

MEMORANDUM

TO: H. David Kotz, Inspector General
Office of the Inspector General

FROM: John H. Walsh, Associate Director - Chief Counsel
Office of Compliance Inspections and Examinations

DATE: June 5, 2009

RE: Measures to Enhance Timeliness and Internal Controls Relating to
Planning, Conducting, Documenting and Concluding Inspections and
Examinations

In our meeting on April 13, 2009, you invited us to inform you of recent measures we have taken to enhance the work of the Office of Compliance Inspections and Examinations ("OCIE"), particularly in regards to its Office of Market Oversight. We appreciate the opportunity and would like to inform you of the steps taken to enhance both the timeliness of inspections and examinations and the internal controls relating to planning, conducting, documenting, and concluding inspections and examinations. Please find below a summary of these measures.

Background

Among its responsibilities, OCIE conducts inspections of Self-Regulatory Organizations ("SROs"). These inspections tend to be large and lengthy reviews, with relatively large teams of examiners and voluminous workpapers. Reports of SRO inspections are reviewed by the Division of Trading and Markets and the Office of General Counsel, and are generally submitted to the Commission for its authorization to send the report to the relevant SRO.

OCIE utilizes a specialized staff in Washington D.C. to conduct these inspections. Through specialization, the staff gains in-depth experience with SRO operations and practices. Many of the areas subject to inspection are complex and require specialized knowledge. These include the SROs' member regulation programs; arbitration programs; surveillance, investigative and enforcement programs; programs for overseeing members' compliance with broker-dealers' financial responsibilities; programs for listing issuers; programs for enforcing broker-dealers' anti-money laundering responsibilities; and programs for regulating floor brokers by SROs that have trading floors; among others.

When OCIE was initially formed, it had one group devoted to conducting inspections of SROs. However, in 2000, recognizing the need for greater specialization, OCIE reorganized and divided its SRO inspection staff into two groups: "SRO 1" and "SRO 2." The SRO 1 Group focuses on inspecting the SROs' programs for providing trading facilities and overseeing members' trading activities. This specialization permits the group to develop and retain expertise in trading facilities and activities. The SRO 2

Group, on the other hand, focuses on inspecting the SROs' programs for overseeing members' activities away from the trading markets. This specialization permits the group to develop and retain expertise in member regulation, listings, arbitration, and the other areas subject to its review.

The SRO 1 Group is now known as OCIE's Office of Market Oversight ("Market Oversight"). Market Oversight's primary focus remains on the SROs. However, to assess the quality of SRO programs relating to trading activity, Market Oversight also conducts examinations of broker-dealers' trading activity. These examinations generally focus on specifically identified trading issues. For example, Market Oversight is currently conducting certain broker-dealer examinations related to short sales.

Two phenomena should be noted regarding the early years of Market Oversight's operations. First, Market Oversight conducted inspections and examinations on many high-profile issues, including research analysts' conflicts of interest, market-timing, specialists' trading ahead of customer orders, payment for shelf space by mutual funds (revenue sharing), and others. Many of these inspections and examinations ultimately found serious violations and were referred to the Division of Enforcement, and resulted in significant enforcement actions that, in some cases, resulted in the payment of penalties in the tens of millions of dollars. These projects required a significant commitment of staff time and resources. To meet these commitments, examiners in Market Oversight were frequently pulled from other inspections or examinations. As a result, through early 2007, while Market Oversight conducted many important and significant inspections and examinations, it was generally stretched very thin in the resources it had available to address its entire inventory of pending projects, and some of its projects suffered considerable delays.

Second, Market Oversight did not generally track its broker-dealer examinations in OCIE's Super Tracking and Reporting System ("STARS"), the database used to track examinations of broker-dealers, investment advisers, investment companies, and transfer agents. As a result, Market Oversight did not conform to the procedures and tracking reports generally applied to examinations of broker-dealers and other non-SRO entities.

In 2006 and 2007 there was significant turnover among managers and staff in Market Oversight, and by 2007, many of the managers in the office, including the Associate Director and two of the three Assistant Directors, were new. This new management team immediately focused on enhancing Market Oversight's timeliness and on formalizing its internal controls with respect to planning, conducting, documenting, and concluding inspections and examinations. The team's initiatives to improve timeliness and internal controls are summarized below.

Enhancements to the Timeliness of Inspections and Examinations

In 2007, under the new management team's leadership, Market Oversight began to emphasize the need to achieve greater timeliness in its inspections and examinations. In particular, the office focused on addressing and resolving older projects.

A concerted effort has been made to bring older projects to an appropriate conclusion. In many cases, new managers and new staff have been assigned to the pending projects, often because the prior managers and staff have left the agency or the office. While this has led to some challenges and delays, as managers and staff master the issues, it has brought a fresh perspective to the projects and enhanced the office's ability to resolve the projects and close them out.

Nonetheless, it should be noted that Market Oversight continues to work on high priority projects that include large and complex matters requiring substantial commitments of staff time and resources. For example, in 2008 Market Oversight conducted groundbreaking and resource intensive inspections of the three largest rating agencies. These inspections were the first to be conducted pursuant to new statutory authority. They found significant issues and resulted in a public report published by the Commission. Currently, Market Oversight is conducting a review of Regulation NMS that presently includes ten SRO inspections and a similar number of broker-dealer examinations. Finally, the office's annual review of SROs' collection of fees pursuant to Section 31 of the Securities Exchange Act continues to require a substantial commitment of staff resources.

Enhancements to Internal Controls with respect to Planning, Conducting, Documenting, and Concluding Inspections

In 2007, under the new management team's leadership, Market Oversight also began to emphasize the need to provide greater formality to its internal controls. In November 2007, the office issued improved *Market Oversight Document Policies and Procedures* (the "Guidelines"). The Guidelines formalize the group's processes for conducting inspections and examinations (hereinafter both will be referred to as "examinations"), including controls over planning, document requests, tracking, managing findings, workpaper and document retention, closing reports or memoranda, and enforcement referrals. These improvements are described below.

- **Planning Examinations:** Pursuant to the Guidelines, a planning memorandum must be created for each examination outlining the scope of the particular areas to be reviewed during the examination. In determining areas of review, staff should, among other things, conduct background research, consult prior examination reports and recent enforcement actions, and consider tips received, news reports, and other similar information.
- **Document Requests:** The Guidelines also establish consistent standards for initial document requests. The initial document request should ask for information that will provide a broad understanding of a Registrant's structure and its activities. Additionally, the Guidelines provide a list of items that should generally be requested in the initial document request, including an organizational chart, and copies of compliance policies and procedures, among other things.

- **Tracking Examinations:** According to the Guidelines, once an examination or inspection has been initiated, it must be entered into STARS. As previously noted, STARS is the database used by OCIE to track examinations of broker-dealers, investment advisers, investment companies, transfer agents, and now SROs. The Guidelines also instruct Market Oversight staff to implement new internal procedures for tracking the status of open examinations. Ongoing examinations are now monitored in the Market Oversight Project Tracking System which tracks summary project information and assists in staffing assignments. Staff is responsible for regularly updating STARS and the Market Oversight Project Tracking System on a monthly basis as the examination progresses. Staff must also contact a Registrant at least once every 120 days to discuss the status of the examination.

- **Conducting Examinations:** The Guidelines also address staff's review of documents and information obtained from a Registrant. The lead examiner and/or branch chief will assign a particular area for an examiner to review. Upon completing his or her assignment, the examiner shall consolidate his or her findings into a memorandum summarizing his or her analysis and relevant findings and recommendations. The lead examiner and/or branch chief shall then review the examiner's submissions. These memoranda are then incorporated into the final examination report.

- **Documenting Examination Work Performed:** The Guidelines also improved Market Oversight's workpaper and document retention policies. Examiners are to secure documents related to an examination in a central file location, including all correspondence with the Registrant. At the close of the examination, staff should organize, file and retain all appropriate documents in the central examination file.

- **Completing Examinations:** Once an examination is completed, the Guidelines require that each examination or inspection have a final closing report or memorandum. The responsible staff must also ensure that the appropriate correspondence is sent to the Registrant, such as an examination report, no further action letter, or deficiency letter. This information should also be included in the Project Tracking System.

- **Enforcement Referrals:** Finally, if the results of an examination warrant a referral to the Division of Enforcement, staff will prepare a formal memorandum to Enforcement staff. The formal memoranda are to be prepared in accordance with Enforcement referral guidelines that OCIE has established for all examinations.

Conclusion

Through these processes, since 2007, OCIE has taken active steps to enhance Market Oversight's timeliness and its controls over its work. The management team in OCIE

and Market Oversight continue to assess the office's timeliness and control environment and to consider additional enhancements.

We appreciate your consideration of these developments. If you have any questions we would be happy to meet with you to further explain these efforts.