer risks no loss; the purchases from customers are made only if simultaneous sales can be made at prices substantially higher than those paid to the customers. Conversely, sales to customers are made only if simultaneous purchases can be made at prices substantially lower than those charged the customer. Another type of violation involves firms engaging in large-scale in-and-out transactions for the customer's account (called "churning") to generate increased commissions, usually without regard to any resulting benefit to the customer.

There is a fundamental distinction between a broker and a dealer. The broker serves as the customer's agent in buying or selling securities for the customer. The broker owes the customer the highest fiduciary responsibility and may charge only such agency commission as has been agreed to by the customer. On the other hand, a dealer acts as a principal and buys securities from or sells securities to customers. The dealer's profit is the difference between the prices for which the securities are bought and sold. The dealer normally will not disclose the fee or commission charged for services rendered. The law requires that the customer receive a written "confirmation" of each securities transaction. This confirmation discloses whether the securities firm is acting as a dealer (a principal for its own account) or as a broker (an agent for the customer). If the latter, the confirmation must also disclose the broker's compensation from all sources as well as other information about the transaction.

Statutory Sanctions

Commission investigations, usually conducted in private, are essentially fact-finding inquiries. The facts developed by the staff are

considered by the Commission to determine whether there is valid evidence of a law violation; whether action should begin to determine if a violation actually occurred; and, if so, whether some sanction should be imposed.

When facts show possible fraud or other law violation, the laws provide several courses of action which the Commission may pursue:

- *Civil action*, where the Commission may apply to an appropriate U.S. District Court for an order prohibiting the acts or practices alleged to violate the law or Commission rules, or request court ordered remedies such as disgorgement or civil money penalties;
- *Administrative remedy*, where the Commission may, after hearings, issue orders to suspend or expel members from exchanges or over-the-counter dealers association; deny, suspend, or revoke broker-dealer registrations; or censure for misconduct or bar individuals (temporarily or permanently) from any association with the securities industry.

Broker-Dealer Revocations

In the case of exchange or association members, registered brokers or dealers, or individuals who may associate with any such firm, the administrative remedy is generally invoked. In these administrative proceedings, the Commission issues an order specifying illegal acts or practices allegedly committed and directs that a hearing be held for the purpose of taking evidence. At the hearing, counsel for the Division of Enforcement or a field office undertakes to establish those facts supporting the charge. Respondents have full opportunity to cross-examine witnesses and to present evidence in defense. If the Commission ultimately finds that the respondents violated the law, it may take remedial action in the form of statutory sanctions as indicated above. The respondent has the right to seek judicial review of the decision by the appropriate U.S. Court of Appeals. Remedial action may effectively bar a firm from conducting a securities business in interstate commerce or on exchanges, or an individual from association with a registered firm, and may also include fines.

The many instances in which these legal sanctions have been invoked present a formidable record. Of great significance to the investing public is the deterrent effect of the very existence of the fraud prohibitions of the law and the Commission's powers of investigation and enforcement. These provisions of the law, coupled with

the disclosure requirements applicable to new security offerings and to other registered securities, tend to inhibit fraudulent stock promotions and operations. They also increase public confidence in securities as an investment medium. This facilitates financing through the public sale of securities, which contributes to the economic growth of the nation.

Administrative Proceedings

All formal administrative proceedings of the Commission follow its Rules of Practice which conform to the Administrative Procedure Act. These rules establish procedural "due process" safeguards to protect the rights and interests of parties to these proceedings. Included are requirements for timely notice of the proceeding and for a sufficient specification of the issues or charges involved to enable parties to prepare their cases adequately. All parties, including counsel for the interested SEC division or office, may appear at the hearing and present evidence and cross-examine witnesses. In addition, other interested persons may intervene or be given limited rights to participate. In some cases, the relevant facts may be stipulated instead of conducting an evidentiary hearing.

Hearings are conducted before a hearing officer, normally an administrative law judge appointed by the Commission. The hearing officer, who is independent of the interested division or office, rules on the admissibility of evidence and on other issues arising during the course of the hearing. At the conclusion of the hearing, participants may urge in writing that the hearing officer adopt specific findings of fact and conclusions of law. The hearing officer then prepares and files an initial decision (unless waived), stating conclusions based on facts established by the evidence and including an order disposing of the issues. Copies of the initial decision are served on the parties and participants, who may seek Commission review. If review is not sought and the Commission does not order review on its own motion, the initial decision becomes final and the hearing officer's order becomes effective.

If the Commission reviews the initial decision, the parties and participants may file briefs and be heard in oral argument before the Commission. On the basis of an independent review of the record, the SEC prepares and issues its own decision. The Office of Opinions and Review aids the Commission in this process. The laws provide that any person or firm aggrieved by a decision of the Commission may seek review by the appropriate U.S. Court of Ap-

poals. The initial decisions of hearing officers as well as the Commission decisions are made public. Ultimately, the Commission decisions (as well as initial decisions which have become final and are of precedential significance) are printed and published.

The Commission has only civil authority. However, if fraud or other willful law violation is indicated, the Commission may refer the facts to the Department of Justice with a recommendation for criminal prosecution of the offending persons. That Department, through its local U.S. Attorneys (who frequently are assisted by Commission attorneys), may present the evidence to a federal grand jury and seek an indictment.

In its investigation and enforcement actions, the SEC cooperates closely with other federal, state, and local law enforcement officials.

THE OFFICES

The Office of the General Counsel

The Office of General Counsel serves as the focal point for handling all appellate and other litigation brought by the Commission, either in connection with the securities laws or against the Commission or its staff. The General Counsel is the chief legal officer of the Commission.

Duties of this office include representing the Commission in judicial proceedings, handling multi-divisional legal matters, acting in disciplinary proceedings under the Rules of Practice, and providing advice and assistance to the Commission, its operating divisions, and offices. Advice concerns statutory interpretation, rulemaking, legislative matters and other legal problems, public or private investigations, and Congressional hearings and investigations. The General Counsel directs and supervises all contested civil litigation and SEC responsibility under the Bankruptcy Code and all related litigation. It also represents the Commission in all cases in the appellate courts, filing briefs and presenting oral arguments on behalf of the Commission. In private litigation involving the statutes the Commission administers, this office represents the SEC as a friend of the court on legal issues of general importance.

The Commission's work is primarily legal in nature. Occasional questions of legality regarding the Commission's own decisions or legal decisions affecting the federal securities laws are handled by the General Counsel.

The Commission also recommends revisions in the statutes which it administers. In addition, the SEC prepares comments on proposed legislation which might affect its work or when asked for its views by Congressional committees. The Office of the General Counsel, together with the division affected by such legislation, prepares this legislative material.

The Office of the Chief Accountant

The Chief Accountant consults with representatives of the accounting profession and the standard-setting bodies designated by the profession regarding the promulgation of new or revised accounting and auditing standards. This implements a major SEC objective to improve accounting and auditing standards and to maintain high standards of professional conduct by the independent accountants.

This office also drafts rules and regulations prescribing requirements for financial statements. Many of the accounting rules are embodied in Regulation S-X, adopted by the Commission. Regulation S-X, together with the generally accepted accounting principles promulgated by the profession's standard-setting bodies and a number of opinions issued as "Accounting Series Releases" or "Financial Reporting Releases," governs the form and content of most of the financial statements filed with the SEC.

This office administers statutes and rules that require that accountants examining financial statements filed with the SEC be independent of their clients. This office also makes recommendations on cases arising under the Commission's Rules of Practice which specify reasons an accountant may be denied the privilege of practicing before the Commission. These reasons include lack of character or integrity, lack of qualifications to represent others, unethical or unprofessional conduct, or the willful violation of (or the willful aiding and abetting of violation of) any of the federal securities laws, rules, or regulations. The Chief Accountant supervises the procedures followed in accounting investigations conducted by the Commission staff.

The Office of International Affairs

The Office of International Affairs has primary responsibility for negotiating and implementing information sharing agreements, coordinating and providing enforcement and regulatory assistance to the

SEC's foreign counterparts, obtaining assistance from foreign counterparts, and developing legislative and other initiatives to facilitate international cooperation. The staff provides special assistance in international litigation matters, such as effecting service of process abroad, gathering foreign-based evidence through international conventions, freezing assets located abroad, and enforcing judgments obtained by the Commission in the United States against foreign parties. The staff also negotiates bilateral information-sharing understandings and agreements with foreign governmental authorities to facilitate obtaining evidence located abroad for use in both investigations and litigation. The staff also acts as consultants to the Commission's other divisions and offices in matters of ongoing international programs and initiatives.

The Office of Legislative Affairs

The Office of Legislative Affairs is responsible for coordinating the legislative efforts of the Commission and communications between the Commission and Congress, including preparation of Congressional testimony. The office serves as liaison with Members of Congress and Congressional Committees and staff, responds to Congressional requests, and disseminates information about Commission legislative proposals and Commission actions to Congress. The Office also coordinates information about legislation in which the Commission has an interest with the Office of Management and Budget and other government departments and agencies, and responds to inquiries from the public about such legislation and Commission testimony before Congress. The Office monitors Congressional activities of interest to the Commission and disseminates information about such activities to appropriate Commission officials.

The Office of the Inspector General

The Office of the Inspector General is responsible for conducting audits and investigations of agency programs and operations, reviewing existing and proposed legislation and regulations related to agency programs and operations to determine their impact on the economy. The office recommends policies to promote economy and efficiency and to prevent fraud and abuse in agency programs and operations. The office also recommends ways to maintain relation-

ships between the SEC and federal, state and local government agencies and non-government agencies regarding programs and operations including the identification and prosecution of individuals involved in fraud and abuse.

The Office of Economic Analysis

The Office of Economic Analysis deals with the economic and empirical issues which are inextricably associated with the Commission's regulatory activities. The office usually works closely with the divisions responsible for rule proposals. Whether working with one of the operating divisions or serving the Commission independently, the office analyzes impacts and benefits of proposed regulations and conducts studies on specific rules.

More specifically, the office analyzes rule changes and engages in long-term research and policy planning. To accomplish this, it builds and maintains diverse computer data-bases, designs programs to access data, and develops and tests alternative methodologies. The office assesses the impact of securities market regulations on issuers (in particular, small issuers), broker-dealers, investors, and the economy in general. One area it monitors is the emerging national market structure and regulation changes affecting the ability of small businesses to raise capital.

The Office of Economic Analysis also analyzes potentially significant developments in the marketplace. Its work includes gathering and analyzing data on a wide range of market activities that may require attention by the Commission. Examples are new types of securities, actions by publicly held entities and their impact on investors, and new or emerging trends in the securities markets.

Results of this work are used internally as part of the process to determine whether Commission action is necessary and to keep abreast of trends in the marketplace. Occasionally, subject to approval of the Commission, the research of this office is published.

The Office of Administrative Law Judges

The administrative law judges are responsible for scheduling and conducting hearings on administrative proceedings instituted by the Commission and appeals of proceedings instituted by others. Opinions and orders resulting from these hearings are prepared by the Office of Opinions and Review.

The Office of the Executive Director

The Executive Director develops and executes the overall management policies of the Commission for all its operating divisions and offices. The Executive Director administers programs to implement certain statutes, regulations, and Executive Orders. Program functions include appointing program officials; reviewing and approving program policies, procedures, and regulations; authorizing and transmitting reports; and assuring appropriate resource requirements to implement the programs.

The Office of Filings and Information Services

The Office of Filings and Information Services is responsible for the receipt and initial handling of all public documents filed with the Commission. The Office is also responsible for the custody and control of the Commission's official records; for the development of plans and implementation of the Commission's records management program; for authentication of all documents produced for administrative or judicial proceedings; and for maintaining liaison with the National Archives and Records Administration and other governmental agencies with respect to the Commission's records and its records management program.

Through the office's Public Reference Branch, the public may obtain a wide range of information from quarterly and annual reports, registration statements, proxy material and other reports submitted by SEC filers. All public documents are available for inspection in the Public Reference Room of the Commission's headquarters office in Washington, D.C. and in the Northeast and Midwest regional offices in New York City and Chicago, respectively. Copies of documents may be obtained for a nominal charge. Estimates of the cost of copying specific documents can be provided.

The Office of the Secretary

This office schedules Commission meetings, prepares and maintains records of Commission actions, and reviews documents submitted to the Commission for action. Specific activities include reviewing all official orders, releases, and other documents approved by the Commission or by the staff pursuant to delegated authority; publishing official documents and releases of Commission

actions in the Federal Register and the SEC Docket; monitoring compliance with the Regulatory Flexibility Act of 1980; tracking compliance with the Government in the Sunshine Act; and receiving documents in administrative proceedings, requests for confidential treatment, and comment letters on rule proposals.

This office also provides direct assistance to the investing public through its Consumer Affairs Branch. It reviews complaints and inquiries from the public concerning entities regulated by the Commission and provides public information about these entities as well as Commission activities. The Branch typically obtains written responses from firms mentioned in complaints. Information suggesting a possible violation of federal securities laws is referred to appropriate Commission staff. When complaints concern private disputes between parties, Commission staff attempt informally to assist the parties in resolving the problem. The Commission is not authorized to arbitrate private disputes or intercede on behalf of a private party to recover losses from the purchase or sale of securities or otherwise act as a collection agency for an individual. Investors must seek financial judgment through civil litigation or binding arbitration. Laws which provide investors with important recovery rights if they have been defrauded can be used in private lawsuits.

The office is also responsible for operation of libraries in the Commission's headquarters and field offices and maintenance of agency records concerning administrative proceedings.

The Office of Public Affairs, Policy Evaluation and Research

The Office of Public Affairs, Policy Evaluation and Research administers internal and external Commission informational programs, coordinates Commission press relations, the foreign visitors and public information programs and monitors press coverage of issues related to the Commission and securities industry. The Office also is responsible for providing research support in regulatory and enforcement policy areas, providing information for speeches for the Chairman and Commissioners, and assisting in planning and coordinating special initiatives of the Commission.

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United States Securities
and Exchange Commission

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The SEC's Exam Program for Investment Advisers

Speech by Lori Richards

Director of OCIE

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 advisors. 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 or 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.

The SEC Document Request List
for Mutual Fund Inspections

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
NORTHEAST REGIONAL OFFICE
7 WORLD TRADE CENTER
NEW YORK, NY 10048

IN REPLYING PLEASE QUOTE

Date

Mr. XXXXXXXXXXXX
XXXXXXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXXXXXX
XXXXXXXXXX, XX 12345

RE: The Increase In Value Funds

Dear Mr. XXXXXXX:

You are hereby advised that pursuant to Section 31 (b) of the Investment Company Act of 1940 (the "Act") and Section 204 of the Investment Advisers Act of 1940 an examination of the above-referenced Funds will commence on September 16, 1996.

In order to facilitate the examination, we request that the following documents or schedules be prepared by the Funds, its investment adviser, principal underwriter or other appropriate persons or entities. The records required should be available to the examination staff on the date the examination commences.

Please provide the following items for ALL Funds.

1. Copy of the latest Form ADV, Parts I and II. Also a copy of any brochure used instead of or in conjunction with Part II of Form ADV and given to clients or prospective clients.
2. Copies of No-Action Letters and/or Exemptive Orders for the Funds.
3. Two copies each of the Funds':
 - a. Current prospectus
 - b. Current Statement of Additional Information
 - c. Latest annual report
 - d. Latest semi-annual report

4. One Copy of each of the following for the period September 1, 1994 through August 30, 1996 for the Funds:
 - a. Board of directors'/trustees' minutes
 - b. Ad Hoc and permanent committee minutes
 - c. Stockholder minutes
 - d. Copies of all materials presented to the board of directors/trustees prior to or during board meetings held during the period September 1, 1994 through August 30, 1996.

5. A copy of the Funds' code of ethics and list of access persons. On the list of access persons, please specify those individuals involved in portfolio management, research and trading. For those individuals, please provide copies of their filings for the period September 1, 1994 through August 30, 1996. (Filings of other access persons may be requested during the course of the examination.)

6. A copy of written policies and procedures adopted pursuant to Section 204A of the Investment Advisers Act of 1940 and the Insider Trading and Securities Fraud Enforcement Act of 1988. Also, please provide a copy of any written Chinese Wall policies and procedures, if any.

7. A list of all proprietary trading or investment accounts of the Adviser.

8. A list of advisory representatives subject to the reporting requirements of personal securities transactions pursuant to Rule 204-2(a)(12) of the Advisers Act of 1940 including all officers, partners, directors, portfolio managers (debt and equity accounts), traders (debt and equity securities) and research analysts (debt and equity securities). Please indicate the following:
 - a. Name;
 - b. Position/Title/Division (i.e. equities, fixed income, foreign securities);
 - c. Percent ownership of the Adviser's outstanding stock;
 - d. Affiliations/positions with other corporations or partnerships and shares or interests held in each.

Please be prepared to provide all records of employee personal security transactions during the period kept pursuant to Rule 204-2(a)(12).

9. Copies of the following agreements/procedures for the Funds, where applicable:
 - a. Investment Advisory/Management Agreements

- b. Sub-advisory agreements, if any
 - c. A sample of a custodian agreement
 - d. A sample of a sub-custodian agreement, if any
 - e. A sample of a transfer agent agreement, if any
 - f. A sample of a loan agreement, if any
 - g. Repurchase guidelines/procedures, including an approved list, if any.
Please provide a sample copy of the board of directors'/trustees' minutes adopting the guidelines/procedures.
 - h. A sample of rule 17e-1 procedures, if any
 - i. A sample of rule 17a-7 procedures, if any
 - j. A sample of 10f-3 procedures, if any
 - k. Errors & Omissions policy, if any
 - l. Guidelines for valuation of restricted securities, if any
 - m. A sample of administrative agreements, if any
 - n. A sample of the distribution agreements, if any
 - o. A sample of 12b-1 Plans, if any
 - p. Any other relevant procedures/agreements, if any
10. Copies of the following, as of August 30, 1996, for each investment company:
- a. Daily net asset value computation sheet
 - b. Trial balance
 - c. List of all portfolio holdings (price make-up sheet) with ticker symbol and CUSIP.
11. The following records for each investment company for the period September 1, 1994 through August 30, 1996.
- a. Broker-dealer ledger
 - b. Purchases and sales journal of portfolio transactions (also, provide these journals on a 3.5 inch diskette in **Microsoft Excel version 5.0 or below**)

- c. Security Ledger
- d. Cash receipts and disbursements journal

12. A list of all derivative products purchased by the Funds from September 1, 1994 through August 30, 1996. For example, any structured notes, inverse floating rate securities, securities with imbedded interest caps, swaps, currency linked securities, index linked securities, two-tiered index bonds, COFI notes, CMT floating rate notes, interest only or principal only securities. Please include date of purchase and the broker or dealer from whom the securities were purchased.

Also, please provide a list of the funds that owned in excess of ten percent of its total net assets in any derivative product, as of August 30, 1996.

- 13. For each investment company, a schedule for each open futures, options, reverse repurchase agreements, forward currency contracts and when-issued security purchases, as of August 30, 1996.
- 14. A list of all private placements purchased by each investment company for the period September 1, 1994 through August 30, 1996. Also, please provide the offering circular or prospectus.
- 15. A list of all securities purchased for each investment company, for the period September 1, 1994 through August 30, 1996, as part of an initial public offering. Also, please provide the offering circular or prospectus.
- 16. A list of securities, as of August 30, 1996, that were in excess of five percent of each investment companies' assets.
- 17. A list of issuers, as of August 30, 1996, that each investment company owned in excess of five percent or more of any of that issuer's outstanding class of securities.
- 18. Copies of the most recent 13D, 13F and 13G filings for each investment company and investment adviser.
- 19. For each investment company, a list of securities, as of August 30, 1996, that were deemed to be "illiquid," as that term is defined in Guide 4 to Form N-1A.
- 20. If applicable, a list of all equity and debt underwritings, domestic and foreign, in which any affiliates were lead manager, co-lead manager or member of any syndicate or selling group. Please provide this information for the period September 1, 1994 through August 30, 1996.
- 21. Brokers' confirmations and order tickets of portfolio transactions for the past 12 months.
- 22. Please provide the following books and records for the Adviser to the Funds:

- a. Cash receipts and disbursements journal from September 1, 1994 through August 30, 1996.
 - b. Trial balance and financial statements for the month ended August 30, 1996.
 - c. Audited Balance Sheet and Income Statement, if any, as of the latest fiscal year end.
23. Please provide the following trading records for the Adviser to the Funds:
- a. Stock record or Securities Cross Reference Report of all clients securities holdings as of December 31, 1995 and August 31, 1996 (including but not limited to cash equivalents, equity, debt, private placements, options, futures, and other derivatives position);
 - b. A record of all securities held in client portfolios (aggregate position totals for all securities) as of December 31, 1995 and August 31, 1996
 - c. The Adviser's trading blotter or purchase and sales journal for the period, preferably featuring the following fields of information in chronological order:

<ol style="list-style-type: none"> 1. Trade date; 2. Buy or sell; 3. Number of shares or principal amount; 4. Security name; 5. CUSIP number; 6. Price; 7. Total commission; 8. Commission in cents per share; 	<ol style="list-style-type: none"> 9. Fees; 10. Accrued interest; 11. Net amount to/from client 12. Client name; 13. Client account number; and 14. Broker or dealer name.
--	--

Please provide the above record in Microsoft Excel version 5.0 or below. If this is not possible, please provide a detailed written explanation signed by a partner/officer of the Adviser and notify the examiner in charge as soon as possible. Also, exclude, if possible from the above record any transactions in cash or cash equivalents, maturities, calls, pay-downs, expirations, or reinvestment of mutual fund dividends or capital gain distributions.

- d. A list of trading errors that occurred in client or proprietary accounts during the period featuring the transaction date, the security, the account and broker-dealer involved, and a summary of the error and its ultimate disposition, including the conditions of any financial settlement;
- e. A list of cross transactions which took place during the period September 1, 1994 through August 30, 1996, between client and/or proprietary or affiliated accounts.

24. A list of all broker-dealers affiliated with the Adviser.
25. A copy of the Adviser's organizational chart, employee list, and a schedule or chart of all affiliated entities.
26. With respect to any soft-dollar arrangements between the Funds, the Adviser and any broker-dealer, please provide the following:
 - a. Copy of any written agreements
 - b. Name and description of product, service or research obtained
 - c. Soft-dollar price or commission commitment rate (i.e. 2 to 1) with respect to each item
 - d. Total hard dollar cost of such item, if known
 - e. Total expected and actually directed commissions to pay for such service or research for the period January 1, 1995 through August 30, 1996.
 - f. Transactions used to generate soft-dollars for the period January 1, 1995 through August 30, 1996, for this commitment (i.e. Equities - exchange traded; OTC - principal or agency; Fixed Income - principal or agency)
 - g. Allocation procedures for non-research items.
27. Any written trading department policies and procedures, including order entry and allocation policies.
28. Any lists of approved broker-dealers currently in use by the Adviser's trading staff.
29. A list of any affiliated broker-dealers, if any, featuring their affiliation and a description of their clearing arrangements.
30. A copy of any affiliates' standard commission schedule currently in use, if any.
31. A copy of the Adviser's brokerage allocation reports for the year ended December 31, 1995 and most current year to date; featuring name of firm, amount of agency commissions, and principal values or imputed compensation for principal transactions.
32. Copies of any internal audit department reports, including findings and recommendations for the past 12 months.
33. A list of all securities of a public offering that were invested in by the Adviser's clients or proprietary accounts at that offering or in the aftermarket that traded at a premium over the public offering price whenever their secondary markets began ("hot issues"). For any IPOs, also, please provide the offering circular or prospectus.

34. A list of all broker-dealers, affiliated or unaffiliated, that, to the Adviser's knowledge, received order flow payments or rebates related to executing transactions for client portfolios.
35. A list of any prior (within 24 months), current or potential litigation or arbitration, with a brief description, in which the investment companies, the Adviser or any affiliate has been or is presently a party to. If none, please provide a written statement to that effect.
36. If applicable, a list of securities that the Adviser or any affiliate underwrote or with respect to which it participated in such securities; underwriting as underwriting manager or member of a syndicate or selling group during the period September 1, 1994 through August 30, 1996 that were purchased by any client portfolios and approximate date of such underwriting.
37. A list of securities in which any affiliate was a market maker for the period September 1, 1994 through August 30, 1996.
38. A list of all creditors' committees where the Adviser or any affiliate participated within the period September 1, 1994 through August 30, 1996.
39. A list of portfolio managers or other individuals making investment decisions for each investment company.
40. A list of directors/trustees and officers of each investment company, including a listing of their functions with respect to any audit, investment or other committees.
41. A list of directors/trustees, partners and owners in excess of five percent of the Adviser and its parent companies.
42. A list of directors/trustees, partners and owners in excess of five percent of the investment companies' distributor and its parent companies.
43. A list of any other organizations that the individuals listed in response to items 41 and 42, are directors/trustees, officers, partners or who have owned in excess of five percent of any issuers outstanding class of securities for the period September 1, 1994 through August 30, 1996.
44. Copies of any compliance procedures and reports prepared by the adviser for the Funds.
45. Copies of the Funds' by-laws, articles of incorporation, and/or declaration of trust.

Other information may be requested during the course of the examination.

We also request that you make available to the inspection staff adequate office facilities to ensure the confidentiality of the examination.

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Enclosed for your information is a copy of SEC form 1661, "Supplemental Information for Regulated Entities Directed to Supply Information Other Than Pursuant to a Commission Subpoena" which discusses the authority for and uses of the requested information. Also, enclosed is a copy of the "Inspection Information Brochure" which provides a brief description of the purpose of the examination program, the inspection process and the methods employed by the Commission for resolving problems disclosed during inspections.

If you have any questions regarding any of the above, please contact:

XXXXXXXX XXXXXX
(212) XXX-XXXX

We appreciate your cooperation in this matter.

Sincerely,

Assistant Regional Director

Enclosures

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GAO Report on Mutual Fund Inspections

5/28/97

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 -----

REPORTNUM: GGD-97-67
TITLE: Mutual Funds: SEC Adjusted Its Oversight in Response to Rapid Industry Growth
DATE: 05/28/97
SUBJECT: Mutual funds
Investments
Inspection
Regulatory agencies
Securities regulation
Stocks (securities)
Information disclosure

.....
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Cover

===== COVER

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

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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. 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. 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.

\\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. 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. 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

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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.

\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. 11

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. 12 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

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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%

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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

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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-collar 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

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
Chicago	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
Philadelphia	80	3	11	23	22	17	76
Total	519	7	78	122	163	123	493
Percentage	--	1%	15%	24%	31%	24%	95%

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

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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.

\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)
Total	316 (100)	328 (100)	313 (100)	348 (100)	308 (100)	1,613 (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

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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.

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

SEC SELECTIVELY REVIEWED
DISCLOSURE DOCUMENTS

----- Letter 15

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-
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(fiscal year)

Disclosure document	1994	1995	1996
Initial registration statements			
Filed	2,570	2,321	2,410
Reviewed\	1,605	1,570	1,900
Percentage reviewed	62%	68%	75%
Initial mutual fund registration statements			
Filed	1,040	819	811
Reviewed	960	755	761
Percentage reviewed	93%	93%	94%
Amendments			
Filed	16,388	15,258	16,864
Reviewed	2,008	1,859	2,494
Percentage reviewed	12%	12%	15%
Proxy statements			
Filed	624	711	750
Reviewed	579	595	669
Percentage reviewed	93%	84%	89%
Periodic reports			
Filed	8,300	9,500	10,000
Reviewed	4,150	4,750	5,000
Percentage reviewed	50%	50%	50%
Total disclosure documents\			
Filed	27,882	28,060	30,324
Reviewed	9,342	8,774	9,963
Percentage reviewed	30%	31%	33%

\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

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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

\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 16

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.

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.²⁵

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.

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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.

\\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.

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."²⁷ 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.

²⁷ 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 16.3

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.

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

----- Letter

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----- Appendix II

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