

Compliance Inspections and Examinations

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

What We Did

- Inspected 228 investment company complexes, 1,405 investment advisers, 21 insurance company complexes, 659 broker-dealers, and 151 transfer agents. We also conducted 31 inspections of specific programs, including at least one program at each of the 11 SROs.
- Continued to increase cooperation among SEC examiners responsible for different types of regulated entities to increase effectiveness and productivity and enhance investor protection. Also enhanced cooperation with foreign, federal, and state regulators, as well as with the SROs. The staff conducted coordinated examinations with staff from the Hong Kong Securities and Futures Commission and the United Kingdom's Financial Services Authority.
- Conducted a coordinated program to review broker dealers' preparations for the conversion to decimal quotations in the markets. This included general

oversight reviews in which the staff, in collaboration with the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE), and the Chicago Board Options Exchange (CBOE) reviewed developments at broker-dealers representing a significant portion of trading volume in equities and options. The staff reviewed registrants' plans and procedures for dealing with potential decimalization problems, including remediation, testing, capacity, and contingency planning.

Investment Company and Investment Adviser Inspections

Investment Companies

Our examiners inspected 228 investment company complexes, including 14 fund administrators. The average frequency of inspections for investment company complexes was 5.2 years. The complexes inspected managed \$2.6 trillion in 11,115 portfolios, which represented approximately 33% of the 33,231 variable insurance products, unit investment trust and mutual and closed-end fund portfolios in existence at the beginning of 2001. The complexes inspected represented a mix of large and small complexes. Twenty-six of the inspections were done on a “for cause” basis, which means the staff had some reason to believe that a problem existed.

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

The staff identified deficiencies or control weaknesses that resulted in a deficiency letter in 206--or 90%--of investment company

examinations. Most frequent deficiencies or weaknesses resulting in deficiency letters were inadequate internal control procedures, impermissible conflicts of interest, inadequate oversight by board of directors, errors and omissions in registration and SEC filings, and books and records problems.

Serious deficiencies found during 8--or 4%--of the examinations warranted referrals for further investigation by the Division of Enforcement. The most common deficiencies resulting in referrals involved fraud; failure to disclose material information, including conflicts of interest; impermissible affiliated transactions; misleading advertising; and failure to properly calculate NAV.

Investment Advisers

The staff completed 1,405 inspections of investment advisers. The average frequency of inspections for the 7,417 registered investment advisers was 5.3 years. The non-investment company assets managed by the advisers inspected totaled \$3 trillion. The staff inspected 87 investment advisers for cause.

Many investment adviser examinations focused on adviser performance advertising, personal trading, and allocation of portfolio securities among accounts. We also continued focusing closely on how advisers fulfill their duty of best execution in client securities transactions.

The staff identified deficiencies or control weakness resulting in a deficiency letter in 1,251--or 89%--of investment adviser examinations. Most frequent deficiencies were related to inadequate internal control procedures, custody, errors and omissions in Form ADV or the brochure, books and records problems, and inadequate marketing and performance practices.

Serious deficiencies warranting enforcement referrals were uncovered in 54--or 4%--of the examinations. The most common deficiencies resulting in referrals involved fraud; failure to disclose

material information, including conflicts of interest; brokerage and execution practices; and related custody and books and records problems.

Mutual Fund Administrators

Many mutual fund complexes use third party administrators to perform their accounting and administrative functions. During 2001, 11 of 14 fund administrator inspections resulted in deficiency letters and one in an enforcement referral.

Variable Insurance Products

In response to the rapid growth in variable insurance product assets and the emergence of new channels of distribution, specialized insurance product teams conducted examinations in this area. These teams identified and examined variable life and annuity contract separate accounts. Deficiency letters were issued to each of the 21 insurance company complexes that were examined.

Broker-Dealer and Transfer Agent Examinations

Broker-Dealers

In fiscal 2001, the staff conducted 659 oversight, cause, and surveillance examinations of broker-dealers, government securities broker-dealers, and municipal securities dealers. These examinations included 113 branch office examinations. Deficiency letters were sent to 545 broker-dealers, representing 83% of those examined. Serious deficiencies discovered in 112--or 17%--of the examinations warranted referrals to the Division of Enforcement for further investigation. An additional 66 examination findings were referred to SROs for appropriate action. The most common deficiencies found were recordkeeping deficiencies, net capital computation errors, unsuitable recommendations to customers, and inadequate written supervisory procedures.

Examination staff continued to conduct reviews of selected broker-dealers' internal controls, involving risk management, funding and liquidity, credit, and operations. Broker-dealer examinations also focused on a variety of sales practices, including retail sales of low priced, speculative securities frequently referred to as microcap stock. The staff continued to examine the sales of variable annuity products, mutual fund switching, and brokered certificates of deposits. The staff also, in conjunction with the NYSE and NASD, conducted examinations of a significant portion of the broker-dealers that clear trades for day trading correspondent firms.

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

Examination staff continued initiatives to enhance cooperation with foreign, federal, and state regulators, as well as with SROs. Examiners worked through National Summit Meetings, Regional Summit Meetings, and other coordinated mechanisms to enhance cooperation and reduce any duplication of effort in broker-dealer examinations.

Transfer Agents

In 2001, our staff conducted 151 examinations of registered transfer agents, including 43 federally regulated banks. The program resulted in 121 deficiency letters, 10 cancellations or withdrawals of registrations, 11 referrals to the Division of Enforcement, 35 referrals to bank regulators, and one staff conference with a registrant. The examinations discovered 48 registrants with

deficiencies in compliance with the Lost Securities Rule. In addition, the staff completed three routine inspections of clearing agencies.

Self-Regulatory Organization Inspections

In fiscal 2001, the staff completed 31 inspections of SROs. The staff's inspections included at least one program at the following SROs:

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

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

The inspections focused on SRO programs dealing with arbitration, initial listing and continued listing of securities for trading, financial and operational surveillance and examinations of member firms, market surveillance, investigations, disciplinary actions, and the detection of and sanctioning for sales practice abuses. In addition, the staff conducted inspections relating to customer order handling requirements in the equities and options markets, alternative trading systems, payment for order flow and internalization, and trading of Nasdaq securities pursuant to unlisted trading privileges. These inspections resulted in

recommendations to improve each SRO's effectiveness and efficiency.

SRO Final Disciplinary Actions

Section 19(d)(1) of the Securities Exchange Act of 1934 and rule 19d-1 require all SROs to file reports with the SEC of all final disciplinary actions. In fiscal 2001, a total of 1,966 reports were filed with the SEC, as reflected in the following table.

SRO Reports of Final Disciplinary Action	
American Stock Exchange	10
Boston Stock Exchange	0
Chicago Board Options Exchange	26
Chicago Stock Exchange	1
Cincinnati Stock Exchange	2
National Association of Securities Dealers	1,725*
National Securities Clearing Corporation	0
New York Stock Exchange	188
Options Clearing Corporation	1
Philadelphia Stock Exchange	13
Pacific Exchange	<u>0</u>
Total Reports	1,966

*This number does not include 19d-1 reports filed regarding Nasdaq delistings.