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January 29, 2008

The Honorable Charles E. Grassley
Ranking Member
Committee on Finance
United States Senate
135 Hart Senate Building
Washington, DC 20510-1501

Dear Senator Grassley:

Thank you for your recent letter, and for the opportunity to respond to your questions regarding how the Commission uses the internal audit reports prepared by self-regulatory organizations (SROs) in conducting its inspections and oversight of SROs.

First, you asked for a description of the SEC's plans to routinely obtain and review internal SRO audits and investigations. At this writing, I can report that it is now the agency's practice to routinely obtain and review SRO audits and investigations.

Beyond merely obtaining and reviewing these materials, the agency is also implementing the GAO recommendations to formalize our written guidance concerning the way in which SEC audits and investigations are used to inform the planning and conduct of SRO inspections. The Government Accountability Office, in its recent report, GAO-08-33, titled "Opportunities Exist to Improve Oversight of Self-Regulatory Organizations," recommended that as Chairman I direct the establishment of a written framework for conducting inspections of SRO enforcement programs. In particular, as your letter noted, the GAO recommended that this framework broaden current guidance to SRO inspection staff on the use of SRO internal audit reports, to "direct examiners to consider the extent to which they will rely on reports and reviews of internal and external audit" when planning SRO inspections. I agree with the recommendation, and have directed the Office of Compliance Inspections and Examinations (OCIE) to implement it fully.

In implementing the GAO's recommendation, OCIE will make clear in its written guidance for examiners that they should consider the extent to which they will rely on reports and reviews of internal and external audit and other risk-management systems when planning SRO inspections. In addition, OCIE is presently drafting new guidance to inspectors regarding risk-scoping techniques. This written guidance will also include a discussion of the use of SRO internal audits in planning inspections.

Second, you asked for an explanation of why the SEC did not fully implement the GAO's recommendation in 2004 that SRO internal reports be routinely used in planning and conducting SRO inspections. As the GAO report noted, beginning in October 2006, the SEC did broaden its use of such reports. It also noted that OCIE now incorporates the results of SRO internal audits into its on-site inspections, which helps to leverage the agency's resources.

The 2004 recommendation is now fully implemented. In planning and focusing inspections, OCIE now conducts an in-depth risk assessment that takes into account all relevant SRO internal audit reports or independent consultant reports. That assessment also includes other important information, such as findings from past inspections and enforcement actions; initial interviews with SRO officials; a review of key SRO records in the area inspected; risks identified through OCIE's internal risk assessment tools; discussions with the other Divisions and Offices within the Commission; tips; information obtained from news reports; and other sources. Some of this pre-inspection risk assessment work is done in the SEC's offices. In other cases, certain elements, such as the initial interviews and the preliminary review of key SRO records, are conducted on-site at the SRO. I have directed that OCIE ensure that this practice is implemented uniformly, and that the forthcoming written guidance for examiners is clear on this point.

I hope that these responses satisfactorily address the concerns you shared. I should emphasize that, even as we are fully implementing the GAO's recommendation concerning written guidance for examiners, it is already OCIE's practice to routinely use SRO internal audit reports for planning purposes. In preparing for routine inspections of critical SRO regulatory programs, OCIE now takes into account all relevant SRO internal audit reports. OCIE is also collecting comprehensive sets of relevant SRO internal audit reports for planning purposes.

Of course, the SEC has substantial experience with the work of SRO internal audit departments. The Commission's observation that the quality of internal audit programs vary among the SROs (GAO-08-33, page 65) is based on OCIE's inspection work. There is currently no legal requirement that SROs have an internal audit function (although each of the larger SROs maintains such a function), and it is the staff's view that some SRO internal audit departments will need to make substantial enhancements before OCIE inspectors can confidently rely on the reports they produce. As the GAO noted (GAO-08-33, page 20), the SEC has on multiple occasions recommended to SROs that they strengthen this function to improve their oversight. OCIE is now taking steps to accelerate our inspections of SRO internal audit departments. The goal of these inspections will be to identify possible improvements in SROs' internal audit programs both to make them more valuable in providing assurance of SROs' regulatory oversight, and to make them more reliable for the SEC to use in planning and conducting SRO inspections.

Again, thank you for your letter. Please call me at (202) 551-2100 or have your staff call Jonathan Burks, Director of the Office of Legislative and Intergovernmental Affairs at 202-551-2010 if you have any questions or further comments.

Sincerely,


Christopher Cox
Chairman