

COMPLIANCE INSPECTION AND EXAMINATION REFERRALS TO ENFORCEMENT

EXECUTIVE SUMMARY

We found that referrals of alleged deficiencies (in the compliance of the securities laws) from the Compliance Inspection and Examination Program (Examination Program) to the Enforcement Program were generally efficient and effective. Several improvements could enhance the referral process including improving communication with the Enforcement Program, the interested divisions (i.e., Market Regulation, Investment Management, and Corporation Finance), and the alleged violator.

During the audit, the Office of Compliance Inspections and Examinations (which has oversight for the Examination Program) issued guidance that addressed many of our recommendations. We commend them for their proactive efforts to improve the Enforcement referral process.

SCOPE AND OBJECTIVES

Our audit objective was to determine whether referrals of alleged deficiencies (in the compliance with the securities laws) from the Compliance Inspection and Examination Program (Examination Program) to the Enforcement Program were efficient and effective.

During the audit, we interviewed and surveyed Commission staff, visited three regional offices, analyzed the broker-dealer (BD) and investment adviser (IA) referrals from fiscal year 1998, and reviewed supporting data in the Commission's computer systems, among other procedures. We limited our analysis to BD and IA referrals because they constitute most of the Enforcement referrals made.

The audit was performed from June 2000 to January 2001 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 computer systems (e.g., STARS and NRSI) used in the audit. In our opinion, detailed testing of these computer systems would most likely not have materially

affected our findings, in part because much of the data we used was confirmed with knowledgeable Commission staff.

BACKGROUND

The Office of Compliance Inspections and Examinations (OCIE) and the field offices administer the Examination Program. Of the approximate 713 staff in the program, 106 are in OCIE, with the remainder assigned to the field offices. The staff perform approximately 650 BD and 1,450 IA examinations each year, besides other types of examinations (*e.g.*, Investment Companies, Transfer Agents, Self-Regulatory Organizations, etc.).

Approximately, 20% of BD and 5% of IA examinations result in Enforcement referrals. Most of these referrals come from cause examinations (*i.e.*, the examination was triggered by an apparent problem).

An examination can have one of three possible outcomes, which may not be mutually exclusive. These are:

- The staff issue a letter to the examined entity, indicating that no deficiencies were identified;
- They issue a deficiency letter to the entity describing alleged deficiencies, and require the entity to take corrective actions and submit a written response describing the actions; and
- They refer serious alleged deficiencies to the Enforcement Program or other entity (*e.g.*, state regulator, self-regulatory organization (SRO)) for investigation.

In addition, the staff may take other steps to enhance a securities firm's compliance. These include:

- They discuss minor alleged deficiencies with the entity during an exit interview; and
- They initiate a conference call between senior Commission officials and the entity when the alleged deficiencies are more serious than those typically included in a deficiency letter, but do not warrant an Enforcement referral.

An Enforcement referral is usually made to enforcement staff in the same office. The enforcement staff then decides whether to investigate the matter, and if the investigation identifies significant violations, they will recommend an action to the Commission. The decision to recommend an action is partly based on input from the interested division (*i.e.*, OCIE, Market Regulation, Investment Management, or Corporation Finance).

In March 1998, we issued an audit report (No. 254) on the Examination Program. That audit identified several issues related to the referral process, which we followed-up in this audit.

AUDIT RESULTS

We found that referrals of alleged deficiencies from the Compliance Inspection and Examination Program to the Enforcement Program were generally efficient and effective. In fiscal year 1998, most BD and IA referrals (about 78%) resulted in an Enforcement investigation. With respect to the referrals that did not result in an investigation, the Enforcement staff indicated that their decisions were based on considerations of prosecutorial discretion. Thus, referrals were rejected because either there were higher priority cases, or other similar factors were present which caused the Enforcement staff to decline to pursue the matter.

The Examination and Enforcement Programs generally believe that the referral process is working well. We identified several improvements to enhance the referral process. OCIE has already issued guidance addressing many of our recommendations. During the audit, OCIE also evaluated selected BD referrals from fiscal years 1998 and 1999. We commend them for their proactive efforts to improve the referral process.

COMMUNICATION OF EXAMINATION FINDINGS

To The Enforcement Program

During our prior audit, some Examination staff stated that communication between the Examination and Enforcement Programs could be improved. Examination and Enforcement Program staff have made efforts to improve communication. For instance, Enforcement staff have spoken to examiners at training conferences describing the characteristics of a good Enforcement referral. Also according to OCIE and the Division of Enforcement, they believe that senior management from both programs have improved the level and frequency of their communication with each other in recent years.

Early communication with Enforcement about a potential referral appears desirable, since the Enforcement staff would be able to communicate their concerns to examiners and be more familiar with the case if it is eventually referred. According to Examination and Enforcement staff, if a significant alleged deficiency is discovered during the examination fieldwork, the Examination staff will immediately inform Enforcement. Other possible deficiencies may take more time to detect and analyze. In these instances, the Examination staff will generally make the referral after the examination is complete.

During the audit, we analyzed whether there is any correlation between early communication with Enforcement and acceptance of a referral for investigation. We reviewed all of the BD and IA referrals from fiscal year 1998. We determined when initial discussions with Enforcement were held, and how often the referral resulted in an investigation.

There were 42 referrals that were rejected (*i.e.*, did not result in an investigation) and 145 referrals that were investigated.¹ Communication after the examination fieldwork occurred in 34 of the 42 rejected referrals (81%). However, communication after the examination fieldwork occurred in only 64 of the 145 investigated referrals (44%). We did not analyze whether the timing of the initial communication was correlated to the type of alleged deficiency.

While we cannot definitely conclude that early communication causes a higher acceptance rate, we believe that they are correlated. Therefore, we concur with OCIE management that the Examination staff should communicate with Enforcement staff as early as reasonably possible when making a referral.

Recommendation A

OCIE should remind Examination staff both in OCIE and in the field offices of the importance of effective early communication with Enforcement staff.

In August 1998, OCIE issued guidance to Examination staff in OCIE and the field offices, stating that early communication with Enforcement staff is important, especially if the alleged deficiency is ongoing. The guidance indicated that early communication should improve the referral process because Enforcement could request that examiners obtain certain documents or ask particular questions prior to completing the examination. It also suggested that if the Enforcement staff rejects a referral from the Examination staff, efforts should be made, where appropriate (*e.g.*, lack of resources), to ascertain whether another Commission office, SRO, or State Security Regulator might be interested in the referral. If the referral is declined for other reasons, the guidance suggests that other steps should be taken to resolve the matter (*e.g.*, meeting with the registrant's senior management, asking the registrant to employ an outside consultant, etc.).

To The Interested Divisions

We analyzed whether early communication between the Examination Program and the interested divisions² (ID) makes an Enforcement referral more likely to be investigated. Unlike the early communication with Enforcement (see above), we found no relationship between early communication with the ID and whether the referral was investigated.

Nevertheless, Market Regulation and Investment Management believe that they should be involved early in the Enforcement referral process, especially if the referral involves interpretation of rules or policy. The ID can suggest legal theories to the Enforcement staff, recommend whether the alleged deficiency warrants a

¹ There were a total of 191 referrals of which 139 were BD and 52 were IA. Forty-two of the referrals were rejected while 145 were investigated. The number of rejected referrals and investigations does not equal 191 because one referral was subsequently not considered a formal referral by the Examination staff in OCIE and the field offices, and there are currently (according to NRSI as of June 28, 2001) three referrals that are in the preliminary stage (*i.e.*, MUI). Thus, we are unsure whether these referrals will be rejected or investigated.

² An interested division is the Division that is primarily responsible for the rulemaking in a specific aspect of the securities industry. For example, the Division of Investment Management is responsible for rulemaking, issuing interpretative guidance, etc for Investment Advisors.

referral, etc. The Division of Enforcement indicated that it prefers early examiner and/or Enforcement consultation with the ID so that potential problems are identified. The Commission's approval of a recommended enforcement action often is significantly influenced by the ID's views. Therefore, the IDs need to provide timely, consistent, and material comments that represent the views of the senior managers of the IDs as soon as possible. Early consultation with an ID should help prevent spending resources on investigations that the ID does not support.

Recommendation B

OCIE should instruct the Examination staff in OCIE and the field offices to consult, when appropriate, with the IDs as early as possible to obtain their views.

In August 1998, OCIE issued guidance that stated that the Examination staff in OCIE and the field offices should discuss novel or unique issues of law as soon as possible with OCIE and with the IDs, and seek their assurance that if the alleged deficiency can be proven, they would support the action. OCIE also recommended that the examination staff provide copies of examination reports to the IDs that involve novel, complex, or unique issues.

To The Entity Examined

During our prior audit, some Examination staff in the field offices stated that when an Enforcement referral is made, the alleged deficiency is not communicated to the entity that was examined. However, the entity could guess the nature of the alleged deficiency based on the documents requested or questions asked during the examination. Communicating the alleged deficiency to the entity can help obtain corrective action sooner and protect investors.

In August 1998, OCIE issued guidance on communicating alleged deficiencies to the entity. It stated that the preference was to communicate all deficiencies to the registrant so that prompt corrective action could be implemented. It further stated that Examination staff in OCIE and the field offices should determine the Enforcement staff's preference on communication, based on the referral's nature, and that in some situations, such as where the registrant may destroy books and records, funds may be dissipated, or emergency Enforcement action is likely, a deficiency letter should not be sent.

We found that the field offices have different procedures for communicating the alleged deficiencies to the entity when an Enforcement referral has already been made. Some offices include the deficiencies in a deficiency letter in these situations; others do not.

Recommendation C

The Division of Enforcement, in consultation with OCIE and the field offices, should provide general advice to their respective staffs as to when it may not be appropriate to inform the entity of alleged deficiencies uncovered during examinations. As these decisions are often based on a number of variables

unique to a particular situation, however, the approach to be used in a specific matter should still be determined on a case-by-case basis.

MONITORING ENFORCEMENT REFERRALS

Our prior audit recommended improvements in the Examination Program's monitoring of Enforcement referrals. OCIE concurred, and stated that the new STARS system ("Super Tracking And Reporting System") would enhance Enforcement referral tracking.

However, Examination staff must still obtain status information from the Enforcement staff, rather than directly from STARS. OCIE has asked the Office of Information Technology (OIT) to interface STARS with Enforcement's CATS2000 system. Nevertheless, Enforcement staff should regularly discuss the status of referrals with the Examination staff. OCIE and senior examination management officials in the field offices need timely information about whether referrals are accepted, why they are rejected, whether the referrals result in Enforcement actions, etc. in order to evaluate the effectiveness of the Examination Program.

Also, Examination staff do not generally record in STARS information as to why a referral was rejected or an investigation closed without action. This makes monitoring Enforcement referrals more difficult. Moreover, STARS does not provide a periodic report on rejected Enforcement referrals or investigations closed without an action. Such a report (or similar technique) would alert Examination staff, so they could possibly take prompt relevant action (*e.g.*, refer an alleged deficiency to an SRO, state securities commission, or another appropriate field office).

Recommendation D

OCIE should continue to work with OIT and the Division of Enforcement to establish an interface between STARS and CATS2000 or an effective alternative (*e.g.*, the Division of Enforcement could provide the Examination Program with CATS2000 reports). Timely information is necessary for OCIE and senior examination management officials in the field offices to evaluate the effectiveness of the Examination Program.

Recommendation E

OCIE and the Division of Enforcement, in consultation with the field office heads, should develop a generic "check the box" data field in STARS that would reflect very basic information regarding the rejection of the referral. This should assist OCIE and senior examination management officials in the field offices in their efforts to monitor the status and trends in Enforcement referrals. Nevertheless, Enforcement staff should still timely communicate their reasons for rejecting referrals.

Recommendation F

OCIE should develop a periodic STARS report (or other similar technique) of the status of all Enforcement referrals and referrals closed without action so that the Examination staff can take prompt action, if appropriate.