

Compliance Inspections and Examinations

The Office of Compliance Inspections and Examinations manages the SEC's examination program. We inspect and examine brokers, dealers, municipal securities dealers, self-regulatory organizations (SRO), transfer agents, clearing agencies, investment companies, and investment advisers.

What We Did

- Inspected 263 investment company complexes, 1,458 investment advisers, 20 insurance company complexes, 650 broker-dealers, and 175 transfer agents. We also conducted 34 inspections of specific programs, including at least one program at each of the 10 SROs.
- Enhanced coordination among SEC examiners responsible for different regulated entities by utilizing multi-disciplinary examination teams and other such partnerships to improve investor protection, increase effectiveness, and boost productivity.
- Collaborated with the National Association of Securities Dealers, Inc. (NASD) and New York Stock Exchange (NYSE) to review programs for converting to decimal quotations and to identify any potential deficiencies in registrants' plans and procedures.

- Improved cooperation with foreign, federal, and state regulators, as well as with SROs, by planning and conducting joint examinations of firms registered in multiple jurisdictions.
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Investment Company and Investment Adviser Inspections

Investment Companies

Our examiners inspected 263 investment company complexes, including 13 fund administrators discussed later. This includes 241 regular inspections, which fulfilled our goal under the Government Performance and Results Act (GPRA) of inspecting the 1,080 investment company complexes once every five years. The inspected complexes managed \$1.7 trillion in 2,603 portfolios, approximately 32 percent of the 8,108 mutual and closed-end fund portfolios in existence at the beginning of fiscal 2000. A mix of large and small complexes were inspected for compliance. Thirty-five of the inspections were initiated on a “for cause” basis, which means the staff had some reason to believe that a problem existed.

The staff identified violations or deficiencies in 213—or 81 percent—of investment company examinations that resulted in a deficiency letter to the registrant. Most frequent violations or deficiencies resulting in deficiency letters dealt with registration and SEC filings, internal controls procedures, boards of directors’ oversight, conflicts of interest, and books and records.

Serious violations found during 18—or 8 percent—of the examinations warranted referrals for further investigation to

the Division of Enforcement. The most common violations resulting in referrals involved fraud, the role of the fund's board of directors, conflicts of interests, and books and records.

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.

Investment Advisers

The staff completed 1,458 inspections of investment advisers. This includes 1,434 regular inspections that fulfilled our goal under the GPRA of inspecting once every five years the 6,700 registered investment advisers. The non-investment company assets managed by the inspected advisers totaled \$2.8 trillion. Seventy-five of the 1,458 investment advisers were inspected "for cause."

The staff sent deficiency letters to 1,318—or 90 percent—of the inspected investment advisers identifying problems found. Most frequent violations or deficiencies were related to form ADV/brochure, books and records, custody, conflicts of interests, and internal controls.

Serious violations warranting enforcement referrals were uncovered in 54—or 4 percent—of the examinations. The most common violations resulting in referrals involved fraud, form ADV or brochure disclosure or delivery, books and records, conflicts of interest, and performance advertising.

Many investment adviser examinations focused on adviser performance advertising, personal trading, and allocation of

portfolio securities among accounts. We also initiated a review of how advisers fulfill their duty of best execution in executing client securities transactions.

The staff conducted coordinated examinations with staff from the Hong Kong Securities and Futures Commission, the United Kingdom's Financial Services Authority acting as the Investment Management Regulatory Organization, and the British Columbia Securities Commission.

Mutual Fund Administrators

Many mutual fund complexes use third party administrators to perform their accounting and administrative functions. During fiscal 2000, examiners inspected 13 fund administrators.

Variable Insurance Products

In response to the rapid growth in variable insurance product assets and the emergence of new distribution channels, the Office of Compliance, Inspections, and Examinations' staff with expertise in specialized insurance products conducted 20 insurance company complex examinations. These teams identified and examined variable life and annuity contract separate accounts. Special emphasis was placed on examining branch offices of broker-dealers selling these products to look for patterns of sales practice abuses.

Broker-Dealer and Transfer Agent Examinations

Broker-Dealers

In fiscal 2000, the staff conducted 650 oversight, cause, and surveillance examinations of broker-dealers, government securities broker-dealers, and municipal securities dealers. These examinations included 103 branch office

examinations. Deficiency letters were sent to 399 broker-dealers, representing 60 percent of those examined. Serious violations discovered in 123—or 18 percent—of the examinations warranted referrals to the Division of Enforcement for further investigation. An additional 70 examination findings were referred to SROs for appropriate action. The most common violations and deficiencies found were recordkeeping deficiencies, net capital computation errors, unsuitable recommendations to customers, and inadequate written supervisory procedures.

Broker-dealer examinations focused on internal controls at several large broker-dealers and retail sales of low priced, speculative securities frequently referred to as “microcaps.” In addition, many of the branch office examinations focused on independent contractors operating franchise branch offices. The staff also organized and conducted substantial examination reviews of on-line firms, day trading firms, and the firms that clear for these firms to assess the issues created by changes in the industry. The staff further examined the sales of variable annuity products, mutual fund switching, and brokered CDs. A public report describing this examination sweep, the *Report of Examinations of Day Trading Broker-Dealers*, was issued on February 25, 2000.

The staff conducted several reviews of registrants’ programs for dealing with the conversion to decimal quotations in the markets. These included general oversight reviews in which the staff, in collaboration with the NASD and NYSE, reviewed developments at the largest broker-dealers. The staff reviewed registrants’ plans and procedures for dealing with potential decimalization problems. Any deficiencies found were promptly brought to the registrants’ attention for correction.

We also reviewed broker-dealers’ compliance with their best execution obligations. We concentrated on the adequacy of information barriers/Chinese Walls. In addition, we focused on problems that can arise when entities merge their

financial and accounting systems. We will continue emphasizing these areas next year.

Our staff enhanced our cooperation with foreign, federal, and state regulators, as well as with SROs by conducting more joint examinations.

Transfer Agents

In fiscal 2000, our staff conducted 175 examinations of registered transfer agents, including 55 federally regulated banks. The program resulted in 137 deficiency letters, 56 cancellations or withdrawals of registrations, 11 referrals to the Division of Enforcement, 52 referrals to bank regulators, and one staff conference with a registrant. In addition, the staff completed one routine inspection of a clearing agency.

Self-Regulatory Organizations Inspections

In fiscal 2000, the staff completed 34 inspections of SRO operations. These inspections included at least one program at the following SROs:

- NYSE,
- 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, and
- NASD.

The NASD inspections included review of the regulatory programs administered by the NASD's 14 district offices. The staff also initiated an inspection of 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 limit order display in the equities and options markets, alternative trading systems, payment for order flow and internalization, after hours trading, and deep discount brokers. These inspections resulted in recommendations to improve each SRO's effectiveness and efficiency.

We issued public reports on the customer limit order project and the payment for order flow in the options market project. The limit order display report described problems in the display of limit orders in the equities and options markets and inadequacies in the markets' surveillance and disciplinary programs for limit order display. (See *Report Concerning Display of Customer Limit Orders*, May 4, 2000). The staff's report on payment for order flow and internalization in the options markets found that between

November 1999 and September 2000, options specialists paid over \$33 million to brokers to induce them to route their customer orders to the specialists. We also concluded that payment for order flow has had an impact on order routing decisions. Specifically, firms with policies not to accept payment for order flow re-routed significantly fewer options classes to specialists that pay for order flow than did firms with policies to accept payment for order flow (See *Payment for Order Flow and Internalization in the Options Markets Report*, December 2000).

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 2000, a total of 1,101 reports were filed with the SEC, as reflected in the following table.

SRO Reports of Final Disciplinary Action	
American Stock Exchange	13
Boston Stock Exchange	0
Chicago Board Options Exchange	47
Chicago Stock Exchange	3
Cincinnati Stock Exchange	0
National Association of Securities Dealers	847
National Securities Clearing Corporation	0
New York Stock Exchange	181
Options Clearing Corporation	0
Philadelphia Stock Exchange	8
Pacific Exchange	<u>2</u>
Total Reports	1,101