

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, transfer agents, clearing agencies, investment companies, and investment advisers.

What We Did

- Inspected 261 investment company complexes, 1,418 investment advisers, 23 insurance company complexes, 681 broker-dealers, 30 SRO's, 223 transfer agents, and 3 clearing agencies.
- Continued to improve coordination among SEC examiners responsible for different types of regulated entities to increase effectiveness and productivity and enhance investor protection.
- Enhanced cooperation with foreign, federal, and state regulators, as well as with self-regulatory organizations (SROs).
- Conducted numerous reviews of registrants' programs for dealing with the

Year 2000 computer problem. These included for cause reviews, in which the staff followed-up on red flags suggesting the firm needed to enhance its preventative efforts, and general oversight reviews.

- Reviewed registrants' plans and procedures for dealing with potential Year 2000 problems, including remediation, testing, and contingency planning.

Investment Company and Investment Adviser Inspections

Investment Companies

We inspected 261 investment company complexes, including inspections of 12 fund administrators. This number included 209 regular inspections, which fulfilled our goal of an average frequency of inspections of once every five years for the 1,075 investment company complexes. The complexes inspected manage \$1.5 trillion in 2,747 portfolios, approximately 36 percent of the 7,647 mutual and closed-end fund portfolios in existence at the beginning of 1999. The complexes inspected represented a mix of large and small complexes. Twenty-seven of the inspections were done on a "for cause" basis, which means the staff had some reason to believe that a problem existed.

We referred 19 examinations, 7 percent, to the Division of Enforcement for further investigation. The most common problems resulting in referrals involved fraud, the role of the fund's board of directors, conflicts of interests, and books and records.

This year, many of our 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, and the fund's use of brokerage and valuation procedures for illiquid securities.

Investment Advisers

We completed 1,418 inspections of investment advisers. This number also includes 1,189 regular inspections which fulfilled our goal of an average frequency of inspections of once every five years for the 6,360 registered investment advisers. The non-investment company assets managed by the advisers inspected totaled \$2.1 trillion. The staff inspected 82 of these investment advisers for cause.

We referred 56 examinations, 4 percent, to the Division of Enforcement for further investigation. The most common problems 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 also focused on adviser performance advertising, personal trading, and the 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.

Mutual Fund Administrators

Many mutual fund complexes use third party administrators to perform their accounting and administrative functions. During 1999, examiners inspected 12 fund administrators. One of the examinations resulted 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. Special emphasis was placed on examining branch offices of broker-dealers selling these products to determine whether there appeared to be patterns of sales practice abuses. A total of 23 insurance company complexes were examined, representing approximately 20 percent of all the insurance sponsors as of the beginning of 1999. This maintains a five-year inspection cycle for insurance sponsors. One of these examinations resulted in an enforcement referral.

Broker-Dealer and Transfer Agent Examinations

Broker-Dealers

In 1999, we conducted 338 oversight and 343 cause and surveillance examinations of broker-dealers, government securities broker-dealers, and municipal securities dealers. These examinations included 109 branch office examinations. Serious problems were discovered in 131, or 19 percent, of the examinations and were referred to the Division of Enforcement for further investigation. An additional 71 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 supervisory practices.

The broker-dealer program focused on internal controls at several large broker-dealers, and retail selling 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 office also organized and conducted extensive examination reviews of both on-line trading firms and day trading firms to assess the impact of changes and developments in this segment of the securities industry.

In addition, we spearheaded a review of broker-dealers' compliance with their best execution obligations and focused on the adequacy of firm procedures to control access to confidential information. We also focused on problems that can arise when entities merge their financial and accounting systems. We plan on continuing to emphasize all of these areas in the next year.

We also enhanced cooperation with foreign, federal, and state regulators, as well as with self-regulatory organizations (SROs). We 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 Ontario Securities Commission.

Transfer Agents

In 1999, we conducted 223 examinations of registered transfer agents, including 67 federally regulated banks. This number of examinations constituted a significant increase over the number of examinations performed in the prior fiscal year. The program resulted in 169 deficiency letters, 48 cancellations or withdrawals of registrations, 15 referrals to the Division of Enforcement, 62 referrals to bank regulators, and one staff conference with a registrant. In addition, the staff completed three routine inspections of clearing agencies.

Self-Regulatory Organizations Inspections

In 1999, we inspected at least one program at the following SROs: American Stock Exchange, Boston Stock Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, Cincinnati Stock Exchange, Municipal Securities Rulemaking Board, National Association of Securities Dealers, New York Stock Exchange, Pacific Stock Exchange, and Philadelphia Stock Exchange. The SRO inspections focused on:

- arbitration programs;
- listing and maintenance programs;
- financial and operational examination programs;
- market surveillance, investigatory, and disciplinary programs;
- customer communication review programs;
- programs for detecting and sanctioning sales practice abuses; and/or
- ethics and conflicts of interest.

The inspections resulted in numerous recommendations to the SRO's that they improve their programs' effectiveness and efficiency. One inspection resulted in a referral to the Division of Enforcement.

We also conducted inspections of the regulatory programs administered by the NASD's 14 district offices. These inspections included reviews of NASD district offices' broker-dealer examination, financial surveillance, and formal

disciplinary programs. We also reviewed the district offices' investigations of customer complaints and terminations of registered representatives for cause.

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 1999, a total of 1,313 reports were filed with the SEC, as reflected in the following table.

<u>SRO Reports of Final Disciplinary Action</u>	
American Stock Exchange	9
Boston Stock Exchange	0
Chicago Board Options Exchange	70
Chicago Stock Exchange	5
Cincinnati Stock Exchange	0
National Association of Securities Dealers	1,065
National Securities Clearing Corporation	0
New York Stock Exchange	146
Options Clearing Corporation	0
Philadelphia Stock Exchange	14
Pacific Exchange	<u>4</u>
Total Reports	1,313