

Compliance Inspections and Examinations

Overview

“In the examination program, we pride ourselves on our ability to respond quickly when new and significant compliance issues suddenly appear. We have worked to reduce the turn-around time between first warning and full regulatory response.”

Lori Richards, Director
Office of Compliance Inspections
and Examinations

We have 100 headquarters examination staff and 596 regional and district office staff conducting examinations. This staff is allocated to our respective functional programs approximately as follows: 399 for investment advisers and investment companies and 297 for broker-dealers, transfer agents, and self-regulatory organizations.

During 2003:

- Inspected 33 self-regulatory organization (SRO) programs.
- Examined 642 broker-dealers, 1,556 investment advisers, 265 investment companies, and 192 transfer agents.
- Conducted 12 special focus examination initiatives, including reviews of the safeguarding of customer records and information, mutual fund breakpoints, hedge funds, the “spinning” of initial public offering shares, best execution, variable annuities, bank loan participation funds and a program of joint examinations with state insurance regulators.
- In examinations of 92 broker-dealers, 55 investment advisers, 14 investment companies, and 9 transfer agents, we referred our findings to enforcement staff for possible further investigation and enforcement action.

Key Results

Issue	Result
New Staffing	As a result of a budget increase, staffing levels for operations were increased significantly. We hired significant numbers of new examiners and began training them this year.
SRO Examinations	We identified needed improvements in regulatory programs at SROs, including with respect to programs for monitoring initial and continued listing of securities for trading, financial and operational surveillance and examinations of member firms, and in market surveillance and disciplinary programs.
Broker-Dealer Examinations	We identified compliance deficiencies including with respect to sales practices, suitability of recommendations, churning, cold calling, supervision, advertising, sales literature and other representations to investors, internal controls, books and records, net capital, compensation, safeguarding of customer funds and securities, and anti-money laundering procedures.

Issue	Result
Investment Company Examinations	We identified compliance deficiencies including with respect to registration and SEC filings, contractual arrangements, board of director activities, fidelity bonding, custody of customer funds, books and records, computation of net asset value, internal control procedures, investment policies for securities in the investment portfolio, money market requirements, best execution of portfolio trades, conflicts of interest, distribution activities and expenses, marketing and performance calculations, processing of fund share transactions, and anti-money laundering procedures.
Investment Adviser Examinations	We identified compliance deficiencies including with respect to SEC filings and reports, Forms ADV, brochure disclosure and delivery, custody of customer funds, books and records, financial condition, internal controls, advisory services, portfolio management, prohibited transactions, conflicts of interest, brokerage and execution costs, wrap fee programs, marketing and performance calculations, compensation and client fees.
Broker-Dealer Comprehensive Compliance	We initiated a series of comprehensive, enterprise-wide examinations in order to evaluate all facets of the organization's compliance program and overall culture.

Issue	Result
Examination Sweep of Mutual Fund Breakpoints	Together with the NASD and the NYSE, we initiated and completed an examination sweep of select broker-dealers to determine whether customers had been provided with discounts on mutual fund purchases. We reported the results publicly and found that one in three transactions had been overcharged.
Special Review of Hedge Funds	We conducted a review of hedge funds and registered funds of hedge funds, as well as their managers and brokers to identify regulatory, operational, and customer protection issues. This information assisted the Commission in its analysis of hedge fund issues.
Special Review of Structured Finance	Together with the bank regulators, we conducted examinations of 11 firms with significant activities in the structured finance area. Triggered by the Enron problems, these exam results will be used to produce guidance to prevent future problems.
Research Analyst Conflicts	Along with the Division of Enforcement, NASD, NYSE, and a number of states, we conducted a review of major investment banking broker-dealers' research analysts' practice of issuing favorable research reports in exchange for investment banking business. The review helped result in a \$1.4 billion global settlement that included, among other things, remedial measures to prevent analysts from being pressured by investment banking interests and to ensure customers have greater access to independent analyst recommendations.

Issue	Result
IPO Spinning	Together with the NASD and the NYSE, we conducted a special review of broker-dealers to identify regulatory and compliance issues associated with initial public offering “spinning” (<i>i.e.</i> , quick re-sales of securities obtained in initial public offerings).
Best Execution	We continued to review the best execution practices of broker-dealers and investment advisers, including whether order-routing broker-dealers are effectively utilizing reports prepared pursuant to Rules 11Ac1-5 and 11Ac1-6 to ensure that customer orders are receiving best execution.
Variable Annuities	Together with the NASD, we conducted a special review of compliance practices in the sale of variable annuity products. The examinations focused on suitability, supervision, disclosure, and books and records and will serve as the basis for a report highlighting practices in these areas.
Safeguarding Customer Records & Information	We conducted a special review of major broker-dealers and fund complexes to evaluate their policies and procedures for preventing identity theft. We also conducted a series of joint examinations of financial complexes containing both insurance and securities firms. The examinations focused on privacy and the safeguarding of customer information.

Issue	Result
Review of Bank Loan Participation Funds	We conducted a special review of all bank loan participation funds to determine whether portfolio securities were accurately priced. As a result of this review, funds investing in these securities switched to a market-based pricing structure that should prevent future valuation problems.
Consolidated Options Audit Trail	We worked with options exchanges and other Commission offices on the design and implementation of a consolidated options audit trail that significantly enhances surveillance.

Main Activities	Fiscal 2003	Fiscal 2002	% Change
Examinations:			
Broker-Dealers	642	626	3%
Investment Advisers	1,556	1,570	-1%
Investment Companies	265	278	-5%
Clearing Agencies	3	3	0%
Transfer Agents	192	138	40%
SRO Programs	33	32	3%

Discussion of Significant Accomplishments

During 2003, we made important contributions to investor protection by: identifying violations, deficiencies, and control weaknesses; prompting registrants to undertake quick remedial action by improving their internal controls to prevent recurrence of the problem; and referring serious violations to enforcement staff for possible further

investigation and enforcement action. We continued to identify deficiencies related to supervision; the accuracy of books and records; sales practices, including the suitability of recommendations; disclosure to investors; conflicts of interest; and the valuation of portfolio securities.

We enhanced our oversight methodologies through

several new initiatives. First, we enhanced our ability to respond quickly and decisively to new compliance issues by: increasing our use of technology; requesting extensive written information from firms to help determine which firms should be reviewed on-site; coordinating with other offices and divisions within the agency; and, when appropriate, redeploying staff. These steps allowed us to initiate, plan, conduct, and resolve several of our special examination reviews quickly after compliance problems came to our attention.

Second, we expanded our review of firms' internal controls, overall compliance systems, and risk profiles because our findings in these areas will help us assess the likelihood that firms will have future compliance

or control problems. Also, the increased complexity of registrant firms and the wider range of their business activities and operations has increased our need to effectively oversee multiple and disparate activities.

Third, we expanded our use of new types of expertise, such as the skills needed to review anti-money laundering programs and firms' programs to safeguard electronic records and information. We also continued our extensive in-house training program for all examiners.

Finally, we coordinated with the broker-dealer SROs, federal banking regulators, and state insurance and securities regulators. This effort has proved fruitful in improving how we work together and share expertise.

Outlook for 2004

With the recent increase in examination resources, our primary objective for 2004 is to continue to enhance customer protection and compliance functions. Specifically, we expect to continue to enhance our methodologies for identifying firms that pose very high levels of compliance risk. We also expect to increase our use and analysis of overall risk assessment procedures to identify compliance risks.

Finally, we will continue to enhance our reliance on information technology.

We anticipate that the following areas will remain high priorities during 2004:

- Market Timing
- Late Trading
- Sales Practices
- Best Execution
- Performance Calculations
- Internal Controls/ Risk Management
- Anti-Money Laundering
- Wrap and Managed Accounts
- Variable Annuity and Mutual Fund Sales