

Compliance Inspections and Examinations

The Office of Compliance Inspections and Examinations manages the SEC's examination program. Inspections and examinations are authorized by the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. Entities subject to this oversight include brokers, dealers, municipal securities dealers, self-regulatory organizations, transfer agents, clearing agencies, investment companies, and investment advisers.

What We Did

- Inspected 278 investment company complexes, 1,570 investment advisers, 24 insurance company complexes, 626 broker-dealers, 138 transfer agents, and 3 clearing agencies. We also conducted 32 inspections of specific self-regulatory organization (SRO) programs, including at least one program at each of the 11 SROs.
- Continued to increase interaction among SEC examiners responsible for different types of regulated entities to increase effectiveness and productivity and enhance investor protection. We also enhanced cooperation with foreign, federal, and state regulators, as well as with the SROs. The staff conducted joint examinations and a number of significant examination sweeps with the SROs. The staff also conducted coordinated examinations with staff from Mexico and the United Kingdom's Financial Services Authority.

- Expanded our review of internal controls at several large broker-dealers, and focused on money laundering, comprehensive compliance, analysts' conflicts of interest, allocation of hot initial public offerings (IPOs), and hedge funds in both routine and special purpose examinations.
 - Conducted, for the first time, joint examination sweeps, one with SROs and state securities regulators and one with state insurance regulators. The first sweep covered 30 offices of a large broker-dealer giving a comprehensive picture of supervision. The sweep focused on large financial complexes containing both insurance and securities firms. The sweep enabled the Office of Compliance Inspections and Examinations and state regulators to take a consolidated look at complexes' compliance with and internal controls for privacy and the safeguarding of customer records and information.
 - Conducted six limited scope examinations of investment companies that invest in bank loan participation agreements (BLPs). These examinations focused primarily on the manner in which BLPs were being valued and whether the open-end investment companies maintain sufficient liquidity to meet emergency redemption demands.
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Investment Company and Investment Adviser Inspections

Investment Companies

SEC examiners inspected 278 investment company complexes, including 19 fund administrators. The average frequency of inspections for investment company complexes was 4.5 years. The complexes inspected managed \$1.3 trillion in 3,037 portfolios, which represented approximately 9 percent of the 34,423 variable insurance products, unit investment trust, and mutual and closed-end fund portfolios in existence at the beginning of 2002. The complexes inspected represented a mix of large and small complexes. Ten of the inspections were done on a “for cause” basis, which means the staff had some reason to believe that a problem existed.

Many investment company examinations focused on the role of the fund’s board of directors in reviewing and approving the advisory contract and the fund’s distribution plan. We also focused on personal trading, allocation of portfolio securities, the fund’s use of brokerage, and valuation procedures for illiquid securities.

The staff identified deficiencies or control weaknesses that resulted in a deficiency letter in 213--or 76 percent--of investment company examinations. Most frequent deficiencies or weaknesses resulting in deficiency letters were inadequate internal control procedures, conflicts of interest, inadequate oversight by board of directors, errors and omissions in registration and SEC filings, and books and records problems.

Serious deficiencies found during 14--or 5 percent--of the examinations warranted referrals for further investigation by the Division of Enforcement. The most common deficiencies resulting in referrals involved fraud; failure to disclose material information, including conflicts of interest; disproportionate

allocation of IPOs; failure to properly value illiquid privately-placed securities; misleading registration filings; and breach of fiduciary duty.

Investment Advisers

The staff completed 1,570 inspections of investment advisers. The average frequency of inspections for the 7,347 registered investment advisers was 4.7 years. The non-investment company assets managed by the advisers inspected totaled \$3.3 trillion. The staff inspected 65 investment advisers for cause.

Many investment adviser examinations focused on adviser marketing and performance advertising, personal trading, suitability of recommendations, policies and procedures adopted in response to Regulation S-P, and disaster recovery procedures. We also continued focusing closely on how advisers fulfill their duty of best execution in client securities transactions. In addition, we participated in a fact-finding review of the activities of hedge fund and hedge fund managers as part of the Commission's investigation of the role of hedge funds in the securities markets and investor protection implications of hedge fund growth.

The staff identified deficiencies or control weakness resulting in a deficiency letter in 1,407--or 90 percent--of investment adviser examinations. Most frequent deficiencies were inadequate internal control procedures, errors and omissions in Form ADV or the brochure, books and records problems, custody, conflicts of interest, and inadequate marketing and performance practices.

Serious deficiencies warranting enforcement referrals were uncovered in 48--or 3 percent--of the examinations. The most common deficiencies resulting in referrals involved fraud; failure to disclose material information, including conflicts of interest; brokerage and execution practices; custody; misleading marketing materials; and books and records problems.

Mutual Fund Administrators

Many mutual fund complexes use third party administrators to perform their accounting and administrative functions. During 2002, 16 of 19 fund administrator inspections resulted in deficiency letters, 2 in no further action, and one in an enforcement referral.

Variable Insurance Products

In response to the rapid growth in variable insurance product assets and the emergence of new channels of distribution, specially trained insurance product teams conducted examinations in this area. These teams identified and examined variable life and annuity contract separate accounts. Deficiency letters were issued to each of the 24 insurance company complexes that were examined. Deficiencies included internal control weaknesses and failure to properly process contract holder transactions.

Broker-Dealer, Transfer Agent, and Clearing Agency Examinations

Broker-Dealers

In fiscal 2002, the staff conducted 626 oversight, cause, and surveillance examinations of broker-dealers, government securities broker-dealers, and municipal securities dealers. These examinations included 96 branch office examinations. Deficiency letters were sent to 529 broker-dealers, representing 84 percent of those examined. Serious deficiencies discovered in 76--or 12 percent--of the examinations warranted referrals to the Division of Enforcement for further investigation. An additional 80 examination findings--or 13 percent--were referred to SROs for appropriate action. The most common deficiencies found were recordkeeping deficiencies, net capital computation errors, unsuitable recommendations to customers, and inadequate written supervisory procedures.

Examination staff continued to conduct reviews of selected larger broker-dealers' internal controls, involving risk management, funding and liquidity, credit, and operations. Broker-dealer examinations also focused on a variety of sales practices, including sales of variable annuity products and mutual fund switching.

In addition to the routine exam work that is so critical to the success of our program, we undertook a number of initiatives this past year, including: an investigation of analysts' conflicts of interest jointly with the National Association of Securities Dealers (NASD) and New York Stock Exchange (NYSE), which resulted in significant enforcement actions; a review of stock borrow/loan arrangements; financial disclosure relating to registrants whose parents are paying the subsidiaries' expenses; private investments in public entities; contingency planning; best execution exams; and broker-dealer comprehensive compliance examinations. We also completed a coordinated exam of a large broker-dealer, working closely with the NASD, NYSE, Chicago Board Options Exchange (CBOE), and 11 states. Through this joint initiative that included exams of 30 offices, and use of a common exam module, we were able to comprehensively examine this registrant and explore the benefits of a coordinated exam approach.

In addition, the staff began a coordinated examination sweep with the NASD and NYSE to assess how broker-dealers are complying with various anti-money laundering rules and regulations. Specifically, we focused on how firms are detecting suspicious activity that could be indicative of money laundering. We also conducted several reviews of registrants' programs for dealing with the privacy rules outlined in Regulation S-P.

Examination staff continued initiatives to enhance cooperation with foreign, federal, and state regulators, as well as with SROs. Examiners worked through National Summit Meetings, Regional Summit Meetings, and other coordinated mechanisms to enhance

cooperation and reduce any duplication of effort in broker-dealer examinations.

Transfer Agents and Clearing Agencies

In 2002, our staff conducted 138 examinations of registered transfer agents, including 34 federally-regulated banks. The program resulted in 107 deficiency letters, 8 cancellations or withdrawals of registrations, 7 referrals to the Division of Enforcement, 31 referrals to bank regulators, and one staff conference with a registrant. The examinations discovered 50 registrants with deficiencies in compliance with the Lost Securities Rule. In addition, the staff completed 3 routine inspections of clearing agencies, and conducted a series of on-site briefings regarding securities/futures cross-margining programs with staff from the Commodity Futures Trading Commission.

Self-Regulatory Organization Inspections

In fiscal 2002, the staff completed 32 inspections of SROs and Alternative Trading Systems (ATs). The completed inspections included at least one program at the following SROs:

- American Stock Exchange,
- Boston Stock Exchange,
- Chicago Board Options Exchange,
- Chicago Stock Exchange,
- Cincinnati Stock Exchange,
- International Securities Exchange,
- Municipal Securities Rulemaking Board,
- National Association of Securities Dealers,
- New York Stock Exchange
- Pacific Exchange, and
- Philadelphia Stock Exchange.

The NASD inspections included review of the regulatory programs administered by the NASD's 14 district offices. The staff also inspected the Securities Investor Protection Corporation.

The SRO inspections focused on programs dealing with arbitration, initial and continued listing of securities for trading, financial and operational surveillance and examinations of member firms, market surveillance, investigations, disciplinary actions, and the detection of and sanctioning for sales practice abuses. The inspections resulted in recommendations to improve each SRO's or ATS's effectiveness and efficiency.

SRO Final Disciplinary Actions

Section 19(d)(1) of the Securities Exchange Act of 1934 and rule 19d-1 require all SROs to file reports with the SEC of all final disciplinary actions. In fiscal 2002, a total of 2,507 reports were filed with the SEC, as reflected in the following table.

**SRO Reports of
Final Disciplinary Action**

American Stock Exchange	30
Boston Stock Exchange	0
Chicago Board Options Exchange	112
Chicago Stock Exchange	414
Cincinnati Stock Exchange	0
National Association of Securities Dealers	1,317
Nasdaq	10*
National Securities Clearing Corporation	0
New York Stock Exchange	528
Options Clearing Corporation	0
Philadelphia Stock Exchange	25
Pacific Exchange	68
International Securities Exchange	<u>3</u>
 Total	 2,507

* This number represents 19d-1 reports filed regarding Nasdaq delisting.