

# TARGETING BROKER-DEALER COMPLIANCE EXAMINATIONS

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## EXECUTIVE SUMMARY

*We conducted an audit of the Commission's targeting of Broker-Dealer (BD) examinations. The BD Examination program (BD program) consists of the Office of Compliance Inspections and Examinations (OCIE) and the BD examination staff in the field offices.*

*The BD program has been incorporating the Commission's increased emphasis on risk into its processes (e.g., conducting risk workshops, increasing the use of sweeps and mini-sweeps, etc.).*

*We found that the BD program's targeting process was generally effective and efficient. We are making several recommendations to enhance the BD targeting process by increasing the likelihood that issues are identified timely.*

*The recommendations include: automating and integrating risk-based information, assessing and documenting the risk level assigned to BDs by the Self Regulatory Organizations (SROs), reviewing the goal for conducting oversight examinations, developing a timeliness performance measure, improving how investor complaints are used, and preparing financial information. During the audit, we also discussed other issues with senior management.*

*Commission management generally concurred with our recommendations.*

## SCOPE AND OBJECTIVES

Our audit objectives were to determine the effectiveness and efficiency of the BD targeting process (*i.e.*, which BDs are selected for examination, and the scope of the individual examination).

During the audit, we interviewed and surveyed BD staff throughout the Commission. In addition, we interviewed officials from the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD). We also analyzed BD examinations and reviewed supporting documentation, among other procedures.

We performed limited audit work regarding Commission inspections of the SROs (*e.g.*, NASD district office examinations). These examinations are performed by OCIE's SRO Inspection program and BD staff in the field offices. We obtained an

understanding of these SRO inspections because they are a central component for OCIE's efforts for evaluating the quality of SRO examinations of their member BDs.

Our audit work focused mainly on the NYSE and NASD, as opposed to the other SROs (*e.g.*, Chicago Board Option Exchange, the American Stock Exchange, etc.). We selected the NYSE and NASD because they conduct most of the BD examinations.

We did not evaluate the BD program's targeting of transfer agents (TA) or clearing agencies (CA)<sup>1</sup>. These examinations are also performed by BD staff in the field offices. No material findings involving the targeting of TAs or CAs, or in the SRO Inspection program came to our attention. TAs, CAs, and the SRO Inspection program will be considered by the OIG in future audit planning.

The audit was performed from August 2004 to April 2005 in accordance with generally accepted government auditing standards, with one exception. Because of time constraints, we did not evaluate the validity and reliability of data from the Examination program's Super Tracking and Reporting System (STARS). STARS is used to provide a historical record of all Commission examinations. We are unaware of any material errors or irregularities involving STARS.

## BACKGROUND

### General Information

The BD program consists of approximately 26 staff in OCIE and 256 staff in the field offices. OCIE provides overall program direction and performs some examinations. The field office staff perform most BD examinations.

There are several types of examinations:

- **Oversight:** These examinations evaluate a BD recently examined by an SRO. Their purpose is to evaluate the quality of the SRO's examination of the BD (*e.g.*, were material violations identified, was the scope and sample selection of the SRO examination adequate, etc.), and to conduct an assessment of the BD's current compliance with the federal securities laws.
- **Cause:** These examinations are initiated for a reason (*e.g.*, an investor complaint) involving a specific issue(s) that could indicate a violation of the securities laws.
- **Surveillance:** These examinations are initiated because the BD

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<sup>1</sup> A transfer agent maintains the names of shareholders, their addresses, and the number of shares owned, etc. A clearing agency handles the settlement of securities transactions. In fiscal year 2004, the Examination program performed 130 TA and 4 CA examinations.

program identified an issue. However, a cause examination is not warranted; and an oversight examination is not appropriate because the last SRO examination is not recent enough.

- **Special:** These examinations include sweeps and mini-sweeps<sup>2</sup>, which focus on a specific industry wide issue (*e.g.*, anti-money laundering). Mini-sweeps can also focus on an issue that only pertains to a few firms in the industry. Besides sweeps, certain special examinations (*e.g.*, internal control-risk management, or comprehensive compliance) are performed at large BDs.

The Division of Market Regulation (MR) is responsible for rules and regulations regarding BDs, while the BD program in OCIE and the field offices conducts examinations. The Enforcement program (consisting of the Division of Enforcement and Enforcement staff in the field offices) is responsible for bringing enforcement actions against BDs.

In fiscal year 2004, the BD program performed 735 BD examinations, of which 322 were oversight or surveillance examinations, 281 were cause examinations, and 132 were special examinations. A total of 202 BD examinations resulted in referrals to the Enforcement program. Most BD examinations result in a deficiency letter. This letter describes the deficiencies found and requests that the BD implement corrective actions, as appropriate.

In November 2004, the Commission issued a concept release seeking public comment on the role and operation of the SRO regulatory structure. This initiative could affect the future of the BD program.

## **BD Universe**

According to OCIE, as of December 2004, approximately 6,900 BDs were registered with an SRO. These BDs employed approximately 664,000 registered representatives (RRs) in 103,400 main and branch offices. The top 100 BDs (as defined by OCIE)<sup>3</sup> controlled approximately 82% of BD assets and 95% of investor accounts.

## **Regulatory Framework**

The Securities Exchange Act establishes SROs to regulate the conduct and activities of their members. All BDs must be a member of an SRO(s). The SRO is the BD's front-line regulator. The Commission has oversight authority over the SROs.

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<sup>2</sup> Sweeps involve numerous BDs and are performed by BD staff throughout the Commission and sometimes are conducted jointly with SRO staff. Mini-sweeps involve fewer BDs and are often performed by one field office or OCIE staff.

<sup>3</sup> OCIE created the top 100 list based on the number of investor accounts, the amount of BD assets, and the amount of BD equity.

To register with an SRO(s), a BD must file an application form (*i.e.*, Form BD). The BD must also register in the state(s) where it plans to conduct business. Form BD must be updated promptly whenever the information becomes inaccurate or incomplete. The nature of the BD's business determines which SRO(s) and state(s) it must register with.

The SROs coordinate among themselves in order to maximize the effectiveness and efficiency of their examinations. Some states also conduct examinations. A primary emphasis of state examinations is sales practice issues (*e.g.*, churning) at branch offices.

A RR is an individual who works for a BD and is engaged in securities related activities. When the RR is hired, a Form U-4 is filed. A Form U-5 is filed when the RR leaves the BD. The BD files these forms with the NASD. They are publicly available on a NASD computer system (Central Registration Depository (CRD)). These forms require the reporting of detailed information concerning the RR (*e.g.*, disciplinary history, education, prior work experience, investor complaints, etc.). The RRs must also be registered with the state(s).

## Examination Timing

The BD program does not perform comprehensive annual examinations on each BD because the SROs are the front-line regulators. Thus, a risk-based approach determines the examination timing and scope (*i.e.*, the targeting process). Besides conducting internal control examinations (as described below), OCIE has no other requirements for how often each BD should be examined.

The BD program has an examination cycle for evaluating the internal controls of the top 100 BDs. The top 20 BDs are examined every two years, the next 30 BDs are examined every three years, and the remaining 50 BDs are examined every four years. These examinations require many staff hours. Besides these internal control examinations, other examinations are also performed on the top 100 BDs.

Some field offices believe that the targeting process could be improved, if they had greater flexibility regarding the timing and scope of the internal control examinations. OCIE is considering changes to make these examinations more risk-based.

OCIE indicated that the time goals for the internal control examinations are generally being met.

## Examination Planning and Scope

Each year, OCIE and the field offices plan the Examination program (*e.g.*, types of examinations, number of examinations to be performed) for the upcoming year. During the year, they discuss the progress towards achieving the examination goals.

The type of examination being performed and the risks that are identified by the Commission staff influence the examination scope. The scope of the examination may include one or more of the following area(s):

- Sales practice issues (*e.g.*, suitability, churning);

- Financial and operations (*e.g.*, net capital, books and records);
- Internal controls (*e.g.*, review of operational and market risks, funding, etc.);
- Priority areas (*e.g.*, after September 11, 2001 the Examination program expanded disaster contingency planning into its examinations); and
- Other issues (*e.g.*, as part of a sweep or mini-sweep, or cause examination).

## AUDIT RESULTS

We found that the BD program's targeting process was generally effective and efficient. Nevertheless, we are making several recommendations to enhance the BD targeting process, as described below. Some of our findings and recommendations might also be applicable to the other Commission Examination programs. The other Examination programs should consider the applicability of these findings and recommendations.

### RECENT INDUSTRY WIDE VIOLATIONS

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Numerous industry wide violations (*e.g.*, the global settlement,<sup>4</sup> late trading and market timing, etc.) have been identified in recent years. The late trading and market timing violations in the mutual fund industry caused the Commission to change how it identified industry wide risks.<sup>5</sup> For instance, in 2004, the Examination program conducted workshops throughout OCIE and the field offices. The goal was to identify industry wide risks, mitigating factors, and recommended actions. We were told that some mini-sweep examinations were initiated as a result of these workshops.

The Commission and the SROs have also attempted to prevent and deter violations from occurring (*e.g.*, new rules on mutual funds and BDs, aggressive Enforcement actions). The Commission's efforts to respond to widespread violations are still evolving. Therefore, we did not evaluate their effectiveness.

We believe that the timely identification of issues will always be a challenge since market participants can alter some aspects of their operations (*e.g.*, policies and procedures) without necessarily being required to disclose the information in an amended BD filing. In addition, as stated above, the BD program does not perform comprehensive annual examinations of all BDs. Nevertheless, as described below, we are making several recommendations to enhance the BD targeting process by increasing the likelihood that issues are identified in a timely manner.

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<sup>4</sup> The global settlement refers to a \$1.4 billion settlement with ten of the largest investment banking firms. The Commission alleged that these firms exercised undue influence over securities research.

<sup>5</sup> See our audit report "Targeting IA/IC Compliance Examinations" (No. 383), dated September 29, 2004 for additional information on late trading and market timing, and the Commission's efforts to identify industry wide risks.

## SELECTION OF BROKER DEALERS TO BE EXAMINED

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### Automate and Integrate Risk-Based Information

The BD program lacks an automated and integrated information system of risk-based information on BDs. Ideally, the system should record risk information and flag high-risk BDs for possible examination. This system could assist the BD program in making well-informed decisions about which BDs (the BDs main office and their branch offices) should be examined.

According to OCIE,

“Smart examining requires that [BDs] are selected for examination based upon greatest risk and examination scopes are focused on the activities reflecting greatest [investor] exposure...”

Some risk-based information is identified only after the BD has been selected for an oversight examination (as the BD staff develops the examination scope), and is not used to select the examination. Most field offices have developed methods to record some risk-based information regarding their assigned BDs. The BD program does not examine most BDs regularly, and some BDs are examined very infrequently. Thus, the BD program would benefit from incorporating more risk-based information into its examination selection process to properly target high-risk BDs.

Many of the field offices believe that the current risk-based information regarding branch offices could be improved. If the BD program readily had better risk-based information, they would be more likely to timely identify branch offices that warrant an examination. Currently, some branch office examinations are initiated only after the BD's main office has been selected for examination, and the BD staff have received information (*e.g.*, exception reports) from the BD's main office. Branch office examinations are also initiated based on investor complaints and information obtained from the SROs, among other things.

The NYSE and NASD have recently submitted to the Commission proposed rule changes to improve the information that BDs must provide regarding branch offices.

Risk-based information that could be incorporated into an automated and integrated information system includes:

- The nature of the BD's operations (*e.g.*, the size and number of branch offices, the RRs employed at the BD and the BD's branch offices, etc.);
- The filing of an amended Form BD, depending on the nature of the information being updated;
- The filing of an early warning notice involving a net capital deficiency;
- Periodic BD filings (*e.g.*, U-4 filings, financial reports, etc.);
- The findings and scope of previous SRO inspections and BD examinations;

- Information regarding enforcement actions;<sup>6</sup>
- Investor complaints; and
- Trading and trend data.

OCIE is considering (based on cost/benefit analysis) an automation project and has performed some initial steps to implement such a system. It indicated that it has developed a draft of its risk-based information requirements in consultation with the field offices. OCIE plans to discuss these information requirements with Office of Economic Analysis (OEA) and Office of Risk Assessment (ORA).

If the BD program develops a system, we believe that a risk rating system (*e.g.*, high, medium and low risk) and a corresponding examination approach (*e.g.*, examination cycles, goals, etc.) would also need to be developed in order to incorporate this new information into the BD program's examination selection process.

The risk rating system should periodically be tested to validate the usefulness of the targeting information that is produced by the system. For instance, the BD program could perform some comprehensive examinations of BDs and compare the results with the targeting information that is produced by the system.

### ***Recommendation A***

OCIE, in consultation with the field offices, OEA, ORA, MR, and the Investment Advisor Task Force (formerly known as the Mutual Fund Surveillance Task Force<sup>7</sup>), should consider the adequacy of the risk-based information that is required in BD filings to identify known and unknown risks (*e.g.*, trend data could indicate that something unusual is occurring).

### ***Recommendation B***

OCIE, in consultation with the field offices, OEA, and ORA, should develop a risk rating system and a corresponding examination approach.

### ***Recommendation C***

OCIE, in consultation with the field offices, OEA, and ORA, should periodically test the risk rating system.

## **Assignment of BDs**

Each field office is responsible for examining the BDs in assigned states, based on the location of the BD's main office. In the past, the field offices rarely conducted examinations of BDs assigned to other field offices. According to OCIE, with the

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<sup>6</sup> Currently, OCIE manually tracks BDs who were the subject of a Commission enforcement action. This information is used to target examinations.

<sup>7</sup> The former Chairman, in response to the late trading and market timing violations, created the Mutual Fund Surveillance Task Force. Its objective is to study a new surveillance system for improving the information that the Commission receives from mutual fund filings.

increased use of sweep examinations, the field offices are more likely now to conduct examinations of BDs assigned to other field offices.

Based on the current assignments, the Northeast Regional Office (NERO) is responsible for approximately half of the top 100 BDs, including 14 of the top 20. In addition, some field offices may have a disproportionate number of small “problem” BDs or other unusual circumstances. The number of BD staff assigned to each field office reflects these disparities.

OCIE believes that these disparities are a necessary consequence of the territorial allocation of examination authority among the field offices. However, this issue should be re-evaluated after the BD program improves its risk-based information and examination approach.

### ***Recommendation D***

OCIE, in consultation with the field offices, should evaluate the assignment of BDs to the field offices, if the automated and integrated information system is developed. The evaluation should be performed after the system has been sufficiently used so that OCIE has confidence in its results.

## **OVERSIGHT EXAMINATIONS**

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### **Risk Level Assessment**

The NYSE and NASD indicated that they conduct BD cycle-based examinations that are influenced by risk.

According to OCIE (memorandum to all Examination staff dated January 2004),

“Oversight exams of NASD should attempt to incorporate some analysis of the effectiveness of the NASD’s risk assessment model for exam selection....”

Some of the field offices stated that during oversight examinations, they evaluate the reasonableness of the risk level assigned to the BD by the SRO. However, the BD program’s examination report<sup>8</sup> does not typically discuss the issue, unless the risk level is not reasonable. According to OCIE, the Commission’s SRO Inspection program would consider this issue when reviewing the SRO examination programs.

We believe that the BD program’s assessment of the risk level assigned by the SRO is important, since the SRO assessment influences which BDs are examined and the frequency of those examinations. According to OCIE, the number of NASD BDs that are designated as high-risk has significantly decreased recently. The cause(s) for the decrease is not readily apparent.

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<sup>8</sup> This report is prepared by the examination staff to summarize the examination and includes background information on the BD, particular risks involving the BD, scope of the examination, violations from prior examinations, work performed, violations found, and disposition.



### **Recommendation E**

OCIE, in consultation with the field offices, should: (1) require that all oversight examinations include an evaluation of the reasonableness of the risk level assigned to the BD by the SRO; and (2) modify their procedures to require a statement in all oversight examination reports regarding the reasonableness of the BD's risk level assignment.

### **Recommendation F**

OCIE, in consultation with the field offices, should evaluate the cause(s) for the significant decrease in NASD BDs identified as high-risk, and take appropriate action.

## **Oversight Examination Goal**

Currently, OCIE has a goal that 40% of BD examinations be oversight examinations in order to maintain the quality of SRO examinations. OCIE management expects to be informed, if a field office will be unable to meet the goal due to unusual circumstances. The 40% goal was established based on the experiences of senior OCIE management.

Many of the field offices believe that the 40% goal should be reduced, thus allowing greater discretion in allocating the staff resources, for the following reasons:

- It is sometimes difficult to identify SRO examinations that qualify as oversight candidates (*e.g.*, the SROs are not timely in completing their examinations); and
- The goal reduces the ability of the examination staff to conduct risk-based examinations.

We believe that more flexibility would allow for better coordination between the BD and IA/IC programs. OCIE believes that coordination between the programs is important.

While oversight of SRO examinations is an important tool to leverage Commission examination resources and provide additional compliance benefits, the appropriate goal (*i.e.*, percentage of) oversight examinations should be reevaluated. OCIE and the field offices have created a task force to examine how the goal should be applied in future years.

### **Recommendation G**

OCIE, in consultation with the field offices, OEA, and ORA, should consider whether the findings from previous oversight examinations could be used in order to help determine the appropriate oversight examination goal. The analysis (*e.g.*, cost-benefit) should be periodically performed in order to adjust the goal as conditions change.

## Oversight Examination Approach

According to OCIE, the percentage of oversight examinations where the BD program finds that the SRO missed at least one violation has remained relatively constant during the last three years. OCIE believes that these missed violations are generally not material, although the SROs repeatedly miss violations in certain areas. OCIE has reminded the field offices to determine why an SRO missed a violation. The BD program has frequent discussions with the SROs regarding the oversight examination results, among other issues.

We believe that the BD program could optimize its staff resources by occasionally targeting the reoccurring weaknesses in SRO oversight examinations. OCIE agrees with our assessment. However, at the current time, this approach would not be useful given the nature of the missed violations. Therefore, we are not making any audit recommendations regarding this issue.

## Other SRO Oversight Examinations

We estimate that 88% of BDs are registered with either the NYSE and/or NASD. As a result, the oversight examinations heavily focus on the NYSE and NASD. For instance, in fiscal years 2003 and 2004, approximately 98% of all oversight examinations were performed on BDs registered with the NYSE or NASD.

OCIE has acknowledged the importance of conducting some oversight examinations of BDs registered with other SROs.<sup>9</sup>

### ***Recommendation H***

OCIE, in consultation with the field offices, and ORA, should discuss how to enhance OCIE's risk assessment regarding the other SROs. The discussion should include the examination results and analyses (*e.g.*, comparisons among SROs) from previous years.

## PERFORMANCE MEASURES

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### Timely Identification of Violations

The BD program does not track how timely it identifies violations (*i.e.*, how much time passed from the inception of the violation at the BD to the BD program's identification of the violation). We believe that a timeliness performance measure would help evaluate and improve the effectiveness of the BD program. This measure could provide insight regarding where (*e.g.*, the types of violations) the BD program's targeting process or examination procedures could be improved. For

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<sup>9</sup> In addition to the NASD and NYSE, several other SROs are responsible for examining their BD members, including the Chicago Board Options Exchange, the Chicago Stock Exchange, the National Stock Exchange, the Philadelphia Stock Exchange, the Pacific Exchange, the Boston Stock Exchange, the International Stock Exchange, and the American Stock Exchange. Some of these SROs, either through agreement or contract, allocate their examination responsibilities or duties to other SROs.

instance, the BD program could evaluate whether it has adequate risk information for those violations that are not identified timely.

However, developing a useful timeliness measure raises certain issues. For instance:

- According to the field offices, they generally focus on recent transactions and events when performing an examination (possible exceptions can include cause examinations and sweeps). Thus, the timeliness measure could be misleading since the BD program is more likely to identify recent violations; and
- Occasionally it may be difficult to determine when a violation began because of a lack of records or the complexity of the issue.

### ***Recommendation I***

OCIE, in consultation with the field offices, OEA, and ORA, should consider whether a useful timeliness measure can be developed and implemented. If a measure is implemented: (1) the measure should be tracked in STARS; (2) guidance should be provided to the BD staff; and (3) OCIE should consider whether the measure would be useful to parties outside the Commission and be reported in external Commission reports (*e.g.*, Government Performance and Results Act reports).

## **Numerical Performance Goals**

Each field office is expected to complete certain numbers and types of examinations each year. Some field offices believe that these numerical performance goals reduce their effectiveness by influencing which BDs are selected for examination and the examination scope.

We found no evidence that the numerical performance goals adversely influenced the targeting process on a widespread basis throughout the BD program. However, our analysis of fiscal years 2003 and 2004 BD examinations did not focus on individual examinations and therefore had certain limitations.

OCIE has stressed to the field offices the need for quality examinations (*e.g.*, thoroughness of the examination scope). For instance, according to a memorandum to all Examination staff from OCIE dated December 2004):

“The primary measure of our effectiveness is the quality of the examinations in terms of the findings, the analysis, and the scope of the examination. While coverage of a sizeable number of registrants {BDs} is valuable, examinations of high quality are essential.”

We are not making any audit recommendations regarding this issue because OCIE’s policy is clear.

## INVESTOR COMPLAINTS

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Investor complaints are a primary source of cause examinations. Thus, sharing of investor complaint information between regulators is an important function. Described below are two possible improvements involving investor complaints.

### Sharing of Investor Complaints

According to the Office of Investor Education and Assistance (OIEA), relatively few investor complaints received by OIEA and the field offices are also filed with another regulator (e.g., an SRO).

Currently, the SROs provide the BD program with periodic reports on RRs who are the subject of investor complaints. According to the field offices, these reports are useful for targeting BDs. In addition, OCIE periodically meets with the SROs about investor complaints.

Prior to our audit, OCIE, OIEA, NYSE, and NASD discussed developing a computerized method for sharing investor complaints. OIEA stated that it could not participate because it did not have the funds to modify its complaint system (ACTS+). OCIE is still discussing the issue with the SROs.

According to most field offices, the BD targeting process could also be improved, if they had real-time access to investor complaints filed with the states. OCIE agrees with the field offices. However, according to OCIE, this is currently not feasible because of technological issues and certain state laws. Therefore, we are not making any recommendations regarding this issue.

### ***Recommendation J***

OCIE, in consultation with, ORA, OIEA, and the Office of Information Technology (OIT), should consider incorporating ACTS+ investor complaint data into its efforts to automate and integrate the risk-based information.

### Identifying Investor Complaint Patterns

ACTS+ reports of investor complaint data are used to target BD examinations. However, ACTS+ does not automatically identify when an investor complaint relates to other investor complaint(s) filed against the same branch office or RR. Nevertheless, a pattern might be detected by the BD staff manually searching ACTS+ during the pre-examination work or by OIEA staff.

### ***Recommendation K***

OCIE should discuss with OIEA and OIT the best method for identifying investor complaint patterns, and take appropriate action as warranted.

## PREPARING FINANCIAL INFORMATION

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OEA prepares financial information for the BD program based on data from BD financial filings. The information is sent to OCIE, which forwards it to the applicable field office. The financial information show BDs with risky net capital positions.

Most field offices do not use OEA's financial information. The field offices generally indicated that they receive the same information from the NASD sooner, or that their BDs (because of the nature of the BDs operations and size) typically are not in a high-risk net capital position. One field office suggested that trend analysis information might be more useful than the financial information.

### ***Recommendation L***

OEA, in consultation with OCIE and the field offices, should consider whether to: (1) continue preparing the financial information; (2) prepare trend information (*e.g.*, would it be useful to the BD program); and (3) incorporate the OEA information (*i.e.*, financial information and/or trend information) into the automated and integrated information system.