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SECURITIES AND  
EXCHANGE  
COMMISSION

Steps Being Taken to  
Make Examination  
Program More Risk-  
Based and  
Transparent





Highlights of [GAO-07-1053](#), a report to congressional requesters

## Why GAO Did This Study

After widespread unlawful trading practices surfaced in the mutual fund industry in late 2003, the Securities and Exchange Commission (SEC), through its Office of Compliance Inspections and Examinations (OCIE), took steps intended to revise its examination process to better identify and focus its resources on those activities representing the highest risk to investors. More recently, some registrants raised concerns about the lack of communication from SEC examiners about the status of and results of examinations. This report (1) describes OCIE's revisions after 2003 to the examination approach for investment companies and investment advisers; (2) discusses OCIE's compliance with its examination exit procedures; and (3) describes reforms OCIE implemented since January 2006 to enhance, among other things, communication with registrants. To address these objectives, GAO analyzed OCIE examination data; planning documents and guidance; interviewed OCIE officials; and gathered views of registrants.

## What GAO Recommends

GAO recommends that SEC consider relocating its registrant complaint hotline to an independent office, such as an ombudsman function, within the agency or within a division or office outside of OCIE. SEC generally agreed and is taking steps to address the intent of the recommendation.

[www.gao.gov/cgi-bin/getrpt?GAO-07-1053](http://www.gao.gov/cgi-bin/getrpt?GAO-07-1053).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Orice M. Williams (202) 512-8678 or [williamso@gao.gov](mailto:williamso@gao.gov).

# SECURITIES AND EXCHANGE COMMISSION

## Steps Being Taken to Make Examination Program More Risk-Based and Transparent

### What GAO Found

Since the detection of mutual fund trading abuses in late 2003, OCIE has shifted its approach to examinations of investment companies and investment advisers from one that focused on routinely examining all registered firms, regardless of risk, to one that focuses on more frequently examining those firms and industry practices at higher-risk for compliance issues. The effectiveness of OCIE's revised approach largely depends on OCIE's accurately assessing the risk level of investment advisers. The method that OCIE employs to predict the level of risk for the majority of investment advisers has some limitations, particularly in that this method relies on proxy indicators of compliance risks without incorporating information about the relative strength of a firm's compliance controls. OCIE has taken steps to assess the effectiveness of this method for predicting risk-levels and to seek additional indicators of compliance risks. GAO continues to believe that implementing GAO's prior recommendation to obtain and use compliance reports from firms—a source of information on the effectiveness of their compliance controls—could potentially help OCIE better identify higher-risk firms.

GAO's review of investment company, investment adviser, and broker-dealer examinations conducted from fiscal years 2003 through 2006 found that examiners generally follow OCIE's exit procedures for communicating deficiencies to registrants and providing written notice of the examination's outcome, except in an estimated 9 percent of investment company and investment adviser examinations where OCIE directed examiners to forgo these procedures. These examinations were part of a series of OCIE examinations that probed specific activities across a number of firms and were initiated in response to the widespread unlawful trading practices which had surfaced at that time. In addition, GAO estimated that in 7 percent of broker-dealer examinations, either examiners did not follow exit procedures or OCIE officials were not able to provide evidence that they did.

OCIE has implemented several initiatives since January 2006 intended to improve communication with registrants and other aspects of the examination program. For instance, OCIE established a hotline for registrants to receive comments or complaints, began requiring examiners to contact registrants when examinations extend past 120 days, and implemented tools and protocols designed to reduce duplicating examinations. GAO's review indicated that examiners generally complied with the new requirement to notify registrants when an examination extends past 120 days. Comments from industry representatives on OCIE's initiatives suggested some concerns about the hotline. Specifically, several registrants questioned the independence of the hotline, as it is located within OCIE, and said that as a result they would hesitate to use it.

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## Abbreviations

CCO	Chief Compliance Officer
NASD	National Association of Securities Dealers
NYSE	New York Stock Exchange
OCIE	Office of Compliance Inspections and Examinations
ORA	Office of Risk Assessment
OIT	Office of Information Technology
RADAR	Risk Assessment Database for Analysis and Reporting
SEC	Securities and Exchange Commission
SRO	self-regulatory organizations

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United States Government Accountability Office  
Washington, DC 20548

August 14, 2007

Congressional Requesters:

The authority of the Securities and Exchange Commission (SEC) to conduct inspections and examinations of certain participants in the securities industry is one of its most important tools in detecting fraud and violations of securities laws. SEC exercises this authority through its Office of Compliance Inspections and Examinations (OCIE). In fiscal year 2006, OCIE conducted over 2,600 examinations of investment companies, investment advisers, broker-dealers, and other securities-related firms registered with SEC (registrants).<sup>1</sup>

After widespread unlawful trading practices in the mutual fund industry surfaced in late 2003, OCIE attempted to address concerns about the effectiveness of its ability to detect such practices in its examinations of registrants by revising its examination approach to try to better identify and focus its limited resources on those activities representing the highest risk to investors.<sup>2</sup> To ensure registrants understand and address weaknesses in compliance and violations found during examinations, OCIE has formal exit procedures for examiners to follow when communicating the findings of examinations to registrants. However, some registrants—including investment companies, investment advisers, and broker-dealers—have raised concerns about OCIE staff's not communicating the status and results of examinations. In May 2006, the SEC Chairman testified before the House Financial Services Committee on recent changes to the examination program, which were designed to

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<sup>1</sup>SEC regulates investment companies and investment advisers under the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933, and the Securities Exchange Act of 1934. The Investment Company Act and the Investment Advisers Act requires certain investment companies and investment advisers, respectively, to register with SEC and thus subject their activities to SEC regulation. Broker-dealers are required to register with SEC and are subject to SEC regulation under the Securities Exchange Act of 1934.

<sup>2</sup>We discussed SEC's response to the surfacing of these widespread abuses previously. See, for example, GAO, *Mutual Fund Industry: SEC's Revised Examination Approach Offers Potential Benefits, but Significant Oversight Challenges Remain*, [GAO-05-415](#) (Washington, D.C.: Aug. 17, 2005) and GAO, *Mutual Fund Trading Abuses: Lessons Can Be Learned from SEC Not Having Detected Violations at an Earlier Stage*, [GAO-05-313](#), (Washington, D.C., Apr. 20, 2005).

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further increase communication with registrants as well as enhance pre-examination planning.<sup>3</sup> These reforms include a new procedure that, among others, requires examiners to contact registrants when an examination extends 120 days beyond the on-site visit and alert them to the status of the examination.

This report addresses your interest in OCIE's progress toward more risk-based examinations for registered investment companies and investment advisers, implementation of recent initiatives in the examination program, and efforts to communicate key examination information to registrants and minimize disruption. Specifically, we (1) describe how OCIE revised the examination approach after 2003 for investment companies and investment advisers registered with SEC; (2) discuss OCIE's exit procedures and the frequency with which examiners have followed these procedures when conducting examinations; and (3) describe reforms OCIE implemented since January 2006 to increase communication with registrants and improve the examination program, including how examiners complied with the new 120-day notification requirement.

To address the first objective, we analyzed information obtained through OCIE documents and interviews with OCIE and other SEC officials on OCIE's revised examination approach for investment companies and investment advisers and a new process for identifying risks in the marketplace. We also observed a demonstration of the information-technology application that OCIE uses to conduct its annual risk-assessment process. To address the second objective, we reviewed OCIE's guidance to examiners, interviewed OCIE officials on exit procedures, and reviewed examination data. We selected two random samples of 129 examinations, one from the population of investment company and investment adviser examinations and one from the population of broker-dealer examinations completed during fiscal year 2003 through fiscal year 2006. This process allowed us to project our results to the two respective populations at the 95 percent level of confidence. All estimates in this report have margins of error of plus or minus 8 percent or less. To address the third objective, we reviewed memorandums from OCIE to the Commission and the revised examination brochure, analyzed examination data related to the notification procedure, interviewed officials from OCIE,

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<sup>3</sup>*Protecting Investors and Fostering Efficient Markets: A Review of the S.E.C. Agenda Before the H. Comm. on Financial Services*, Statement of Christopher Cox, Chairman, Securities and Exchange Commission, 109th Cong. 45-46 (2006).

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and obtained the views of various industry participants representing investment companies, investment advisers, and broker-dealers. In determining the frequency with which examiners complied with the new notification procedure, we identified all closed examinations that lasted 120 days or more conducted between July 31, 2006, the day the guidance was implemented, and February 2, 2007, the day OCIE gave us the records. We reviewed all 13 examinations that met these criteria. In conducting our analyses of examination data, we conducted a data reliability assessment of the data OCIE provided us and determined it was reliable for our purposes.

We performed our work in Washington, D.C., between October 2006 and July 2007 in accordance with generally accepted government auditing standards. Appendix I provides a more detailed description of our scope and methodology.

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## Results in Brief

Since 2003, when SEC and state securities regulators discovered widespread unlawful conduct in mutual fund trading by investment advisers and other service providers, OCIE has revised its approach to examining registered investment companies and investment advisers to try to better identify firms with greater compliance risks as well as emerging industry practices that may have potential compliance issues and to target examination resources accordingly.<sup>4</sup> More specifically, in fiscal year 2005 OCIE shifted its focus from the routine examination of all registered investment companies and advisers, regardless of compliance risks, to the examination of “higher-risk” firms—about 10 percent of the population—once every 3 years. From the remaining 90 percent of the population designated as “lower risk,” OCIE examines a small random sample annually. Under OCIE’s revised approach, “sweep” examinations, which target specific activities across firms, and “cause” examinations, which target known problems at an individual firm, are also a higher priority. The effectiveness of OCIE’s revised approach depends on its ability to accurately assess the level of risk at individual investment advisers; inaccurately categorizing firms as lower-risk could result in harmful

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<sup>4</sup>Compliance risks refers to the propensity of an SEC registrant to be in violation of federal securities laws and regulations or, where applicable, the rules of a governing self-regulatory organization.

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practices' going undetected.<sup>5</sup> Since 2002, OCIE has assigned risk ratings to investment advisers after evaluating their compliance controls through routine examination. However, most firms have not yet received this evaluation. To assign risk ratings to unexamined firms, OCIE assesses publicly available information to identify risks inherent in a firm's businesses, such as conflicts of interest. While these variables may indicate areas of high risk, they do not provide any information on the firm's policies or procedures for mitigating these risks. OCIE's analysis of fiscal year 2006 data showed that the accuracy of this methodology for predicting whether firms are higher- or lower- risk has some limitations. OCIE officials said that they are evaluating other potential indicators of compliance risks, such as investment adviser performance, to improve their risk-rating methodology and otherwise aid them in identifying higher-risk firms. Implementation of our prior recommendation to obtain and review documentation associated with the compliance reviews that firms must conduct under SEC rules—a source of information on the effectiveness of their compliance controls—could potentially help OCIE better identify higher-risk firms as part of its risk-assessment methodology.<sup>6</sup>

Our review of investment company, investment adviser, and broker-dealer examinations completed during fiscal year 2003 through fiscal year 2006 found that examiners generally applied OCIE's exit procedures, with the major exceptions occurring during sweep examinations relating to mutual fund trading abuses, instances where OCIE directed examiners to forgo exit procedures. To communicate deficiencies to registrants, OCIE has instituted specific exit procedures that include an exit interview, which examiners use to inform registrants of deficiencies prior to the close of an examination, and a "closure notification" letter, which communicates the outcome of the examination. OCIE guidance allows examiners to refrain from applying these procedures when they refer their findings to the

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<sup>5</sup>OCIE assigns risk ratings to investment advisers, but not investment companies. Many investment companies have few employees and rely on investment advisers to perform key functions such as providing management and administrative services. When OCIE examines an investment adviser, it generally examines related investment companies concurrently. OCIE officials estimated that about one-third of registered investment advisers have received applicable risk ratings from an examination as of September 2006.

<sup>6</sup>Currently, the use of these reports is limited to the routine examinations of investment companies and investment advisers, where OCIE examiners review the reports as part of the examination planning process to learn about compliance issues identified by these firms. See [GAO-05-313](#), p. 35, for previous discussion of these reports and our related recommendation.



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Division of Enforcement (Enforcement) and are asked to forgo the exit interview, the deficiency letter, or both; or when an examination results in no findings, in which case an exit interview is not necessary. OCIE management also has directed examiners to deviate from exit procedures under exigent circumstances, such as during the extensive sweep examinations initiated to address the widespread unlawful trading in mutual funds that surfaced in 2003 and that included inappropriate market timing, among other practices.<sup>7</sup> Our analysis of a sample of investment company and investment adviser examinations completed during fiscal year 2003 through fiscal year 2006 estimated that examiners conducted exit interviews for 79 percent of the examinations completed during this period. They did not conduct interviews in an estimated 12 percent for reasons consistent with their guidance. In the other estimated 9 percent, OCIE directed examiners not to conduct exit interviews because the examinations were part of ongoing sweep examinations related to market timing. We also estimated that examiners sent either a deficiency letter or a “no further action” letter in 87 percent of the examinations. Examiners did not send closure notifications in an estimated 11 percent because the examination was part of the ongoing sweep examinations related to market timing and in 2 percent for other guidance-related reasons. We did not find evidence that examiners sent closure notification letters in the remaining estimated 1 percent, when OCIE guidance indicated they should have been sent.<sup>8</sup> We also analyzed a sample of broker-dealer examinations and estimated that examiners conducted exit interviews and sent closure notifications in 82 percent and 88 percent, respectively, of the total number of examinations completed during the review period and did not conduct these procedures in 11 percent and 9 percent, respectively, of examinations for reasons consistent with OCIE’s guidance. However, in an estimated 7 percent of examinations, we did not find evidence of an exit interview when OCIE guidance indicated one was warranted. This estimate includes an estimated 3 percent of cases where OCIE officials told us examiners conducted the interviews but did not document the discussion.

OCIE generally followed its new procedure requiring examiners to inform registrants of the status of examinations extending past 120 days, one of a variety of new initiatives OCIE implemented to improve coordination and

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<sup>7</sup>Other compliance issues that surfaced during this time included the late trading of fund shares and the misuse of material, nonpublic information.

<sup>8</sup>Percentages do not add exactly to 100 percent due to rounding.

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communication among examiners, and with other SEC divisions and registrants. Other examples include protocols and tools to help examiners across SEC headquarters and regional offices coordinate their examinations and avoid duplication as well as a hotline for registrants to call with complaints or concerns about the examination program. In reviewing OCIE examination data to determine the extent to which examiners followed the 120-day requirement, we identified 13 closed examinations to which this procedure was applicable. In 12 of the 13, examiners either provided the notification or had a guidance-related reason for not contacting the firm, such as a request by Enforcement. To obtain the views of registrants on OCIE's new initiatives, we contacted various industry participants representing investment companies, investment advisers, and broker-dealers. A number of registrants questioned the effectiveness of the new hotline, as it is located within OCIE's Office of the Chief Counsel and not in another SEC office or division that is independent of OCIE. These registrants said they would hesitate to use the new hotline, thereby limiting its effectiveness as a communication tool.

This report contains one recommendation designed to facilitate greater use of OCIE's new examination hotline by relocating it to a division or office that is independent of OCIE. We received comments on a draft of this report from SEC, which are included in appendix II. In its written comments, SEC agreed with our conclusions and noted that in response to our recommendation, OCIE is developing a revised hotline where callers can choose to speak with the Commission's Office of the Inspector General, in addition to staff from OCIE's Office of the Chief Counsel. SEC also provided technical comments on a draft of the report, which were incorporated into the final report, as appropriate.

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## Background

SEC oversees investment companies and investment advisers primarily through OCIE; the Division of Investment Management (Investment Management); and Enforcement. OCIE examines investment companies and investment advisers to evaluate their compliance with federal securities laws, determine if these firms are operating in accordance with disclosures made to investors, and assess the effectiveness of their compliance control systems. Investment Management administers the securities laws affecting investment companies and investment advisers. It reviews the disclosure documents that investment companies registered with SEC are required to file with the agency and engages in other regulatory activities, such as rule making, responding to requests for exemptions from federal securities laws, and providing interpretation of

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those laws. Enforcement is responsible for investigating and prosecuting violations of securities laws or regulations that are identified through OCIE examinations, referrals from other regulatory organizations, and tips from firm insiders, the public, and other sources.

OCIE conducts routine, sweep, and cause examinations to oversee registered investment companies and investment advisers. Routine examinations are conducted according to a cycle that is based on the registrant's perceived risk. During a routine examination, OCIE assesses a firm's process for assessing and controlling compliance risks. In 2002, OCIE started to use a systematic approach for documenting and assessing the effectiveness of investment advisers' compliance controls.<sup>9</sup> Based on that assessment, examiners assign investment advisers risk-ratings indicating whether they are at higher- or lower- risk for experiencing compliance problems. In a sweep examination, OCIE probes specific activities of a sample of investment companies and investment advisers to identify emerging compliance problems in order that they may be remedied before becoming too severe or systemic. OCIE conducts cause examinations when it has reason to believe something is wrong at a particular registrant. Investment companies and investment advisers can be candidates for cause examinations if they are the subject of investor complaints, tips, or critical news media reports.

SEC regulates broker-dealers in conjunction with National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE), among others.<sup>10</sup> NASD and NYSE are self-regulatory organizations (SRO) with statutory responsibilities to regulate their own members. As part of their responsibilities, they conduct examinations of their members to ensure compliance with SRO rules and federal securities laws. OCIE evaluates the quality of NASD and NYSE oversight in enforcing their members' compliance through oversight inspections of the SROs and broker-dealers. SRO oversight inspections review all aspects of an SRO's

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<sup>9</sup>Prior to 2002, routine examinations typically focused on discrete areas that staff viewed as representing the highest risks of compliance problems that could harm investors.

<sup>10</sup>In July 2007, after the completion of our fieldwork, NASD and the member regulation, enforcement and arbitration functions of NYSE consolidated to become the Financial Industry Regulatory Authority.

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compliance, examination, and enforcement programs.<sup>11</sup> Through broker-dealer oversight examinations, OCIE re-examines a sample of firms within 6 to 12 months after the SRO completed its examination.<sup>12</sup> In addition to broker-dealer oversight examinations, OCIE also directly assesses broker-dealer compliance with federal securities laws through special and cause examinations. Special examinations include sweep examinations and internal controls risk management examinations of the 20 largest broker-dealer firms. The Division of Market Regulation (Market Regulation) administers the securities laws affecting broker-dealers and engages in related oversight activities such as rule making. Both SEC's Enforcement and the SROs' enforcement divisions are responsible for investigating and disciplining violations of securities laws or regulations by broker-dealers.

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## OCIE Revised Its Examination Approach to Target Higher-Risk Registrants and Compliance Issues

Since 2003, OCIE changed its examination program for certain registrants including investment companies and investment advisers to try to focus its examination resources on those firms and industry practices with the greatest risk of having compliance problems. In particular, OCIE went from routinely examining registered firms on an established schedule to emphasizing the examination of higher-risk firms. Accurate risk ratings of investment advisers are critical to making this revised approach effective. However, to assign risk ratings to firms that have not had their compliance controls evaluated through routine examinations, OCIE uses proxy indicators for compliance risk that do not incorporate information on the strength of the firm's compliance controls, a limitation that OCIE has recognized. One potential source of information that could be used to improve the accuracy of risk ratings is the compliance reports that firms must prepare and maintain on-site under rules that became effective in 2004 (Compliance Program Rules), but do not have to file with SEC.<sup>13</sup>

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<sup>11</sup>OCIE undertakes SRO inspections in order to evaluate whether an SRO is (1) adequately assessing risks and targeting its examinations to address those risks, (2) following its examination procedures and documenting its work, and (3) referring cases to enforcement authorities when appropriate.

<sup>12</sup>OCIE also conducts surveillance examinations, which are generally broker-dealer oversight examinations that occur slightly more than 12 months after the examination.

<sup>13</sup>Rule 38a-1 applies to registered investment companies, including business development companies. See 17 C.F.R. §§ 270.38a-1 (2006). Rule 206(4)-7 applies to registered investment advisers. See 17 C.F.R. §275.206(4)-7. Prior to the adoption of these rules, investment advisers were already subject to requirements to maintain written compliance policies and procedures in certain areas. See *Compliance Programs for Investment Companies and Investment Advisers*, 68 *Federal Register* 74714, 74715 n. 14 (Dec. 24, 2003) (adopting release), for a list of such requirements.

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These reports include information on the quality of the firms' compliance controls and any material weaknesses identified, which could be useful to OCIE for risk-rating purposes if OCIE were able to review these records regularly outside of routine examinations. Implementation of a prior recommendation to periodically obtain and review these compliance reports could potentially help OCIE better identify higher-risk firms.

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### Goal of Revised Examination Approach for Investment Companies and Investment Advisers Is to Identify and Shift Resources to Higher-Risk Firms and Compliance Issues

Following the detection of mutual fund trading abuses in the summer of 2003, OCIE revised its examination approach for investment companies and investment advisers. Specifically, OCIE shifted its examination approach from one that focused largely on the routine examination of all registered firms on an established schedule, regardless of risk, to one that targets resources on firms and issues that present the greatest risk of having compliance problems. Between 1998 and 2003, routine examinations accounted for about 90 percent of the approximately 10,400 investment company and investment adviser examinations OCIE conducted. During this period, OCIE generally tried to examine each firm at least once every 5 years.<sup>14</sup> However, the growth in the number of investment advisers, from 5,700 to about 7,700, and in the breadth of their operations did not allow OCIE to maintain this routine examination cycle. Also, OCIE concluded that routine examinations were not the best tool for broadly identifying emerging compliance problems, because firms were selected for examination based largely on the passage of time and not their particular risk characteristics.

To address these limitations, OCIE implemented a new risk-based examination approach in fiscal year 2005 that provides for more frequent routine examination of investment advisers determined to be higher-risk for compliance issues. Under this revised approach, OCIE's goal is to conduct at least one on-site, comprehensive, risk-based examination of all firms that have a higher-risk profile every 3 years. From those firms designated as lower-risk, OCIE randomly selects a sample each year to routinely examine. According to the 2007 "goals" memorandum—OCIE's key planning document for communicating examination priorities and guidance to examiners nationwide—OCIE targets more than three times the amount of examination resources to the routine examinations of

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<sup>14</sup>During 2003, OCIE began to address these concerns by establishing a 2-, 4-, or 5-year examination cycle based on the size or risk level of the investment adviser. However, this cycle was not fully implemented before OCIE made significant changes to its examination program for investment companies and investment advisers as described in this section.

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higher-risk investment advisers (and their associated investment companies) than to the routine examination of lower-risk firms. Higher-risk firms represent about 10 percent of registered firms and 51 percent of assets under management. OCIE also now targets greater resources to sweep and cause examinations.

As part of its revised approach, OCIE began a pilot program in fiscal year 2006 that uses dedicated teams of two to four examiners to provide more continuous and in-depth oversight of the largest and most complex groups of affiliated investment companies and investment advisers. As of June 2006, OCIE officials said that a few select firms, representing approximately \$1.5 trillion, or 4 percent, of assets under management in the United States, are currently participating in this voluntary program. Because these firms have been in the program for less than 12 months, we were unable to evaluate the effectiveness of OCIE's monitoring teams or this pilot. OCIE officials told us they plan on adding a limited number of additional firms and corresponding monitoring teams to the program by the end of 2007. Depending on the results of the pilot, the officials tentatively plan to have at least one and, perhaps, two monitoring teams in each field office.

To enhance OCIE's ability to identify and address emerging risks across the securities industry, in 2004 OCIE implemented a process intended to identify and map high-risk industry practices and compliance issues across the securities markets, including investment companies, investment advisers, and broker-dealers. SEC's Office of Risk Assessment (ORA) initially developed this process for agencywide use. In 2005, this process was automated, using a database application called Risk Assessment Database for Analysis and Reporting (RADAR).<sup>15</sup> As used by OCIE, examiners in headquarters and regional offices identified and prioritized various risks to investors and registrants. OCIE staff then used RADAR to identify the highest-risk areas designated by examiners and then develop and recommend regulatory responses to address these higher-risk areas.<sup>16</sup> For example, OCIE officials said that they are addressing some risks by

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<sup>15</sup>OCIE developed the RADAR application in conjunction with staff from the Office of Risk Assessment (ORA) and OIT. In 2005 and 2006, RADAR was a database application; in 2007, OCIE and OIT staff enhanced RADAR to make it a Web-based application.

<sup>16</sup>OCIE officials said that the risks entered into RADAR by SEC examination staff and managers are based on information learned during examinations and constitute non-public information.

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conducting examinations on the related issues and other risks by recommending that Market Regulation and Investment Management provide new rules or interpret existing ones. In addition, as part of OCIE's fiscal year 2007 goals memorandum, OCIE included information on the key risks identified through RADAR for each registrant type. OCIE examiners were directed to consider these risk areas as they plan examinations. OCIE officials said that they have not yet formally evaluated the effectiveness of RADAR for identifying new or resurgent compliance risks, as they have been largely focused on developing RADAR and the risk-assessment process itself. However, they said that the implementation of their recommended regulatory responses, through their own examination program and by other divisions and offices, would allow them to validate the risks identified through RADAR. OCIE officials said that they are considering developing a task force whose role, in part, would be to track the outcome of what OCIE recommends for risks entered in RADAR.

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### OCIE Is Taking Steps to Refine Its Method for Assessing the Compliance Risk Level of Investment Advisers but Faces Challenges

Accurately identifying compliance risk among registered investment advisers is critical to OCIE's revised approach to examinations, particularly for routine examinations. Because only a small number of low-risk firms are selected for routine examinations in a year, improperly categorizing investment advisers as lower-risk could lead to harmful practices' not being detected on a timely basis. To determine which firms are higher-risk and thus a priority for routine examination, every year OCIE queries its examination database and identifies those investment advisers that have been examined during the past 3 years and assigned a compliance risk rating of "high," indicating that their compliance controls have been assessed as "weak." These firms are automatically placed on the high-risk list and scheduled for routine examination within a 3-year period. However, because OCIE had only begun assigning risk ratings to firms in 2002 when it started using its risk-scorecard approach to evaluate compliance risks at individual firms, it was unable to assign risk ratings to all firms prior to revising the approach to routine examinations in 2004. Approximately 70 percent of registered investment advisers had not yet received a compliance risk-rating through a routine examination before OCIE implemented its new approach. Further, according to OCIE, its staff have not yet examined most of the more than 4,500 new investment advisers that have registered with SEC since fiscal year 2004.

To assign a risk rating for investment advisers that have never been examined by OCIE, OCIE uses an algorithm to calculate a numeric "score" for each firm based on certain affiliations, business activities,

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compensation arrangements, and other disclosure items that pose conflicts of interest.<sup>17</sup> Examples include participation or interest in client transactions, managing portfolios for individuals, and receiving performance fees. OCIE determines the risk profile of all registered investment advisers every year using the risk algorithm. Those that are designated as higher-risk through this method are added to the high-risk list and scheduled for routine examination within the next 3 years. At the start of fiscal year 2006, OCIE officials said they had identified about 10 percent of registered investment advisers as higher-risk. Slightly more than half of these were firms that had been routinely examined by OCIE within the last 3 years and given a risk-rating of “high” and slightly less than half were rated as higher-risk through the risk algorithm. A small percentage were firms OCIE had classified as higher-risk because of their large size. OCIE automatically designates the top 20 investment advisers according to assets under management as higher-risk.<sup>18</sup> According to OCIE officials, these larger firms are a priority because of the number of investors who could suffer adverse consequences as a result of any compliance problems at these firms.

Although the risk algorithm allows OCIE to determine an investment adviser’s relative risk profile in the absence of a compliance risk rating, it is potentially limited because it does not measure the effectiveness of the investment adviser’s compliance controls that are designed to mitigate conflicts of interest or other risks that could harm mutual fund shareholders. Rather, it relies on information that serves largely as proxy measures of the firm’s compliance-related controls. OCIE has recognized these limitations and has taken some steps to evaluate the effectiveness of this methodology. OCIE officials told us they evaluate the accuracy of the risk ratings generated by the risk algorithm by comparing the results of completed routine examinations of firms initially presumed to be low-risk against the examination’s outcome. According to data generated by OCIE, 91 percent of investment advisers that were initially rated lower-risk and examined in fiscal year 2006 retained the lower-risk designation after examination. OCIE officials said that they are reviewing the remaining 9 percent of examinations where the risk rating changed from lower to

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<sup>17</sup>The risk algorithm, developed by OCIE and the Office of Economic Analysis, is a formula using values of various factors to derive a relative ranking for the firm’s compliance risk.

<sup>18</sup>Combined, these 20 investment advisers have \$8.9 trillion in assets under management, about 28 percent of all registered investment advisers’ assets under management.



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higher to determine the reasons for the change and whether they can use that information to improve the accuracy of the risk algorithm.

OCIE data also showed that 25 percent of all investment advisers that were initially rated higher-risk and examined during fiscal year 2006 retained their higher-risk rating, while the remaining 75 percent were reclassified as lower-risk. According to OCIE officials, one reason that the accuracy rate for predicting higher-risk firms appears low is that many of the firms on the higher-risk list, as previously discussed, were classified as higher-risk as a result of a prior examination. These firms likely took steps in the interim to improve their compliance controls, so OCIE officials expected that these firms would be rated as lower-risk after re-examination. However, the officials said that there are also many firms that had ratings assigned through the risk algorithm, and the fact that their ratings were changed from higher- to lower-risk after the examination demonstrates the limitations of the algorithm—it can determine which firms are at higher risk for compliance problems, but does not indicate the effectiveness of the firms’ policies or procedures for mitigating these risks.<sup>19</sup>

To improve the accuracy of the risk-algorithm, OCIE initiated a sweep examination during 2007 of a sample of recently registered investment advisers that were identified as lower-risk and that had not yet been subject to a routine examination by OCIE. These reviews are typically targeted, 1-day reviews that allow examiners to obtain an initial assessment of these recently registered investment advisers’ conflicts of interest, the related compliance policies and procedures these advisers use to manage these risks, and the capabilities of the firms’ compliance and other personnel. OCIE anticipates that these limited-scope visits will assist examiners in determining whether a recently registered investment adviser’s risk rating is accurate, and if it is not, will allow them to assign a more accurate risk rating and potentially identify additional information to refine the risk algorithm. According to OCIE officials, thus far, examiners have concluded over 225 of these reviews, with 85 percent of these resulting in firms’ remaining classified as lower-risk and 15 percent being reclassified as higher risk and placed on a 3-year examination cycle. The

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<sup>19</sup>OCIE officials said that the composition of the higher-risk risk firms examined reflected the composition of the total firms rated higher-risk at the start of fiscal year 2006, in that slightly more than half were firms that had received a higher-risk rating through routine examination and slightly less than half had received higher-risk rating through the risk algorithm.

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officials said that they plan to make these sweep examinations a regular component of the examination program.

In addition, OCIE officials said that they are exploring ways to obtain and use additional sources of information that will allow them to further identify higher-risk firms.<sup>20</sup> OCIE officials told us they have purchased access to several commercial databases containing information on various data points, such as the performance of investment advisers, that OCIE does not otherwise have. OCIE officials said that they are currently assessing the usability of these databases for surveillance purposes, primarily to identify higher-risk firms. For example, if a firm's reported performance is significantly higher or lower than its peers, the officials said that performance could indicate that the firm's business processes deviate from the norm and require follow-up. Further, OCIE officials said that several OCIE and Office of Information Technology (OIT) staff are working on a project to identify other possible information sources that OCIE could use to better monitor investment companies and investment advisers. OCIE officials said that they are formalizing this effort by creating a Branch of Surveillance and Reporting, which will have staff permanently dedicated to the review and analysis of internal and external data sources to identify compliance risks at registered investment companies and investment advisers.<sup>21</sup>

The accurate prediction of each investment adviser's risk-level is critical to the protection of investors under the revised approach, as some firms rated lower-risk may never be routinely examined within a reasonable period of time, if at all, because of the sampling approach being used.<sup>22</sup> According to OCIE's review of 2006 examination data, 9 percent of investment advisers currently classified as lower-risk firms are actually higher-risk firms that should be scheduled to be examined within the next

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<sup>20</sup>In 2005, SEC considered the development of a surveillance program for OCIE to gather and analyze additional information from investment companies and investment advisers outside of the data collected in OCIE's usual examination and reporting process. However, OCIE officials told us that SEC decided to postpone this effort, which would have imposed potentially significant costs for SEC and firms and required formal rule making to implement, in favor of obtaining access to third-party databases.

<sup>21</sup>OCIE officials told us they are planning to staff the new Branch of Surveillance and Reporting with a branch chief and four analysts.

<sup>22</sup>OCIE officials said that when preparing to generate the random sample of investment advisers rated as lower-risk, they first remove from the universe those firms that were selected and routinely examined the previous year.

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3 years. Among newly registered advisers, the results of OCIE's targeted 1-day reviews show that the percentage of firms inappropriately characterized as lower-risk appears to be higher. OCIE's efforts to improve the capacity of the algorithm and obtain alternative sources of surveillance information could increase the likelihood that higher-risk firms will be identified and examined. However, neither the risk algorithm nor the alternative information sources OCIE is currently considering give OCIE any insights into the effectiveness of a firm's internal controls for mitigating identified compliance risks.

One potential source of information that might allow OCIE to assess the effectiveness of firms' internal controls is the reports registered investment companies and investment advisers are required to prepare at least annually under the Compliance Program Rules.<sup>23</sup> These rules require firms subject to the rule to adopt written compliance policies and procedures and review, at least annually, the adequacy of such compliance controls, policies, and procedures and the effectiveness of their implementation. Registered investment companies must designate a chief compliance officer responsible for giving the firm's board of directors a written report that, among other requirements, addresses the operation of the compliance controls of the investment companies and the controls of each of its service providers, including its investment adviser, and each material compliance matter that has occurred during the reporting period. Under the Compliance Program Rules, each investment company and investment adviser is required to maintain as part of its books and records any records documenting the firm's annual review of its compliance controls. OCIE staff currently review these compliance reports as part of the examination-planning process to learn about compliance issues identified by the firms and determine whether the firms have implemented corrective action. Currently, the rule does not require firms to submit the annual reports to the agency for its ongoing review. We previously recommended that SEC obtain and review these reports or the material weaknesses identified in them periodically rather than solely in connection with a planned examination.<sup>24</sup> OCIE officials noted that obtaining these reports on a regular basis would require rule making by SEC. We continue to believe, however, that using these reports outside of the examination process could potentially allow OCIE to improve its ability to identify higher-risk firms.

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<sup>23</sup> 17 C.F.R. §§ 270.38a-1 and 275.206(4)-7 (2006).

<sup>24</sup> [GAO-05-313](#), 35.

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## With Some Exceptions, OCIE Generally Applied Exit Procedures for the Period We Reviewed

Our review of investment company, investment adviser, and broker-dealer examinations completed during fiscal year 2003 through fiscal year 2006 found that examiners generally applied OCIE's exit procedures. OCIE's guidance on exit procedures gives examiners flexibility for communicating deficiencies and outcomes of examinations to registrants. These procedures include an exit interview, in which examiners inform registrants of deficiencies before closing an examination, and a closure notification letter, which communicates the outcome of the examination. Under certain circumstances, these procedures may not apply, such as when examiners refer their findings to Enforcement and are asked to forgo any or all of the procedures. OCIE management also has directed examiners to deviate from exit procedures under exigent circumstances, most recently for certain sweep examinations conducted during fiscal years 2003 through 2004 that addressed market timing and other newly emergent, high-risk compliance issues. OCIE officials told us that they did not inform the industry of their decision to forgo exit procedures for many of these sweep examinations, a situation that various industry participants told us confused the firms because they did not receive information on the status or outcome of the examination. We reviewed a sample of investment adviser and investment company examinations and a sample of broker-dealer examinations completed during fiscal year 2003 through fiscal year 2006. Based on this review, we estimated that examiners generally applied exit procedures. The exceptions were an estimated 9 percent of investment company and investment adviser examinations that were part of the market-timing and other related sweep examinations, as well as an estimated 7 percent of broker-dealer examinations where examiners either did not conduct these exit procedures or they did not provide evidence that they conducted them.

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## OCIE Guidance on Exit Procedures Gives Flexibility to Examiners for Communicating Examination Findings

OCIE has instituted specific exit procedures that give flexibility to examiners for communicating deficiencies and notifying registrants of the outcome of examinations. Prior to closing an examination, the guidance generally requires examiners to offer registrants an exit interview to inform them of any deficiencies that examiners found. According to a December 2001 memorandum, which formalizes OCIE's guidance for conducting exit interviews, these interviews are to ensure that registrants are informed of examiners' concerns at the earliest possible time, give registrants an opportunity to provide additional relevant information, and

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elicit early remedial action.<sup>25</sup> According to the guidance, OCIE's goal is to ensure that examiners inform registrants of all deficiencies prior to sending written notification of the examination findings, while at the same time giving examiners flexibility as to when to communicate their concerns. If examiners find deficiencies, they can communicate them either informally during the course of the fieldwork while on-site at the registrant, during a formal exit interview at the end of the on-site visit, or in an exit conference call after they complete additional analysis off-site. The guidance directs examiners to document these discussions in the examination's work papers and in the final examination report. OCIE's guidance for exit interviews also permits examiners to take into consideration the extent and severity of matters found during examinations when determining whether to conduct an exit interview. For example, when examiners refer a firm to Enforcement for securities law violations, in some cases Enforcement staff will ask the examiners to refrain from further discussions with the firm to protect the integrity of the impending investigation.

OCIE officials also told us that if the examiners did not identify any deficiencies to bring to the firm's attention once the on-site visit and subsequent fieldwork were complete, they were not expected to conduct formal exit interviews. Instead, examiners would let the firm know at the end of the on-site visit that they had not found any problems to date. If after completion of the off-site analysis, the examiners still did not identify any deficiencies, the guidance directs examiners to inform the firm of that fact prior to closing the examination.

Examiners formally close an examination by sending a "closure notification" letter to the firm. A closure notification letter can be a no further action letter, which indicates the examination concluded without any findings, or a deficiency letter, which cites any problems found. While the examiners may issue a deficiency letter and also refer some or all of the examination findings to Enforcement, in some cases, as with exit interviews, Enforcement staff may ask the examiners to refrain from sending a deficiency letter or exclude certain findings from a deficiency letter.

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<sup>25</sup>Prior to the December 2001 memorandum, examiners were not required to offer an exit interview.

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## OCIE Deviated from Exit Procedures for Certain Market-Timing and Other Related Sweep Examinations, but Did Not Inform the Industry

OCIE officials said that they only direct examiners to deviate from established exit procedures when they believe it is in the best interest of the examination program and under exigent circumstances, such as during the period OCIE conducted sweep examinations of hundreds of firms to gather information on market timing and other newly emergent, high-risk compliance issues. OCIE officials said that in consultation with Enforcement staff, they decided for several of the market-timing and certain other concurrent sweep examinations to direct examiners not to conduct exit interviews or send closure notification letters. OCIE officials told us that they conducted these sweep examinations largely over fiscal years 2003 and 2004. As discussed later in this section, examination data we reviewed showed that some of these examinations were not completed until fiscal year 2005 or fiscal year 2006.

OCIE officials discussed the factors that contributed to their decision. First, they said that OCIE staff and examiners in the regional offices had little prior experience planning, conducting, and reporting on sweep examinations of such large scale and on such complex issues as market timing. At that time, OCIE did not have formal protocols in place to guide examiners when conducting sweep examinations. Second, the officials said that these sweep examinations involved a prolonged production of documents, data, and e-mails by firms and analysis of this information by OCIE and other SEC divisions and offices over periods as long as a year or more. For example, OCIE staff said that the review of initial documents provided by many firms often did not reveal any deficiencies, but the review of more detailed data a few months later did reveal deficiencies. OCIE officials said that if they had conducted an exit interview or sent a no further action letter based on the initial review of data, registrants would have stopped sending documents to the examination staff. As a result, the examiners would not have been able to detect the deficiencies that such information would have revealed. Third, OCIE officials said that to expedite the process for some groups of firms, they directed examiners not to write individual examination reports, which would have formed the basis for exit interviews and deficiency or no further action letters. Rather, they asked examiners to write a global report summarizing their findings.

Further, OCIE officials said that they did not inform the individual firms targeted during these sweep examinations or the industry generally of their decision to direct examiners to forgo exit procedures. We obtained the views of various industry participants representing investment companies, investment advisers, and broker-dealers on OCIE's decision. Several registrants said that the lack of communication during these sweep examinations was problematic and unsettling, as often they were

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unsure of the status of the examination, if they should be concerned about what OCIE was finding, or when they could assume the examination was over. Other industry representatives echoed these concerns and said that for any OCIE examination, early and ongoing communication with the examiners regarding any deficiencies identified, in addition to holding prompt exit interviews, is essential for the examination process to be effective and efficient. First, the representatives said that firms want to know immediately whether the examiners have identified any deficiencies so they can begin to address them as soon as possible. Second, if examiners identify deficiencies early, it allows the firm the opportunity to clarify any potential misinterpretations by examiners of the firm's policies, procedures, and practices before a deficiency letter is sent.

In the wake of the market-timing and other related sweep examinations, OCIE officials said they expect examiners to follow standard exit procedures for all sweep examinations, i.e., to conduct exit interviews to discuss any deficiencies, send deficiency or no further action letters, and make referrals to Enforcement as appropriate. In March 2006, OCIE issued formal guidelines for initiating, conducting, and concluding these examinations. As part of the guidelines, OCIE clarified that it expected sweep examinations to follow the same procedures as for other types of examinations. OCIE officials said that these expectations were reinforced with the issuance of an updated examination brochure (described in more detail below) in July 2006, which examiners are to provide registrants when beginning any examination and which details the exit procedures.

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### Examiners Generally Applied Exit Procedures during Review Period, with Some Exceptions Noted

Based on our review of a sample of investment company and investment adviser examinations and a sample of broker-dealer examinations completed during fiscal year 2003 through fiscal year 2006, we estimated that examiners generally applied exit procedures, with some exceptions. The exceptions were an estimated 9 percent of investment company and investment adviser examinations that were part of the market-timing and other related sweep examinations, as well as an estimated 7 percent of broker-dealer examinations where examiners either did not conduct these exit procedures or they did not provide evidence that they conducted them. In conducting this analysis, we analyzed examination data from two random samples of 129 examinations each, drawn from (1) the population of 8,107 investment company and investment adviser examinations and (2) the population of 3,044 broker-dealer examinations completed during fiscal year 2003 through fiscal year 2006. These samples allowed us to project the results of our review to the population of all investment company and investment adviser examinations and to the population of all

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broker-dealer examinations completed during this period at a 95 percent level of confidence.

We estimated that examiners held exit interviews to discuss deficiencies found in 79 percent of the investment company and investment adviser examinations completed during the review period (see fig. 1). In addition, examiners did not conduct these interviews for reasons allowed under OCIE's exit interview guidance in an estimated 12 percent of the examinations. For example, in some cases examiners did not find any deficiencies during the examination and so were not required to conduct an exit interview. Instead, they were only required to inform the firm that they did not find any deficiencies and later send a no further action letter closing the examination.<sup>26</sup> Other reasons for not conducting exit interviews included referrals to Enforcement, where Enforcement staff directed the examiners to forgo the interviews, and other circumstantial reasons.

We estimated that for the remaining 9 percent of examinations, examiners did not conduct exit interviews because these examinations were part of the market-timing and other related sweep examinations where OCIE directed examiners to forgo these interviews, even though deficiencies were found.

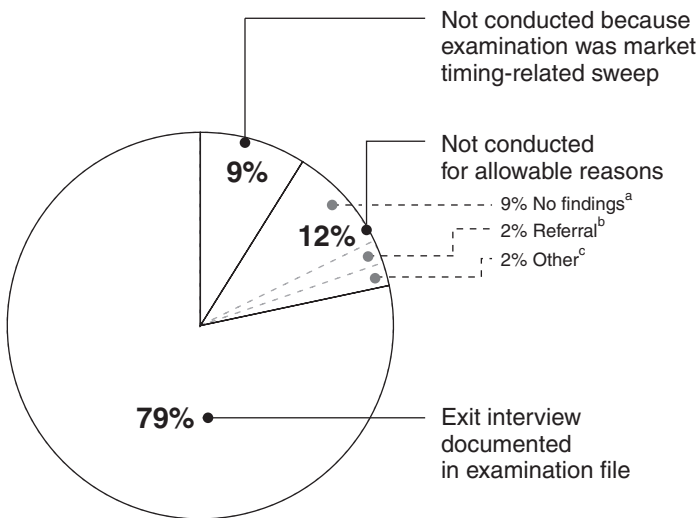
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<sup>26</sup>Several of the examinations in our sample which resulted in no deficiencies were market-timing and other related sweep examinations where OCIE officials told us that in many cases examiners did not provide any indication of the outcome of the examination regardless of whether any deficiencies were found.

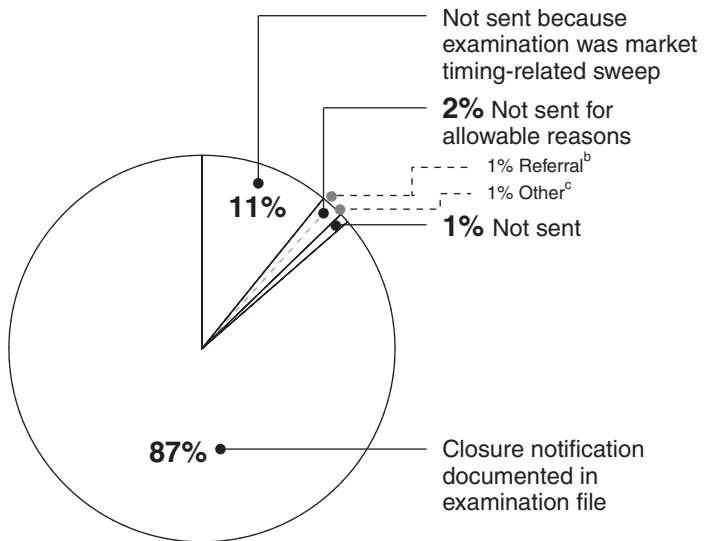


**Figure 1: Estimated Percentage of Investment Company and Investment Adviser Examinations Where Examiners Conducted Exit Interviews and Sent Closure Notifications, Fiscal Years 2003 to 2006**

**Exit interviews**



**Closure notifications**



Source: GAO analysis of SEC examination data.

Note: Percentages may not add exactly because of rounding. All estimated percentages in this table have margins of error of plus or minus 8 percent or less.

<sup>a</sup>Examiners were not required to conduct a formal exit interview because they did not find any deficiencies during the examination.

<sup>b</sup>Examiners referred deficiencies found to Enforcement, whose staff requested that examiners forgo conducting the exit interview, sending a deficiency letter, or both.

<sup>c</sup>Other reasons include more circumstantial reasons OCIE examiners did not conduct exit interviews or send closure notifications. For example, in one case, the firm did not produce requested documents in a timely manner during a sweep examination conducted by headquarters staff, and the examination team closed the exam and referred the firm to a regional office, which began a new examination. We did not request additional information on the new examination.

We also analyzed the frequency with which examiners sent closure notifications to investment companies and investment advisers and estimated that examiners sent either a deficiency or a no further action letter in 87 percent of the examinations completed during the review period. The predominant reason for the higher rate of closure notifications sent compared with exit interviews conducted was that examiners sent no further action letter to firms when no deficiencies were found.

Examiners did not send closure notification letters in an estimated 11 percent of examinations (14 of the 129 examinations we reviewed) because the examinations were part of the market-timing and other related

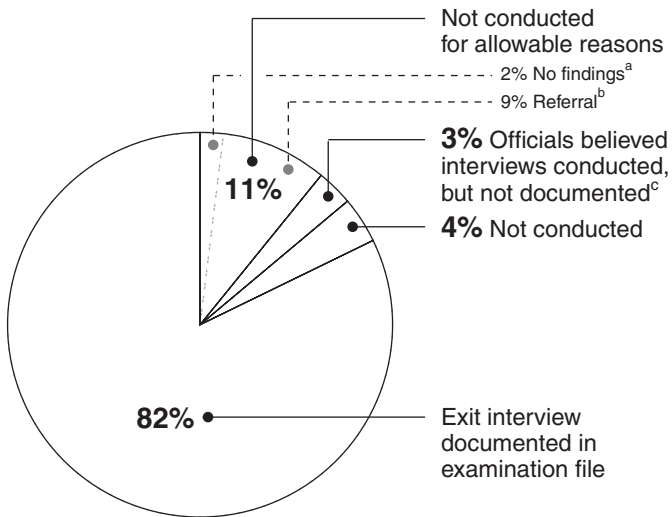
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sweep examinations and OCIE had directed examiners not to send any letters. We found that of these 14 examinations, 11 concluded in fiscal year 2004, 2 concluded in fiscal year 2005, and 1 concluded in fiscal year 2006. Examiners did not send closure notifications for allowable reasons in an estimated 2 percent of examinations, and in an estimated 1 percent, we found no evidence that closure notifications were sent and no legitimate reason why they should not have been sent.

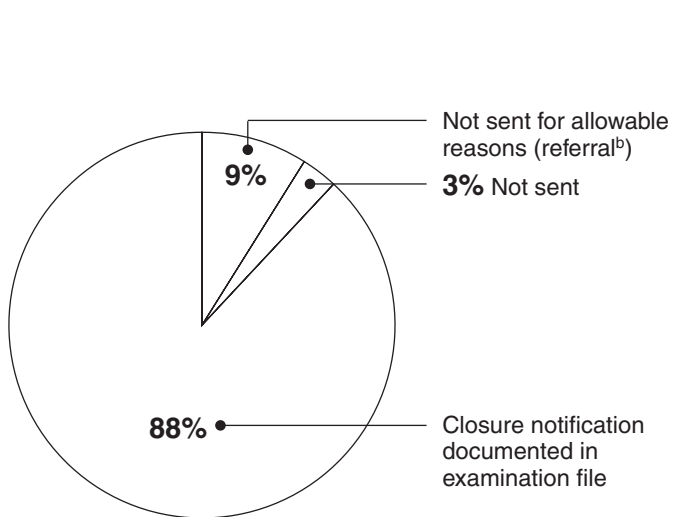
For the population of broker-dealer examinations, we estimated that examiners conducted exit interviews and sent closure notifications in an estimated 82 percent and 88 percent, respectively, of examinations conducted during the review period (see fig. 2). Examiners did not conduct exit interviews or send closure notifications for reasons allowable under OCIE guidance, such as related to referrals to Enforcement, in an estimated 11 percent and 9 percent, respectively, of the examinations.

**Figure 2: Estimated Percentage of Broker-Dealer Examinations Where Examiners Conducted Exit Interviews and Sent Closure Notifications, Fiscal Years 2003 to 2006**

**Exit interviews**



**Closure notifications**



Source: GAO analysis of SEC examination data.

Note: Percentages may not add exactly because of rounding. All estimated percentages in this table have margins of error of plus or minus 8 percent or less.

<sup>a</sup>Examiners were not required to conduct a formal exit interview because they did not find any deficiencies during the examination.

<sup>b</sup>Examiners referred deficiencies found to Enforcement, whose staff requested that examiners forgo conducting the exit interview, sending a deficiency letter, or both.

<sup>c</sup>“OCIE officials believed interviews conducted, but not documented,” refers to those cases where OCIE officials believed that examiners conducted exit interviews, but were not able to provide documentation of them.

In an estimated 7 percent of examinations, we did not find evidence of an exit interview when OCIE guidance indicated one was warranted. However, this estimate includes the 3 percent of cases where OCIE officials told us they believed examiners conducted the interviews but did not document the discussion. For the other estimated 4 percent, we found no evidence that exit interviews were held and no legitimate reason why they should not have been held. In addition, we found no evidence that closure notifications were sent in an estimated 3 percent of examinations and no legitimate reason why they should not have been sent.

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## OCIE Implemented New Initiatives Intended to Improve Communication and Coordination

OCIE has implemented several initiatives since January 2006 designed to improve internal and interagency coordination and communication with registrants. For instance, OCIE has undertaken efforts that include developing tools and protocols to avoid duplication of examinations and forming interdivisional committees intended to improve referrals to Enforcement. Other initiatives include establishing a “hotline” for registrants and formalizing a new requirement to notify registrants when an examination extends past 120 days. Our review indicated that examiners generally complied with this new notification requirement. Some industry participants who provided their views on OCIE’s initiatives expressed hesitations about using the new hotline. Specifically, several participants questioned the independence of the new hotline, because it is located within OCIE’s Office of the Chief Counsel and not in another SEC office or division.

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## OCIE Has Recently Implemented Initiatives to Increase Communication with Registrants and Improve Interagency Coordination

In May 2006, the SEC Chairman testified before the House Financial Services Committee on several reforms designed to improve pre-examination planning and increase the transparency of SEC’s examination program. We found that OCIE has generally implemented the following reforms and additional protocols and tools that are intended to improve coordination across SEC headquarters and regional offices and with other key SEC divisions.

- To minimize the number of firms selected for multiple sweep examinations and to provide advance notice to the commission regarding planned sweep examinations, OCIE developed a formal review and approval process for sweep examinations that is detailed in the March 2006 sweep examination guidance previously discussed. As part of this guidance, OCIE field examiners and OCIE staff are directed to submit a list of firms to OCIE management that they propose to include as part of the sweep examinations. OCIE management is responsible for comparing the list of proposed firms against a master list of firms subject to ongoing or recently completed sweep examinations to ensure that the firms are not bearing an undue share of examination focus, given the nature of their business and OCIE’s risk assessment. Once OCIE has approved the proposed sweep examination and the targeted firm, the new guidance directs OCIE to provide the proposal to Market Regulation, Investment Management, or Enforcement for notification and to obtain comments. Finally, OCIE is to provide the Commission an information memorandum summarizing the proposed sweep examination and its objectives. The memorandum directs staff to allow the Chairman and Commissioners time to review the memorandum and ask questions before commencing the

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sweep examination. We reviewed four of these memorandums, which discussed the time frames for the sweep, the issues OCIE planned to investigate and the methodology it would use, and the firms it planned to include.

- SEC, NASD, and NYSE have developed a database, maintained by NASD, which collects data on examinations conducted by SEC, NYSE, and NASD on 170,000 broker-dealer branch offices. OCIE officials said that examiners are now using this database when planning examinations to avoid dual examinations of the same branch office (with the exception of the broker-dealers selected for review as part of SEC's oversight program of the SROs). Further, as part of the pilot program for assigning permanent monitoring teams to the largest investment company and investment adviser complexes, each firm's monitoring team is responsible for conducting all examinations related to the firm, including examinations at branch offices in different areas of the country. OCIE officials said that prior to the implementation of this program, examiners from different regional offices would conduct separate examinations of the firm's branch offices, which resulted in duplication and imposed a burden on the firm.
- To improve coordination with other key SEC divisions, OCIE officials said they have designed a new training program for fiscal year 2007 that is designed to educate examiners about rules affecting investment companies, investment advisers, and broker-dealers. The four scheduled courses are taught by Investment Management and Market Regulation staff and focus on rules that are new or about which examiners have frequent questions in the course of conducting examinations for compliance with these rules. Second, OCIE and Enforcement have established interdivisional committees in headquarters and the regional offices in late 2006 and 2007 to bring more transparency and consistency to the decisions made to pursue OCIE referrals to Enforcement about investment companies, investment advisers, and broker-dealers. According to joint guidance issued by OCIE and Enforcement in November 2006, the responsibilities of these committees include discussing new referrals to understand their strengths and weaknesses and reviewing those examinations referred to Enforcement that have not resulted in an investigation or enforcement action. In headquarters, these committees also include staff from Investment Regulation and Market Regulation, whose role is to provide insight with respect to referrals that involve novel fact patterns or applications of the law.

OCIE has also taken the following measures that are intended to improve communication with registrants.

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- In January 2006, OCIE established an examination hotline where registrants can call or e-mail anonymously to ask questions about their specific examinations or other issues, lodge complaints, or make comments. To preserve anonymity of the registrants, OCIE does not keep a formal log of calls and e-mails to share with OCIE management although staff take notes on the calls. OCIE officials told us that examples of complaints and concerns to date have included duplicative requests, complaints about examiners, and questions about public statements made by OCIE officials about the examination program. We discuss registrants' views of the effectiveness of the new hotline later in this section.
  - In July 2006, OCIE began requiring examiners to contact registrants when examinations extend beyond 120 days to discuss the status of the examination, the likely schedule for completion, and the date of the final exit interview. Previously, OCIE officials told us that examiners had no notification requirement but as a best practice, tried to contact the registrant if the examination extended beyond the usual 90 days it took to complete most examinations. However, because of the increasing complexity of firms and the increased emphasis on sweep examinations, both of which require additional analysis on the part of examiners and can increase the time needed to complete an examination, OCIE decided to formalize this practice so that firms would be fully aware of the status of the examination. We discuss the extent to which examiners complied with the new notification requirement later in this section.
  - OCIE officials said that they have made more information publicly available on the examination program and current compliance issues. In July 2006, OCIE issued a revised examination brochure, which provides more detailed information to registrants about the examination process, including the 120-day notification procedure and exit procedures. Later, in January 2007, SEC issued a guide, prepared by OCIE, to assist broker-dealers in their efforts to comply with anti-money-laundering laws and rules. Finally, in June 2007, OCIE issued its first *Compliance Alert* letter to chief compliance officers (CCO) of investment companies and investment advisers as part of its CCO outreach program.<sup>27</sup> These letters, which OCIE officials said they plan to issue twice a year, are intended to describe areas of recent examination focus and certain issues found during investment company, investment adviser, and broker-dealer examinations.

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<sup>27</sup>SEC implemented the CCO Outreach program in 2005. The program is jointly sponsored by OCIE and Investment Management and is designed to enable the Commission and its staff to better communicate and coordinate with the CCOs of investment companies and investment advisers.

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## Examiners Generally Followed OCIE's New Procedure to Notify in 120 Days Where Applicable

We reviewed OCIE examination data to determine the extent to which examiners followed the new 120-day notification procedure for investment company, investment adviser, and broker-dealer examinations and determined that examiners generally followed this procedure where applicable since its implementation on July 31, 2006. As previously discussed, OCIE implemented the new 120-day notification procedure to better inform registrants of the status of examinations that would not be completed within 120 days. OCIE has directed examiners to contact the firm on or about the 120th day after the completion of the on-site visit to discuss the status of the examination and the likely schedule for completing the examination and conducting an exit interview. OCIE officials said that this procedure largely was intended to address those instances when an examiner left the firm after the on-site portion of the examination and did not have further contact with the firm while conducting subsequent analysis. OCIE examiners are instructed to call the firm in these cases to update the firm on the examination and should document the discussion in a note to the examination file. However, OCIE officials said that sometimes an examination will extend beyond 120 days because OCIE is waiting for the firm to produce documents or data. In those cases, the firm knows that the examination is still ongoing and examiners are not expected to call on or about the 120th day.

We identified a total of 13 closed examinations that had lasted 120 days or more in the period between the date OCIE implemented the new procedure (July 31, 2006) and the date OCIE provided us its records (February 2, 2007). These 13 cases included 10 investment company and investment adviser examinations and 3 broker-dealer examinations. In 7 of the 13 examinations, examiners either contacted the firm on or around the 120th day of the examination or otherwise already had ongoing communication with the firm because they were waiting for documents or other data from the firm. In 5 of the 13 examinations, examiners did not provide 120-day notification for allowable reasons. For example, in two of these five cases, the examiners referred their findings to Enforcement staff, who asked the examiners to cease contact with the firm. In the other three of these five cases, further contact was not warranted, either because the firm decided to withdraw its registration or the examiners only reviewed available data about the firm in SEC's offices and never contacted the firm to open a formal examination. In the last of the 13 examinations, examiners did not contact the firm on or about the 120th day.

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## Comments from Industry Participants on OCIE's New Initiatives Revealed Concerns about the Independence of the New Hotline

We contacted various industry participants representing investment companies, investment advisers, and broker-dealers to gather their views on OCIE's recent initiatives. They generally expressed support for these initiatives, but some expressed hesitations about using the new hotline. More specifically, several registrants viewed the new hotline as a positive step by OCIE to provide an additional channel of communication, and at least one registrant reported finding the hotline very useful. However, others expressed concern about the independence of the staff that operate the hotline, because, as previously discussed, OCIE's hotline is staffed by attorneys in OCIE's Office of the Chief Counsel. Other industry participants questioned the utility of the hotline as a tool for addressing issues that are of concern to them. For example, they said that they often have concerns about the interpretation of SEC rules by examiners during examinations. They said that when these issues arise, they would like OCIE to consult with Market Regulation—the SEC division that writes and interprets the rules for broker-dealers—to ensure that examiners interpret these rules appropriately. However, they said that they do not perceive that this consultation currently occurs, and as a result, have doubts that calling the hotline would result in an effort by OCIE to obtain clarification. Further, they said that it is important to resolve concerns about rule interpretations while an examination is ongoing and obtain the views of Market Regulation early on, before the exit conference occurs or a deficiency letter is sent. Similarly, another group of registrants thought that OCIE was unresponsive to their past concerns and did not see the hotline as a valuable tool for addressing these concerns.

OCIE officials told us they decided to locate the hotline in their Office of the Chief Counsel because this office is the ethics office for OCIE. OCIE managers thought it was important to keep the hotline in a centralized location, as an issue could arise that involved any one of OCIE's examination programs (such as the programs for investment companies and investment advisers or broker dealers). In addition, according to OCIE officials, the Associate Director and Chief Counsel reports directly to the OCIE director, and therefore the Chief Counsel's Office can exercise a great deal of institutional autonomy when determining how to handle the calls or e-mails received. As discussed earlier, OCIE officials said the Chief Counsel's Office does not keep a formal log of contacts, to better preserve the anonymity of registrants. Finally, the officials said that the issues that registrants bring to them may be legally sensitive, so it made sense that the Chief Counsel's office evaluates them first to determine how to best address them.



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In contrast to OCIE, NASD has created an Office of the Ombudsman to receive and address concerns and complaints, whether anonymous or not, from any source concerning the operations, enforcement, or other activities of NASD. The Office of the Ombudsman is an independent office within NASD that reports directly to the Board of Directors. As part of its responsibilities, the Office of the Ombudsman also provides summary information on the development of trends based on complaints, which may support resulting system change. By locating the hotline in an office or division that is independent of OCIE, OCIE could lessen registrants' concern about the independence of that staff who operate the hotline and thus encourage greater use of it. Besides assisting callers with any complaints, the independent office could periodically summarize information from complaints and concerns for OCIE, while preserving the anonymity of the contacts. Such information could allow OCIE management to identify and respond to any trends in this information and potentially improve the examination program.

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## Conclusions

In the aftermath of the widespread trading abuses that surfaced in the mutual fund industry in late 2003, OCIE has taken steps to make its approach to examining investment companies and investment advisers more risk-based. While such an approach may provide a basis for OCIE to allocate its limited resources to examine firms that are designated as higher risk for compliance problems, the effectiveness of the program largely depends on OCIE's ability to accurately determine the risk level of each investment adviser. Since many firms rated lower-risk are unlikely to undergo routine examinations within a reasonable period of time, if at all, harmful practices could go undetected if firms are inappropriately rated as lower-risk. The risk algorithm that OCIE employs to predict the level of risk for the majority of investment advisers is potentially limited in that it relies on proxy indicators of compliance risks without incorporating information about the relative strength of a firm's compliance controls, information that is critical to assessing a firm's risk level. OCIE has recognized this limitation and has started to take steps to enhance the effectiveness of the risk algorithm to accurately predict risk levels by seeking additional information that could improve OCIE's ability to identify higher-risk firms. Based on fiscal-year-2006 data, OCIE's internal assessment showed that the risk algorithm has a 91 percent accuracy rate for predicting lower-risk ratings but appears to have a lower accuracy rate when considering newly registered investment advisers. Further, the accuracy rate for higher risk firms was 25 percent—in part because the risk-rating did not incorporate information on the firms' ability to mitigate the compliance risks identified. The results of these initial analyses

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indicate that continued assessing and refining the risk algorithm is warranted. As we have previously recommended, one potential source OCIE might consider, as it continues to enhance its methods that assess risk, is the documentation associated with the compliance review that firms must conduct under the Compliance Program rules. We recognize that SEC would first have to require that firms submit these reports to SEC through rule making. However, we continue to believe that using them could potentially allow OCIE to improve its ability to identify higher-risk firms. As part of the revised examination approach, OCIE has also implemented a process intended to identify, map, and develop regulatory responses to high-risk industry practices and compliance issues across the securities markets, although it has not yet developed a formal approach to evaluate the effectiveness of this process for identifying new or resurgent compliance risks. Implementing the task force that OCIE is currently considering could facilitate such an assessment.

Our review found that OCIE examiners generally followed OCIE guidance for conducting exit procedures during the period reviewed, with a major exception for market-timing and other related sweep examinations conducted largely over fiscal years 2003 and 2004, with a few concluding in fiscal year 2005 and fiscal year 2006. OCIE directed examiners to forgo these exit procedures. OCIE guidance provides management and examiners flexibility in determining when and how to communicate deficiencies to registrants and is responsive to Enforcement's directives. However, by not providing the industry any notice or explanation of the decision to forgo these procedures for certain market-timing and other related sweep examinations, OCIE unnecessarily created concern and confusion for some registrants during this difficult time. Going forward, OCIE has directed its examiners to follow standard exit procedures for all sweep examinations.

Since January 2006, OCIE has generally implemented a number of initiatives to improve coordination and communication. Ongoing monitoring and reassessing of these initiatives by OCIE is important to ensure that they are achieving their intended objective. For example, OCIE's procedure to notify firms when examinations continue beyond 120 days could help mitigate the uncertainty firms told us they experience when examiners leave the firm and do not update the firm on the status of examinations for long periods of time. While our review of 13 examinations revealed general compliance with this notification procedure, OCIE must ensure that examiners continue to adhere to the requirement in the future. Another new initiative, the examination hotline, could give registrants an effective means to communicate concerns or

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complaints about the examination program, but several registrants reported reluctance to use it because the hotline was located in and staffed by OCIE. Their concerns about OCIE's receiving their complaints or concerns included a perceived lack of impartiality. Locating the hotline in a division or office that is independent of OCIE could encourage greater use and increase effectiveness. Further, this new office could analyze the contact information and give OCIE management with information summarizing trends generated from analysis of complaints or inquiries, information that OCIE could use to improve its examination programs.

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## Recommendations for Executive Action

To encourage registrants to communicate their concerns, questions, or complaints to SEC about the examination process, we recommend that the SEC Chairman explore relocating the hotline to an independent office such as an ombudsman function within the agency or within a division or office that is independent of OCIE and, as part of the responsibilities of this office, consider requiring it to give OCIE management summary information on the development of trends resulting from complaints or inquiries.

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## Agency Comments and Our Evaluation

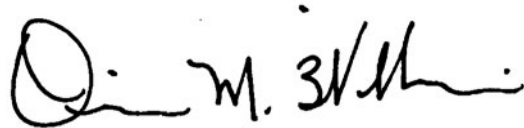
SEC provided written comments on a draft of this report, which are reprinted in appendix II. SEC also provided technical comments, which were incorporated into the final draft as appropriate. SEC noted in its comment letter that while an important benefit of the current establishment of the hotline is that it provides immediate access to a member of senior OCIE management, it also wants to encourage calls from anyone who has a question or concern about an examination. As a result, SEC stated it is taking steps to revise the hotline in order that callers can choose to speak with the commission's Office of the Inspector General, in addition to staff from OCIE's Office of the Chief Counsel. In taking this step, SEC believes it is preserving the benefits of the current system while responding to our recommendation.

As agreed with your office, unless you publicly announce the report's contents earlier, we plan no further distribution of this report until 30 days after the date of this report. At that time, we will send copies of this report to the Chairmen of the Committee on Financial Services and its Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, House of Representatives; and other interested committees. We will also send a copy of the report to the Chairman, Securities and Exchange Commission. We will make copies available to others upon

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request. The report will also be available at no charge on our Web site at <http://www.gao.gov>.

If you or your staff have any questions regarding this report, please contact Orice M. Williams at (202) 512-8678 or [williamso@gao.gov](mailto:williamso@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix III.

A handwritten signature in black ink, appearing to read "Orice M. Williams". The signature is stylized with a large initial "O" and a long horizontal flourish at the end.

Orice M. Williams  
Director, Financial Markets  
and Community Investment

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*List of Congressional Requesters*

The Honorable Spencer Bachus  
Ranking Member  
Committee on Financial Services  
House of Representatives

The Honorable Deborah Pryce  
Ranking Member  
Subcommittee on Capital Markets, Insurance,  
and Government Sponsored Enterprises  
Committee on Financial Services  
House of Representatives

The Honorable Richard H. Baker  
House of Representatives

The Honorable Vito Fossella  
House of Representatives

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# Appendix I: Scope and Methodology

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To better understand the Office of Compliance Inspections and Examination's (OCIE) revisions to the examination approach for investment companies and investment advisers after 2003 and the process OCIE implemented to better identify compliance risks across the securities markets, we obtained and analyzed information from OCIE on its revised examination approach for investment companies and investment advisers and a new, examiner-driven process for identifying emergent or resurgent systemic risks to investors and SEC registrants. Specifically, we reviewed OCIE's internal planning documents, a memorandum from OCIE to the Commission, and data OCIE generated as part of an internal evaluation on its methodology for assessing compliance risk at investment advisers. We did not verify these data. We also observed a demonstration of the information technology application OCIE uses to conduct its annual risk-assessment process, reviewed prior GAO reports, and interviewed OCIE and other Securities and Exchange Commission (SEC) officials.

To identify OCIE's exit procedures and assess the frequency with which examiners have followed these procedures when conducting investment company, investment adviser, and broker-dealer examinations, we reviewed OCIE's guidance to examiners and interviewed officials from OCIE and industry participants representing investment companies, investment advisers, and broker-dealers, and analyzed examination data. We focused our analysis on these registrants because they comprise over 95 percent of all SEC registrants and OCIE expends most of its examination resources on these entities. We analyzed broker-dealer examinations separately from investment company and investment adviser examinations because the two examinations areas have different types of examinations and are managed separately within OCIE.

We obtained data from OCIE on all investment adviser, investment company, and broker-dealer examinations completed during fiscal year 2003 through fiscal year 2006. We chose to review this period because it included a time when OCIE did not require examiners to apply their usual exit procedures for certain sweep examinations as well as periods when OCIE said that it applied the exit procedures to most examinations. We selected random samples of 129 examinations each from the population of 8,107 investment company and investment adviser examinations and the population of 3,044 broker-dealer examinations. This sample size allowed us to project our results from these two samples to the two respective populations at the 95 percent level of confidence. All estimates have margins of error of plus or minus 8 percent or less. To determine the extent to which examiners conducted exit interviews and sent closure

notifications in our samples, we reviewed the electronically available examination reports and, where necessary, asked OCIE for additional documentation from the examination files. The results of our analysis for each of these two registrant types are limited to estimates of this combined 4-year time frame. In conducting our analysis, we conducted a data reliability assessment of the data OCIE provided us and determined they were reliable for our purposes.

To identify OCIE's recent initiatives to increase communication with registrants and improve the examination program, including the frequency with which examiners have followed OCIE's new notification requirement for examinations that continue longer than 120 days, we reviewed documentation obtained from OCIE, including memorandums to the Commission, internal OCIE guidance, and the revised examination brochure. We also analyzed examination data related to the 120-day notification procedure and interviewed officials from OCIE and the industry participants previously discussed. In determining the frequency that examiners have complied with the new 120-day notification procedure, we obtained data from OCIE of all of the investment adviser, investment company, and broker-dealer examinations conducted between July 31, 2006, the day the policy was implemented, and February 2, 2007, the day OCIE gave us the records. We identified all closed examinations that lasted 120 days or more, thus triggering the 120-day notification requirement. Because there were only 13 closed examinations where the procedure was applicable, we reviewed all of them. We first reviewed the electronically available reports for evidence of the notification and, in those cases where we did not find evidence, asked OCIE for additional documentation from the examination files. In conducting our analysis, we conducted a data reliability assessment of the data OCIE provided us and determined they were reliable for our purposes.

We conducted our work in Washington, D.C., between September 2006 and July 2007 in accordance with generally accepted government auditing standards.

# Appendix II: Comments from the Securities and Exchange Commission



OFFICE OF COMPLIANCE  
INSPECTIONS AND  
EXAMINATIONS

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

August 3, 2007

Ms. Orice M. Williams  
Director, Financial Markets and Community Investment  
United States Government Accountability Office  
441 G St., NW  
Washington, DC 20548

RE: *Securities and Exchange Commission; Steps Being Taken to Make Examination Program More Risk-Based and Transparent (GAO-07-1053)*

Dear Ms. Williams:

We thank you for your report presenting the results of your audit of the examination program of the Securities and Exchange Commission ("Commission"). As you note in the report, conducting examinations is one of the Commission's most important tools in detecting fraud and violations of securities laws for the protection of investors. As you note, in fiscal 2006 the Commission conducted over 2,600 examinations and inspections of investment companies, investment advisers, broker-dealers, and other registered securities-related firms. We applaud your findings that overall, steps have been taken to make the Commission's examination program more risk-based and transparent. Our ongoing commitment is to maintain excellence in the Commission's examination program for securities firms registered with the Commission, for the protection of investors.

As you report, in recent years, with the growth in the number and activities of securities firms, we've worked hard to develop a variety of risk assessment tools, including a risk-algorithm for investment advisers, compliance risk-ratings based on examinations, a program-wide risk analysis and action process, and expanded usage of commercial databases and other sources of information. In addition, as you report, we have been actively developing mechanisms for testing the effectiveness of our risk assessment tools, including random examinations of firms scored low-risk, and a sweep review of recently-registered investment advisers that had been scored low-risk and had not been examined by the Commission. We are also piloting other approaches to oversight, such as monitoring teams for selected entities. We are continuing to identify and consider other sources of information and data that could assist us in further refining our risk based programs, including compliance reports of investment advisory firms, as well as other information. In this respect, we believe that important new information will be derived from advisers' Form ADV Part 2 when it is filed with the Commission.

As you also report, our program has a very high level of compliance with our internal standards of practice governing exit interviews and closure notifications. Indeed, your analysis shows that



Appendix II: Comments from the Securities  
and Exchange Commission

exit interviews and closure letters were issued consistent with our internal guidelines and management guidance in between 96% and 100% of the examinations sampled. Specifically, compliance with our internal standards was fully documented (in 79-88% of all examinations), the standard was met but without documentation (in 3% of broker-dealer examinations), compliance was waived for allowable reasons (in 2-12% of all examinations), and compliance was waived by management directive in the exigent circumstances of the market-timing related reviews initiated in 2003 and 2004 (in 9-11% of fund and adviser examinations). While compliance with our internal standards with respect to exit interviews and exam closure letters was very high, we are nonetheless putting in place system modifications to our internal examination tracking system (STARS) that we believe will ensure both better documentation and maximum consistency with our internal guidelines with respect to providing exit interviews and exam closure letters.

Additionally, as you report, in recent years we have undertaken a number of new initiatives to enhance our transparency and communications with the registered community, and to improve inter-agency coordination. We are pleased that industry representatives expressed support for these initiatives, and we believe that enhanced communications with securities firms have served to help improve attention to compliance in the securities industry. As you note, our *CCOutreach* program and our *ComplianceAlerts* provide compliance professionals with useful information that they can use to improve their compliance programs to avoid violations.

Finally, as you note in your report, in 2006, we established a hotline so registrants can quickly contact a senior member of our management with any questions or concerns about an examination -- the goal of the hotline is to improve our responsiveness to the firms we examine by giving them immediate access to a member of the program's senior management. We are pleased that registrants told you that they viewed the hotline as a positive step to provide an additional channel of communications. In your report, you recommend that we consider relocating the hotline to an independent office. While we believe that an important benefit of the current hotline is that it provides immediate access to a senior examination manager, we want to encourage calls from anyone who has a question or concern about an examination. Therefore, we are developing a revised hotline system, in which callers will be able to choose to speak either with staff in the Commission's Office of the Inspector General or staff in the Office of Chief Counsel in the Office of Compliance Inspections and Examinations. We believe this responds to your recommendation and also preserves the benefits of the current system.

\* \* \* \*

We appreciate GAO's attention to these issues.

Sincerely,



Lori Richards  
Director

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# Appendix III: GAO Contact and Staff Acknowledgments

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## GAO Contact

Orice M. Williams (202) 512-8678 or [williamso@gao.gov](mailto:williamso@gao.gov)

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## Staff Acknowledgments

In addition to the contact named above, Karen Tremba (Assistant Director), James Ashley, Rudy Chatlos, Nina Horowitz, Stefanie Jonkman, Christine Kuduk, Marc Molino, Omyra Ramsingh, and Barbara Roesmann made key contributions to this report.

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