



U.S. Securities and Exchange Commission
Office of Inspector General
Office of Audits

Audit of the Office of Compliance Inspections and
Examinations' Investment Adviser Examination
Completion Process





OFFICE OF
INSPECTOR GENERAL

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

M E M O R A N D U M

July 21, 2017

TO: Peter Driscoll, Acting Director, Office of Compliance Inspections and Examinations

FROM: Carl W. Hoecker, Inspector General 

SUBJECT: *Audit of the Office of Compliance Inspections and Examinations' Investment Adviser Examination Completion Process, Report No. 541*

Attached is the Office of the Inspector General (OIG) final report detailing the results of our audit of the Office of Compliance Inspections and Examinations' (OCIE) investment adviser examination completion process. The report contains three recommendations for corrective action that, if fully implemented, should improve OCIE's internal controls over the examination completion process and enhance oversight of examination outcomes generally.

On June 28, 2017, we provided management with a draft of our report for review and comment. In its July 14, 2017, response, management concurred with our recommendations. We have included management's response as Appendix II in the final report.

Within the next 45 days, please provide the OIG with a written corrective action plan that addresses the recommendations. The corrective action plan should include information such as the responsible official/point of contact, timeframe for completing required actions, and milestones identifying how the agency will address the recommendations.

We appreciate the courtesies and cooperation extended to us during the audit. If you have questions, please contact me or Rebecca L. Sharek, Deputy Inspector General for Audits, Evaluations, and Special Projects.

Attachment

cc: Jay Clayton, Chairman
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Executive Summary

Audit of the Office of Compliance Inspections and Examinations' Investment Adviser Examination Completion Process Report No. 541 July 21, 2017

Why We Did This Audit

The U.S. Securities and Exchange Commission's (SEC) National Examination Program (NEP), conducted by the Office of Compliance Inspections and Examinations (OCIE), is risk-based and data-driven. As part of the NEP, OCIE examines SEC-registered entities, including about 12,000 investment advisers (IAs). According to the SEC's Fiscal Year (FY) 2016 Agency Financial Report, "OCIE uses the findings from these examinations to improve industry compliance, detect and prevent fraud, inform policy, and identify risks." We initiated this audit to assess the controls over OCIE's IA examination completion process, and to follow-up on prior Office of Inspector General (OIG) recommendations.

What We Recommended

We recommended that OCIE (1) design control activities related to the review and approval of examination work products to require adequate segregation of duties, (2) update NEP policies and procedures to more clearly define the requirements for documenting in TRENDS examination meetings and interviews, and (3) develop and disseminate to OCIE staff guidance for assigning final examination risk ratings before closing examinations. Management concurred with the recommendations, which will be closed upon completion and verification of corrective action.

What We Found

We found that controls over OCIE's IA examination completion process are generally effective but improvements are needed. We reviewed documentation from all IA Corrective Action Reviews (CARs) OCIE approved between FYs 2015 and 2016 and closed in the Tracking and Reporting Examination National Documentation System (TRENDS) as of November 22, 2016. We also reviewed documentation from a statistical sample of 240 of the 2,443 IA examinations OCIE approved and closed in TRENDS during the same period. We did not find any deficiencies related to the IA CARs we reviewed. Moreover, we determined that OCIE has addressed prior OIG recommendations. However, we also identified deficiencies in OCIE's IA examination completion controls that warrant management's attention. Specifically, we found that:

- two IA examination completion controls regarding control sheets and post-exam fieldwork lacked adequate segregation of duties;
- examiners did not always document preliminary exit interviews with examined IAs; and
- examiners either did not assign final risk ratings, or may have assigned final risk ratings inconsistently.

These deficiencies occurred because sufficiently robust policies and controls were not in place to prevent their occurrence. If OCIE does not appropriately review and consistently document IA examination results and risk assessments (1) examination work products may be more susceptible to error, (2) OCIE examiners' ability to sufficiently review prior examination findings and perform comprehensive risk assessments may be reduced, and (3) OCIE may not effectively consider the results of examinations during its evaluation of risk for future examinations. OCIE can improve its IA examination completion process and internal controls by updating or documenting policies and procedures consistent with the Standards for Internal Control in the Federal Government.

During the audit, we also inquired about the status of (1) recommendations OCIE received in November 2016 from a consultant's efficiency study, and from an internal steering committee; and (2) plans to apply to the NEP the Government Accountability Office's Risk-Management Framework. We discussed with OCIE management, including the Acting Director, these other matters of interest, which did not warrant recommendations. We will continue to monitor these matters, as needed.

For additional information, contact the Office of Inspector General at (202) 551-6061 or <http://www.sec.gov/oig>.

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ABBREVIATIONS

CAR	Corrective Action Review
DAS	Data and Analytic Solutions, Inc.
ERP	Enterprise Resource Performance, Inc.
FY	fiscal year
GAO	U.S. Government Accountability Office
IA	investment adviser
NEP	National Examination Program
OCIE	Office of Compliance Inspections and Examinations
OIG	Office of Inspector General
SEC or agency	U.S. Securities and Exchange Commission
TRENDS	Tracking and Reporting Examination National Documentation System

Background and Objectives

Background

The Office of Compliance Inspections and Examinations' (OCIE) conducts the U.S. Securities and Exchange Commission's (SEC or agency) National Exam Program (NEP). The NEP's mission is to protect investors, ensure market integrity, and support responsible capital formation through risk-focused strategies that (1) improve compliance with Federal securities laws, (2) prevent fraud, (3) monitor risk, and (4) inform the SEC's regulatory policy. Under the NEP, OCIE uses a risk-based, data-driven process to select entities for examination. Examiners in Washington, DC, and the SEC's 11 regional offices (examination staff) are charged with overseeing about 26,000 market participants. These include about 12,000 investment advisers (IAs), about 10,000 mutual funds and exchange-traded funds, more than 4,000 broker-dealers, 400 transfer agents, and self-regulatory organizations including 21 securities exchanges, 7 active registered clearing agencies, and the Financial Industry Regulatory Authority. In addition, OCIE conducts a limited number of Corrective Action Reviews (CARs) to verify whether examined entities took corrective actions in response to deficiencies identified during previous OCIE examinations. Because IA's represent the largest segment of the population examined by OCIE, OCIE allocates the majority of its examination resources to its IA program.

To standardize examination processes and documentation and to provide guidance and requirements for examination staff, OCIE management established NEP policies and procedures. In addition, OCIE management implemented the Tracking and Reporting Examination National Documentation System (TRENDS), which examination staff use to document work performed and deficiencies identified during examinations. NEP policies and procedures and TRENDS contribute to OCIE's control environment and provide a foundation of required processes and automated controls that facilitate examination completion.

Objectives

Our objective was to determine whether OCIE established effective controls over its IA examination completion process, including but not limited to the issuance and resolution of deficiency letters and the performance of CARs, to improve compliance with Federal securities laws, prevent fraud, inform policy, and monitor risk. Specifically, we sought to determine whether OCIE:

1. established effective controls (including systems, policies, and procedures) to complete examinations and resolve identified deficiencies;
2. established effective controls (including systems, policies, and procedures) to perform and document CARs; and

3. effectively used findings from examinations and CARs as part of its risk-based, data-driven examination selection process.

We also reviewed OCIE's planned and completed corrective actions resulting from a prior Office of Inspector General (OIG) evaluation.¹

Our audit covered fiscal years (FYs) 2015 and 2016 (the period between October 1, 2014, and September 30, 2016). Because the majority of OCIE's examination resources are allocated to its IA program, we focused on IA CARs and examinations. Specifically, our universe consisted of IA CARs and IA examinations approved in FYs 2015 and 2016 that were closed in TRENDS as of November 22, 2016. To address our objectives, we reviewed:

- NEP policies and procedures, OCIE's Risk and Control Matrix, and TRENDS guidance used to complete examinations and resolve deficiency letters;
- TRENDS documentation from all IA CARs and from a statistical sample of 240 of the 2,443 IA examinations approved and closed in TRENDS during the period reviewed to determine compliance with requirements, including requirements for issuing and resolving deficiency letters; and
- OCIE's use of examination data in its risk-based, data-driven examination selection process and relevant examination planning documents and guidance.

Appendix I includes additional information on our scope and methodology, our review of internal controls, and prior coverage.

¹ U.S. Securities and Exchange Commission, Office of Inspector General, *Office of Compliance Inspections and Examinations' Management of Investment Adviser Examination Coverage Goals* (Report No. 533; March 10, 2016).

Results

Controls Over OCIE's IA Examination Completion Process Are Generally Effective But Improvements Are Needed

We did not find any deficiencies related to the IA CARs approved in FYs 2015 and 2016 and closed in TRENDS as of November 22, 2016. Moreover, we determined that OCIE has addressed recommendations made in OIG Report No. 533. However, we tested each of the 240 IA examinations we reviewed for compliance with 16 IA examination completion requirements established in OCIE policies and procedures² and identified deficiencies that warrant management's attention. Specifically, although 12 of the 16 controls we tested (or 75 percent) were sufficiently designed and operating effectively, we found that:

- 2 IA examination completion controls lacked adequate segregation of duties;
- examiners did not always document preliminary exit interviews with examined IAs; and
- examiners either did not assign final risk ratings, or may have assigned final risk ratings inconsistently.

As described further below, these deficiencies occurred because sufficiently robust policies and controls were not in place to prevent their occurrence. If OCIE does not appropriately review and consistently document IA examination results and risk assessments (1) examination work products may be more susceptible to error, (2) OCIE examiners' ability to sufficiently review prior examination findings and perform comprehensive risk assessments may be reduced, and (3) OCIE may not effectively consider the results of examinations during its evaluation of risk for future examinations. OCIE can improve its IA examination completion process and internal controls by updating or documenting policies and procedures consistent with the Standards for Internal Control in the Federal Government.

Two Controls Lacked Adequate Segregation of Duties. NEP policies and procedures require that examination staff document their actions, analysis, observations, and conclusions in TRENDS control sheets. Control sheets are organized by risk areas and contain fields where OCIE staff can enter examination

² We determined the 16 IA examination completion requirements by reviewing and selecting testing attributes from OCIE's Risk and Control Matrix, NEP policies and procedures, and TRENDS guidance. For OCIE's Risk and Control Matrix, we included testing attributes from 6 of 97 control activities.

findings, sampling logic, key procedures performed, general comments, and control sheet approval information. NEP policies and procedures further require that examination staff submit control sheets to an Exam Manager or Assistant Director for review. Exam Manager or Assistant Director approval is also required for post-fieldwork completion steps documented in TRENDS, including control sheet review, final risk rating selection, and finalization of examination findings. Nonetheless, we found a lack of segregation of duties for the submission and review of TRENDS control sheets and post-fieldwork completion information.

Specifically, for 58 of the 240 IA examinations we reviewed (or about 24 percent), an OCIE supervisor³ both submitted and reviewed in TRENDS at least one examination control sheet. In addition, OCIE supervisors both submitted and approved post-fieldwork completion information in TRENDS for 56 of the 240 IA examinations we reviewed (or about 23 percent). Therefore, we estimate that about 600 of the 2,443 IA examinations approved in FYs 2015 and 2016 (or about 25 percent) lacked adequate segregation of duties in at least one of these two areas.⁴ In October 2016, the U.S. Government Accountability Office (GAO) also reported OCIE's lack of segregation of duties related to TRENDS workbook approval.⁵ GAO found that, in 11 of the 92 exams it tested, the same Exam Manager both submitted and approved examination workbooks.

According to GAO's *Standards for Internal Control in the Federal Government*,⁶ management considers segregation of duties in designing control activity responsibilities so that incompatible duties are segregated and, where such segregation is not practical, management designs alternative control activities to address the risk. Moreover, management considers the need to separate control activities related to authority, custody, and accounting of operations to achieve adequate segregation of duties. In accordance with these principles, mitigating control activities should be used when segregation cannot be obtained or is not practical.

Although NEP policies and procedures require that examination staff use TRENDS control sheets to document their actions, analysis, observations, and conclusions, neither NEP policies and procedures nor TRENDS prohibits OCIE supervisors from reviewing and approving control sheets and post-fieldwork completion information that they created. According to OCIE management, the lack of segregation of duties is

³ OCIE supervisors include both Exam Managers and Assistant Directors.

⁴ We estimate that supervisors both submitted and reviewed at least one control sheet for as many as 619 IA examinations. We also estimate that supervisors both submitted and approved post-fieldwork completion information in TRENDS for as many as 598 IA examinations.

⁵ U.S. Government Accountability Office, *Management Has Enhanced Supervisory Controls and Could Further Improve Efficiency* (GAO-17-16, October 2016).

⁶ U.S. Government Accountability Office, *Standards for Internal Control in the Federal Government* (GAO-14-704G, September 2014).

mitigated by a requirement that an Assistant Director sign each examination disposition letter, which indicates overall approval of the entire examination. Therefore, OCIE management supports the current practice and values the flexibility it provides.

Because OCIE supervisors submitted examination control sheets and post-fieldwork status information that they also reviewed and approved,⁷ control activities in these areas are not operating as effectively as they should. Without adequate segregation of duties in examination review and approval processes, IA examination work products may be more susceptible to error. Undue risk is created when workpapers that support examination conclusions are not directly reviewed by an OCIE supervisor, as intended by the design of the control activities and NEP policies and procedures. We believe that segregation of the review and approval of control sheets and post-fieldwork completion information is practical within OCIE's NEP operations.

Examiners Did Not Always Document Preliminary Exit Interviews. OCIE examiners conduct preliminary exit interviews to inform the examined entity of the next steps in the examination process, as well as to discuss preliminary findings or concerns that require immediate attention. The preliminary exit interview is generally held on the last day of the on-site review. We found that examiners who conducted 133 of the 240 IA examinations we reviewed (or about 55 percent) did not document preliminary exit interviews. Therefore, we estimate that as many as 1,327 of the 2,443 IA examinations approved in FYs 2015 and 2016 (or about 54 percent) lacked documentation of preliminary exit interviews.

According to NEP policies and procedures, notes from interviews are considered examination workpapers, and examination staff should store all workpapers in TRENDS or in an approved off-TRENDS storage site. NEP policies and procedures also state that the examination team, in consultation with their supervisors, should determine the appropriate note-taking protocol for the examination. Generally, at least one member of the examination team should take notes of interviews, and all notes taken should be maintained with the workpapers and should include the date of the interview, the name of participants, and the matters discussed.

Although NEP policies and procedures require examiners to retain interview notes in the examination workpapers, the policies and procedures do not specifically address documentation requirements for preliminary exit interviews. Also, TRENDS guidance does not specify expectations for the "Exit Interview" fields in TRENDS, and TRENDS allows examination staff to close examinations without including preliminary exit information in these fields.⁸ We determined that examiners primarily use the TRENDS "Exit Interview" fields to document the exit conference call, which is a separate meeting

⁷ In TRENDS, the control sheet approval history indicates a reviewed status when complete, while the post-fieldwork completion history indicates an approved status when complete.

⁸ The TRENDS "Exit Interview" fields document whether an exit interview was conducted, the exit interview date, and a narrative of the examiners' "Interview Comments."

typically held after the examination findings have been determined and approved by an OCIE supervisor. According to OCIE management, regional offices have varying practices with respect to whether or not examiners conduct preliminary exit interviews and how, if at all, to document such interviews.

However, unclear guidance and expectations can lead to inconsistent examination documentation among OCIE examination staff. Key interviews that support examination conclusions, including identification of deficiencies, may not be documented in TRENDS, which could reduce OCIE examiners' ability to sufficiently review prior examination findings and perform comprehensive risk assessments. Additionally, examiners may be unable to recall certain details or conclusions reached from the preliminary exit interview, which may inhibit their ability to support discussions held with the examined entity in the future, if needed.

Examiners Did Not Always Assign Final Examination Risk Ratings or May Have Assigned Them Inconsistently. Final examination risk ratings are one of many components OCIE uses in its risk-based, data-driven examination selection process. However, we found that examiners did not assign final risk ratings for 23 of the 240 IA examinations we reviewed (or about 10 percent). Therefore, we estimate that examiners did not assign final risk ratings for as many as 226 of the 2,443 IA examinations approved in FYs 2015 and 2016 (or about 9 percent). Moreover, those examiners who assigned final risk ratings in FYs 2015 and 2016 may have done so inconsistently.

According to OCIE management, before May 2016, OCIE management and TRENDS system controls did not require examiners to assign a final risk rating before closing an examination. We confirmed this assertion through our testing. Specifically, the 23 IA examinations we reviewed that were missing final risk ratings were closed before May 2016. All IA examinations we reviewed that were closed after May 2016 included final risk ratings. Additionally, we confirmed that the current TRENDS guidance states that final risk rating information must be included in TRENDS before closing an examination.

Although the current version of TRENDS ensures examiners must assign a final risk rating before closing each examination, NEP policies and procedures do not provide examiners with guidance for assigning final risk ratings. Likewise, TRENDS guidance does not direct examiners on how to complete this step, other than to "select a final risk rating for the registrant from the drop down [menu]." According to OCIE management, examination staff assign final risk ratings based on their judgment, experience, and the findings of the examination.

However, prior examination results can influence OCIE's risk-based, data-driven examination selection process, and the lack of guidance and instruction provided to examiners regarding final risk rating selection may have contributed to incomplete or inconsistent final IA examination risk ratings in FYs 2015 and 2016. Specifically, according to personnel from OCIE's Office of Risk Analysis and Surveillance, OCIE's risk assessment process is based, in part, on prior OCIE examinations. Personnel from the Office of Risk Analysis and Surveillance analyze prior examination results along with

other factors, including annual NEP priorities and data from regulatory filings, to develop an initial risk profile which constitutes several risk-based outputs for each SEC-registered IA (for example, inherent risk, workforce risk, and controls-based risk). The Office of Risk Analysis and Surveillance then prepares annual IA examination planning information by IA, which is accessible to all OCIE examiners through OCIE's intranet. Therefore, a continued lack of guidance regarding assigning final examination risk ratings could lead to inconsistent final risk ratings in the future, which could negatively impact OCIE's ability to assess and select IAs for future examination.

Recommendations, Management's Response, and Evaluation of Management's Response

To improve OCIE's internal controls over the IA examination completion process, we recommend that OCIE:

Recommendation 1: Design control activities related to the review and approval of examination work products to require segregation of duties, and update NEP policies and procedures and TRENDS system controls and guidance, as needed, to reflect this requirement.

Management's Response. OCIE's Acting Director concurred with the recommendation and stated that OCIE has controls in place to ensure Assistant Directors review important aspects of the examination from pre-examination fieldwork to citing a regulated entity for deficiencies. The Acting Director further stated that OCIE will strengthen other controls, as well as update its policies and procedures and TRENDS, to ensure adequate segregation of duties at intermediate phases of the examination process. Management's complete response is reprinted in Appendix II.

OIG's Evaluation of Management's Response. Management's proposed actions are responsive; therefore, the recommendation is resolved and will be closed upon verification of the action taken.

Recommendation 2: Update NEP policies and procedures to more clearly define the requirements for documenting in TRENDS examination meetings and interviews, including preliminary exit interviews, and make corresponding revisions to the TRENDS system controls and guidance, as needed.

Management's Response. OCIE's Acting Director concurred with the recommendation and stated that OCIE senior management should more clearly define expectations for examination staff when it comes to conducting and documenting preliminary exit interviews. The Acting Director also acknowledged that varying practices exist among regional offices due to a lack of clearly articulated policies and procedures. Management's complete response is reprinted in Appendix II.

OIG's Evaluation of Management's Response. Management's proposed actions are responsive; therefore, the recommendation is resolved and will be closed upon verification of the action taken.

Recommendation 3: Develop and disseminate guidance for assigning final examination risk ratings, and notify all OCIE examination staff of the requirement and importance of selecting final examination risk ratings before closing examinations.

Management's Response. OCIE's Acting Director concurred with the recommendation and stated that OCIE's Exam Process Steering Committee reviewed the use of final examination risk ratings and, in consultation with OCIE senior management, will recommend guidance for assigning final examination risk ratings. Management's complete response is reprinted in Appendix II.

OIG's Evaluation of Management's Response. Management's proposed actions are responsive; therefore, the recommendation is resolved and will be closed upon verification of the action taken.

Other Matters of Interest

During the audit, we inquired about the status of (1) recommendations OCIE received in November 2016 from a consultant's efficiency study, and from an internal OCIE Exam Process Steering Committee; and (2) plans to apply to the IA program GAO's Risk-Management Framework. We discussed with OCIE management, including the Acting Director, these other matters of interest, which did not warrant recommendations.

Consultant's Study on Efficiency in the NEP. Under contract with the SEC, Enterprise Resource Performance, Inc. (ERP) conducted a 12-month assessment of the NEP and identified opportunities to increase the NEP's effectiveness and efficiency. ERP's final report, dated November 16, 2016, included recommendations for potential program enhancements related to OCIE's organizational structure, workload management, examination staffing, and other NEP processes.

SEC Chairman, Jay Clayton, was sworn in on May 4, 2017. OCIE management has provided to Chairman Clayton's staff ERP's report, and had previously briefed the Acting Chairman on the report's contents. As of the date of this audit report, OCIE management's review and consideration of the ERP report recommendations was ongoing.

Exam Process Steering Committee Recommendations. In February 2016, OCIE's Exam Process Steering Committee⁹ surveyed OCIE regional offices to study registrant risk analysis and exam selection practices. After reviewing the survey information, the Committee conducted follow-up interviews with each regional office in April 2016. On November 17, 2016, the Committee provided OCIE management a final report, which included five recommendations.

OCIE accepted the Committee's recommendations and plans to complete necessary updates to NEP policies and procedures by the end of FY 2017. Implementation of the recommendations should strengthen OCIE's candidate selection process and ensure regional offices follow minimum common procedures and documentation requirements, which should improve consistency and enhance OCIE's overall NEP control environment.

Implementation of GAO's Risk-Management Framework. In response to a recommendation from OIG Report No. 533, OCIE engaged a consultant (IBM Corporation) to better understand how each of the five components of GAO's Risk-

⁹ The Exam Process Steering Committee was formerly known as the Risk and Exam Process Steering Committee.

Management Framework¹⁰ could be applied to the NEP. OCIE awarded the contract to IBM Corporation in September 2016, and expects the project to be completed in early 2018.

As needed, we will continue to monitor and report on how OCIE prioritizes and takes positive steps to (1) assess and implement recommendations from ERP's efficiency study and from the internal Exam Process Steering Committee, and (2) consider the application of GAO's Risk-Management Framework to the NEP.

¹⁰ U.S. Government Accountability Office, *Further Refinements Needed to Assess Risks and Prioritize Protective Measures at Ports and Other Critical Infrastructure* (GAO-06-91, December 2005).

Appendix I. Scope and Methodology

We conducted this performance audit from October 2016 through July 2017 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope. Our objective was to determine whether OCIE established effective controls over its IA examination completion process, including but not limited to the issuance and resolution of deficiency letters and the performance of CARs, to improve compliance with Federal securities laws, prevent fraud, inform policy, and monitor risk. Specifically, we sought to determine whether OCIE:

1. established effective controls (including systems, policies, and procedures) to complete examinations and resolve identified deficiencies;
2. established effective controls (including systems, policies, and procedures) to perform and document CARs; and
3. effectively used findings from examinations and CARs as part of its risk-based, data-driven examination selection process.

We also reviewed the implementation of corrective actions from a prior OIG evaluation titled, *Office of Compliance Inspections and Examinations' Management of Investment Adviser Examination Coverage Goals* (Report No. 533; March 10, 2016).

The audit covered FYs 2015 and 2016 (the period between October 1, 2014, and September 30, 2016). Because the majority of OCIE's examination resources are allocated to its IA program, we focused on IA CARs and examinations. Specifically, as discussed further below, our universe consisted of IA CARs and IA examinations approved in FYs 2015 and 2016 and closed in TRENDS as of November 22, 2016.¹¹

Methodology. We performed fieldwork at the SEC's Headquarters in Washington, DC. To address our audit objectives, we reviewed:

- NEP policies and procedures, OCIE's Risk and Control Matrix, and TRENDS guidance used to complete examinations and resolve deficiency letters;

¹¹ OCIE considers an examination approved once the examination fieldwork is reviewed and approved in TRENDS and the disposition letter is signed and issued to the examined entity. An approved examination may be in "pending response" status after the disposition letter is issued. To ensure we tested examinations that were complete in TRENDS, we included only IA examinations approved in FYs 2015 and 2016 with a "closed" status in TRENDS as of November 22, 2016.

- Federal securities laws related to the SEC’s authority to conduct inspections and examinations;
- TRENDS documentation from all IA CARS and from a statistical sample of 240 of the 2,443 IA examinations approved and closed in TRENDS during the period reviewed to determine compliance with requirements, including requirements for issuing and resolving deficiency letters; and
- the corrective actions taken and planned to address the recommendations made in OIG Report No. 533.

We also:

- interviewed officials from OCIE’s NEP and Office of Chief Counsel to gain an understanding of the NEP and to discuss the IA examination and CAR test attributes we identified;
- interviewed officials from OCIE’s Office of Risk Analysis and Surveillance to gain an understanding of how OCIE uses examination data in its risk-based, data-driven examination selection process;
- confirmed OCIE’s use of examination data in its risk-based, data-driven examination selection process by reviewing relevant examination planning documents and guidance;
- conducted a walkthrough of TRENDS; and
- assessed the reliability of relevant TRENDS data.

We engaged a contractor—Data and Analytic Solutions, Inc. (DAS)—to develop our sampling methodology. The sample size was determined using a desired confidence level of 95 percent, a tolerance rate of 50 percent, and a presumed error rate of ± 6 percent. As of November 22, 2016, OCIE approved and closed in TRENDS 2,443 IA examinations for FYs 2015 and 2016. Using the sampling methodology developed by DAS, we selected a statistical sample of 240 of these 2,443 IA examinations, stratified by year, SEC regional office, and examination disposition type.¹² Therefore, the sample included randomly selected IA examinations of different examination disposition types from each regional office population in each year. We tested each sampled IA examination for compliance with 16 IA examination completion requirements. We determined these 16 IA examination completion requirements by reviewing and selecting testing attributes from OCIE’s Risk and Control Matrix, NEP

¹² The statistical sample ensured that all SEC regional offices were represented for both FYs under review, and that each examination disposition type (Deficiency Letter, Close-Out Letter, and No-Further-Action Letter) was represented in each regional office sample.

policies and procedures, and TRENDS guidance. For OCIE's Risk and Control Matrix, we included testing attributes from 6 of 97 control activities.

We tested all IA CAR examinations for FYs 2015 and 2016, which were approved and closed in TRENDS as of November 22, 2016, for compliance with the five examination requirements established in NEP policies and procedures that are unique to CAR examinations.

Internal Controls. To assess internal controls relative to our objectives, we reviewed OCIE's management assurance statements and risk assessments for FYs 2015 and 2016. In its FY 2015 management assurance statement, OCIE management reported that it tested 26 control activities to evaluate the design and effectiveness of OCIE's internal controls. OCIE management identified areas requiring improvement but reported that the areas did not create the risk of material weakness. OCIE management concluded that its controls and processes in place provide reasonable assurance that the NEP's operations and programs are effective and efficient. Additionally, in its FY 2016 management assurance statement, OCIE management reported testing 21 control activities to evaluate the design and effectiveness of OCIE's internal controls. OCIE management reported no material weaknesses in controls and concluded that the controls and processes in place provided reasonable assurance that the NEP's operations and programs were effective and efficient.

We assessed OCIE's control environment in accordance with GAO's *Standards for Internal Control in the Federal Government*. We tested key internal controls associated with OCIE's IA examination completion process and requirements specific to IA CARs. Specifically, as part of our review of select IA examinations and CARs, we assessed OCIE's controls related to (1) management review of examination work products, (2) documentation of examination interviews and meetings, (3) TRENDS review and approval processes, (4) documentation of examination findings and disposition letters, and (5) selection of final examination risk ratings. We found that controls over the IA examination completion process were generally effective in supporting OCIE's mission, but noted that improvements should be made. As stated in this report, we identified opportunities for OCIE to improve how management and staff review examination fieldwork, document preliminary exit interviews, and select and assign final examination risk ratings. Our recommendations, if implemented, should strengthen OCIE's control environment and improve the IA examination completion process.

Computer-processed Data. GAO's *Assessing the Reliability of Computer-Processed Data* (GAO-09-680G, July 2009) states that "data reliability refers to the accuracy and completeness of computer-processed data, given the uses they are intended for. Computer-processed data may be data (1) entered into a computer system or (2) resulting from computer processing." Furthermore, GAO-09-680G defines "reliability," "completeness," and "accuracy" as follows:

- "Reliability" means that data are reasonably complete and accurate, meet your intended purposes, and are not subject to inappropriate alteration.

- “Completeness” refers to the extent that relevant records are present and the fields in each record are appropriately populated.
- “Accuracy” refers to the extent that recorded data reflect the actual underlying information.

To address our objectives, we relied on examination data from OCIE’s TRENDS. To assess the reliability, completeness, and accuracy of the data from TRENDS, we interviewed OCIE personnel, obtained access to TRENDS, and conducted walk-throughs to determine the system’s capabilities. We used TRENDS reports to perform limited reliability testing and reviewed TRENDS information system controls, as well as security assessment and contingency planning documents. We determined that the TRENDS report data was sufficiently reliable to address our audit objectives.

Prior Coverage. During 2016, the SEC OIG and GAO issued the following two reports of particular relevance to this audit:

SEC OIG:

- *Office of Compliance Inspections and Examinations’ Management of Investment Adviser Examination Coverage Goals* (Report No. 533, March 10, 2016)

GAO:

- *Management Has Enhanced Supervisory Controls and Could Further Improve Efficiency* (GAO-17-16, October 2016)

These reports can be accessed at:

https://www.sec.gov/about/offices/oig/inspector_general_audits_reports.shtml (SEC OIG) and <https://www.gao.gov> (GAO).

Appendix II. Management Comments

MEMORANDUM

TO: Rebecca L. Sharek
Deputy Inspector General for Audits, Evaluations, and Special Projects
Office of the Inspector General

FROM: Pete Driscoll *LDK*
Acting Director, Office of Compliance Inspections and Examinations

RE: Office of Compliance Inspections and Examinations' Response to the Office of Inspector General's Report, *Audit of the Office of Compliance Inspections and Examinations' Investment Adviser Completion Process*

DATE: July 14, 2017

The Office of Compliance Inspections and Examinations ("OCIE") submits this memorandum in response to the Office of Inspector General's ("OIG") draft report number 541 titled *Audit of the Office of Compliance Inspections and Examinations' Investment Adviser Completion Process* ("Report").

Over the past several years, OCIE has made significant improvements in standardizing its nationwide examination process through the use of technology, including the implementation of the TRENDS system to create electronic, integrated workpapers that track examinations from pre-exam research and scoping through final conclusions, and the development of program-wide policies and procedures, which place additional controls over the examination process. OCIE appreciates the OIG's findings that 75 percent of the examination process controls it tested were "sufficiently designed and operating effectively" and that the OIG found no deficiencies with respect to OCIE's investment adviser ("IA") corrective action reviews.

We welcome the OIG's recommendations¹ to strengthen controls around three aspects of OCIE's examination completion process. Our response to the recommendations is below.

Recommendation 1: *Design control activities related to the review and approval of examination work products to require segregation of duties, and update the NEP policies and procedures and TRENDS system controls and guidance, as needed, to reflect this requirement.*

OCIE concurs with this recommendation. OCIE has two key controls over the conclusion of its examination completion process that ensure the Assistant Director conducts a supervisory review and approval of examination work products. First, as noted in the Report, OCIE's policies and procedures provide that an Assistant Director should approve and sign the final examination disposition letter, which is usually a deficiency letter (after the Examination Manager has reviewed it). Second, OCIE's policies and procedures state that an Assistant Director closes an examination. These two controls

¹ The Report states on pages i and three that OCIE may not effectively "use the results of examinations to inform policy" because of the deficiencies identified in the Report. OCIE understands that this reference is to informing its own internal policies and procedures and not its ability to inform the Commission's public policy, such as rulemaking.

OIG comment: The language quoted in footnote 1 of OCIE's response appeared in the draft report, but OIG removed this language in the final report.

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ensure that an Assistant Director has reviewed important aspects of the examination from pre-examination fieldwork, such as background research and risk scoping, to citing a regulated entity for deficiencies. In order to be consistent with these two controls that OCIE believes do ensure appropriate segregation of duties at the point of approving the disposition letter and closing the examination, OCIE will strengthen other controls, as well as update its policies and procedures and TRENDS, to ensure adequate segregation of duties at intermediate phases of the examination process.

Recommendation 2: Update the NEP policies and procedures to more clearly define the requirements for documenting in TRENDS examination meetings and interviews, including preliminary exit interviews, and make corresponding revisions to the TRENDS system controls and guidance, as needed.

OCIE concurs with this recommendation. OCIE senior management should more clearly define its expectations for examination staff when it comes to conducting and documenting preliminary exit interviews. Due to a lack of clearly articulated program-wide policies and procedures, the OIG findings with respect to preliminary exit interviews reflect the fact that regional offices have varying practices with respect to whether or not examiners conduct preliminary exit interviews and when non-substantive, whether or not they are documented and where they are documented.

OCIE senior management's long-standing expectation is that examination staff will conduct an exit conference call, at which time examination staff will usually discuss potential deficiencies with senior management of the entity under examination and give the entity's senior management an opportunity to clarify facts that may impact the examination staff's analysis or conclusions regarding deficiencies. OCIE policies and procedures state that examination staff should take notes during the call and that the notes reflect the substance of the conversation. We also note that the OIG audit did not identify any deficiencies with respect to exit conference calls. OCIE believes that these requirements mitigate concerns raised by the OIG on page six of the Report with respect to potential consequences of undocumented preliminary interviews.

Recommendation 3: Develop and disseminate guidance for assigning final examination risk ratings, and notify all OCIE examination staff of the requirement and importance of selecting final examination risk ratings before closing examinations.

OCIE concurs with this recommendation. Last year OCIE's Exam Process Steering Committee ("EPSC") decided to conduct a program-wide review of OCIE's use of final examination risk ratings. As part of its review, the EPSC, in consultation with OCIE senior management, will also recommend guidance for assigning final examination risk ratings.

As noted in the Report, the final examination risk ratings "are one of many components" OCIE uses in its risk assessment process to develop an IA's risk profile. Furthermore, when examination staff assess a potential examination candidate, staff often review all aspects of prior examinations, including the type and scope of the prior examination and any deficiencies. Therefore, a final examination risk rating is one piece of a much larger process examination staff use in selecting IA examination candidates.

We appreciate the opportunity to review and comment on the Report. Please contact Jane Jarcho, Deputy Director and co-head of the IA/IC Examination Program, or Kristin Snyder, Associate Director and co-head of the IA/IC Examination Program, if you have any questions.

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Comments and Suggestions

If you wish to comment on the quality or usefulness of this report or suggest ideas for future audits, evaluations, or reviews, please send an e-mail to OIG Audit Planning at AUDplanning@sec.gov. Comments and requests can also be mailed to the attention of the Deputy Inspector General for Audits, Evaluations, and Special Projects at the address listed above.