

# Planning Investment Management Filing Reviews

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## Executive Summary

*We found that the Offices of Disclosure and Review (ODR) and Insurance Products (OIP), in the Division of Investment Management (IM) planned filing reviews by setting general goals for their filing review functions and defining specific objectives for review timeliness and compliance with Sarbanes/Oxley filing review requirements. Also, ODR and OIP staff appeared to generally communicate effectively with each other on disclosure issues encountered in filings.*

*ODR and OIP can improve controls over their filing review planning by developing outcome objectives and information regarding their filing reviews. This would aid in assessing program effectiveness, developing risk assessments and additional proactive reviews, and providing data required by the Government Performance and Results Act of 1993 (GPRA).*

*Other recommendations include: improving communication between ODR and the Office of Financial Analysis (OFA); including filing review plans, as appropriate, in action memoranda; scheduling and holding periodic staff meetings in OIP; and updating IM's public notice regarding its filing processing procedures.*

*ODR and OIP recently started pilot programs to document significant filing review outcomes. This should allow them to begin to gather and analyze results-based information. Also, ODR and OIP support training for their managers in developing outcomes and measures. In addition, OIP has begun to schedule and hold periodic staff meetings. We commend them for their efforts.*

## Scope and Objectives

Our audit objective was to evaluate internal controls regarding filing review planning in the Offices of Disclosure and Review (ODR) and Insurance Products (OIP). We interviewed IM staff and reviewed relevant laws, regulations and other documentation. Also, we reviewed and analyzed information related to rules issued in fiscal year (FY) 2004. We conducted the fieldwork between May and November 2004, in accordance with generally accepted government auditing standards.

## Background

The Commission's Fiscal Year (FY) 2005 budget estimate reported approximately 900 investment company complexes with approximately 35,000 investment company portfolios and assets of approximately \$7 trillion (as of the beginning of FY 2004).

The Investment Company Act of 1940 (the I/C Act) imposes requirements and prohibitions on investment companies. Also, the Securities Act of 1933 (the

Securities Act) requires that investors receive financial and other significant information regarding securities offered for public sale. For example, the I/C Act requires investment companies to disclose their investment policies and prohibits them from changing certain of these policies without shareholder approval.

The Commission's Division of Investment Management (IM) drafts and proposes rules, including disclosure rules, to implement the I/C and Securities Acts. Disclosure rules generally add, change, or delete specific items in filing forms (e.g., Item 3 of Form N-1A, fee table disclosure).

IM's Office of Disclosure and Review (ODR), with approximately 32 staff, reviews investment company filings for compliance with disclosure rules. Similarly, IM's Office of Insurance Products (OIP), with approximately 18 staff, reviews filings related to variable insurance products, as well as processing exemptive applications and performing other regulatory functions.

ODR and OIP's general goals include ensuring that investment companies fully disclose their policies, procedures and risk and that their proposed activities are consistent with the law.<sup>1</sup> Other goals include responding to filers promptly and complying with review requirements in the Sarbanes-Oxley Act of 2002 (Sarbanes/Oxley).

To accomplish this, ODR and OIP plan to review all new investment company disclosures, material changes to existing disclosures, and certain proxy information. Also, ODR and OIP developed timeliness objectives for filing reviews (e.g., complete proxy reviews within 10 days). In addition, ODR and OIP set annual numerical filing review targets to ensure that they review the periodic filings of all issuers at least once every three years, as required by Sarbanes/Oxley. ODR and OIP may also review filings in response to disclosure issues that arise during the year.

According to the FY 2005 budget estimate, ODR and OIP reviewed an estimated 16,000 of 40,400 filings in FY 2004.<sup>2</sup> These filings included new and existing portfolios, insurance contracts, fund profiles, proxies, and periodic reports.

The Office of Financial Analysis (OFA) provides research and analysis for IM. It researches and analyzes filing information from the Commission's internal databases as well as from external databases. OFA's products include "watch lists," which are lists of stock, bond, and money market funds with unusual returns for their categories.

ODR and OIP currently use three Information Technology (IT) systems to receive and store filings and correspondence, as well as manage its filing reviews. Also, OIP is developing another IT system to enhance its filing review tracking.

## Audit Results

We found that ODR's and OIP's filing review planning consisted of general goals for filing reviews and specific objectives regarding review timeliness and compliance

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<sup>1</sup> Commission's FY 2005 Budget Estimate, dated February 2004.

<sup>2</sup> Commission's FY 2005 Budget Estimate, dated February 2004. We did not audit these numbers.

with Sarbanes/Oxley review requirements. Also, review staff in ODR and OIP appeared to generally communicate effectively with each other on disclosure issues encountered in filings.

ODR and OIP could further enhance the effectiveness of their filing review planning processes by developing specific objectives, improving their information regarding filing reviews results and improving other internal controls, as discussed below.

## **Disclosure Objectives**

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The Government Performance and Results Act (GPRA) requires outcome-based goals and objectives. Outcome goals and objectives would help ODR and OIP monitor their effectiveness, plan proactive reviews and perform risk assessments regarding compliance with disclosure requirements.

As noted above, ODR and OIP defined general goals for their disclosure review functions and specific objectives for review timeliness and Sarbanes-Oxley compliance. Also, ODR and OIP appeared to have a number of sources from which to develop specific disclosure objectives (e.g., recent IM and Commission speeches, Section 1(b) of the I/C Act<sup>3</sup>, filing form items, etc.). ODR and OIP, however, had not developed specific disclosure objectives for their filing reviews.

ODR and OIP were reluctant to focus their review resources on certain disclosure items in a filing and not on others. Consequently, ODR and OIP managers had not routinely developed specific outcome objectives and tracked progress toward them. Also, their IT systems were not designed to collect and analyze data on filing review results.

ODR and OIP, however, recently implemented pilot programs to identify and measure significant outcomes from disclosure reviews. As ODR and OIP gain experience in identifying and analyzing outcomes, they could begin to define disclosure objectives to guide their proactive review efforts.

However, ODR and OIP currently plan to maintain this information in paper and as electronic text documents. Their current IT systems cannot effectively extract or analyze this data. Alternatively, ODR and OIP could add data fields to an existing database or develop a database to record and analyze key information.

Also, ODR and OIP supported training its managers in GPRA performance measurement methods, and were looking into how this training would be provided and funded.

IM's public notice of its filing processing procedures (Release No. 33-6510, dated March 26, 1984) did not include current filing selection practices. Over time, IM has changed certain of its filing selection and review procedures (e.g., filings selected for review to meet Sarbanes/Oxley requirements). IM should consider updating this notice.

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<sup>3</sup> Section 1(b) of the Investment Company Act lists a number of investment company practices that were deemed potentially harmful to investors.

### **Recommendation A**

The Division of Investment Management should continue development of its pilot program to identify and measure outcomes from disclosure reviews.

### **Recommendation B**

ODR and OIP should consider developing specific filing review objectives (*e.g.*, based on issues identified by IM or to address risks to investors listed in Section 1(b) of the Act).

### **Recommendation C**

The Division of Investment Management should consider ways to better analyze outcome data (*e.g.*, through a modified or new database).

### **Recommendation D**

The Division of Investment Management should continue its efforts to identify and provide training to ODR and OIP managers on developing GPRA outcome goals, objectives and measures.

### **Recommendation E**

The Division of Investment Management should consider updating its public notice of filing review policies and procedures to reflect its current practices.

## **Information Sharing**

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ODR and IM's Office of Financial Analysis (OFA) could improve communication with each other. For example, OFA had little information on the usefulness of its watch lists or how its services could be made more useful to ODR. Better communication between the two offices could help OFA further enhance its products and services for ODR.

### **Recommendation F**

OFA should consider ways to obtain input from IM staff regarding its products and services (*e.g.*, surveys, feedback on usefulness of watch lists).

## **Compliance Monitoring Plans in Action Memoranda**

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When recommending a rule change to the Commission, IM prepared an action memorandum which summarized the relevant issues. However, the Office of Disclosure and Insurance Product Regulation's (ODIPR) action memoranda for disclosure rules generally did not include compliance monitoring information. ODIPR did not include this information because ODR and OIP generally routinely review the filings affected by new disclosure rules.

However, compliance monitoring information appears appropriate when significant issues are involved in a proposed rule. For example, the disclosure rule might have had significant Congressional or Commission interest (*e.g.*, market timing, fund proxy voting, etc.). Or, the rules might institute new forms (*e.g.*, N-CSR for financial

information and N-PX for fund proxy voting disclosures) or would require a significant increase in resources to implement.

Including compliance information in action memoranda would improve the planning of compliance monitoring. The action memorandum would inform the Commission about IM's plans to ensure compliance with the recommended rule. The Commission could then provide timely input to IM on the plans.

### **Recommendation G**

When appropriate, IM should include compliance monitoring plans in its action memoranda for recommended rules.

## **Staff Meetings**

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OIP's filing review staff did not meet regularly to discuss disclosure issues. Some OIP staff attended meetings held twice a month by ODR. However, ODR issues did not always relate to OIP, and vice versa. OIP staff we interviewed favored holding regularly scheduled meetings. Recently, OIP began holding regularly scheduled meetings.

### **Recommendation H**

The Office of Insurance Products should continue to schedule and hold periodic staff meetings.

## **Other Matters-Budget Information**

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ODR had not documented its methodology for computing its estimate of 2,024 new portfolios filed on registration statements for FY 2004. ODR included this amount in IM's FY 2005 budget estimate total of 2,570 new portfolios filed in FY 2004.

Budget estimates generally include adjustments and projections because the Commission requests data for an entire fiscal year before the fiscal year is completed. However, these estimates and projections should be documented to ease their verification and consistent application.

### **Recommendation I**

ODR should document its methodology for developing its budget estimates.