

**EXAMINATIONS BY THE SECURITIES AND EXCHANGE COMMISSION
OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS
February 2009**

I. EXAMINATIONS OF INVESTMENT ADVISERS, INVESTMENT COMPANIES, BROKER-DEALERS, TRANSFER AGENTS, CLEARING AGENCIES, SELF-REGULATORY ORGANIZATIONS, AND NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

Materials from February 2009 *SEC Speaks in 2009* Conference (posted June 30, 2009)

A. Overview of Examination Program/New Developments in 2008

1. The Office of Compliance Inspections and Examinations ("OCIE") provides consolidated management of the Commission's examination program for broker-dealers, investment advisers, investment companies, transfer agents, nationally-recognized statistical rating organizations, clearing agencies, and self-regulatory organizations ("SROs"), and includes examination staff located in Washington, DC, New York, Boston, Philadelphia, Chicago, Denver, San Francisco, Los Angeles, Miami, Atlanta, Fort Worth, and Salt Lake City.
2. OCIE's goal is to identify emerging areas of compliance risk, conduct examinations, and take steps to remedy identified problems. Given the number of registrants and the breadth of their operations, the staff continues to focus examination resources on those registrants and activities where the investing public or market integrity is most at risk. In the past few years, the examination program was significantly improved by efforts to proactively detect and address potential risks.
3. To assist the staff in identifying risks warranting additional examination, OCIE continues to use a risk-identification and risk-assessment methodology. This methodology uses an internal database for examiners and managers to identify and prioritize risks, and to recommend regulatory, examination or other actions to be taken to address or mitigate the risks identified. OCIE's Risk Assessment Staff sorts and analyzes this risk information and generates management-level reports that identify and provide insight on potential high-risk areas. The information is used by management in prioritizing risks for examination attention and in allocating program resources. The risk-assessment reports are also used in a number of examination training initiatives to enable examiners to learn about risk details, identifiable focus areas and examination program priorities. Risk information is also shared with other divisions and offices for their attention and action, when appropriate. The risk-assessment process is used to identify risks requiring further regulatory or examination attention and to build a culture of risk-assessment within the examination program.
4. The SEC conducts several types of inspections and examinations:
 - a. Risk-focused Examinations: These are conducted to determine the extent, scope, and danger of emerging risks in the regulated community. These examinations are also sometimes known as "risk-targeted examinations" or "examination sweeps." In them, the staff reviews risk conditions and responsive compliance controls at a sample of firms. Special examinations and risk-focused examination sweeps scrutinize a specific activity, control, or compliance area at a number of firms. This approach allows the staff to obtain a more comprehensive view of any particular risk, assess the gravity of the risk, evaluate the compliance performance of individual firms and compare it with that of their peers and recommend regulatory solutions.
 - (1) Risk-focused reviews are managed by OCIE and by the regional office that is conducting the review. In many cases, the lead office will conduct examinations on a national scale, not just within its local territory. This provides for greater continuity and consistency in the review.
 - (2) During the past few years, controls were installed to reduce potential duplication or overlap among risk-focused examinations. These new controls provide more vigorous approval processes for risk-focused reviews and for selecting the firms to be examined and reducing the possibility of duplicative document requests.
 - b. Cyclical Examinations: These are designed to periodically test an entity's compliance with applicable laws and regulations.
 - (1) Each higher-risk investment company complex and investment adviser is inspected at least once every two to three years. Higher-risk advisers are identified by a new Branch of Surveillance and Reporting within OCIE based on a risk-scoring process, and by regional office staff based on a number of factors, including: results of prior inspections, investor complaints, and assets under management. Other adviser and fund firms are subject to examination in a random selection process.

- (2) Inspections of mutual fund transfer agents affiliated with an investment company complex are examined in conjunction with the affiliated fund complex. All other mutual fund transfer agents are examined periodically with a goal of examining them at least once every three years.
 - (3) The largest broker-dealers' risk management and compliance controls covering market, credit, operational, and legal risks are examined on a cyclical basis.
 - (4) Beginning in FY09, all NRSROS will be examined on a routine frequency.
- c. Cause Examinations and Inspections: These examinations are conducted when the staff has reason to believe that there have been violations of the federal securities laws, and are occasioned by press reports, complaint letters, information provided by other regulators, tips, or other indications of wrongdoing.
- d. Oversight Examinations: These examinations of broker-dealers test both the firm's compliance processes and the quality of the SRO's examination. They are not conducted on a periodic basis, because the SROs visit these firms on a regular basis.
- (1) The SROs examine every broker-dealer on cycles varying from annually to once every four years, depending on the type of firm.
 - (2) In recent years OCIE employed a new approach to oversight examinations that brings greater methodological rigor to the program and focuses greater efforts on working with the SROs to ensure that appropriate remedies are fashioned to address problems identified in the oversight findings. As a result, the staff is able to focus on what caused an SRO to overlook violations and how to improve the SRO's examination methodologies.
- e. Oversight Inspections: SROs are routinely conducted on a cyclical basis. Rather than inspecting an entire SRO, the staff generally focuses on particular program areas. At least one program area of each SRO is inspected every other year. These inspections test the SROs' compliance with their regulatory duties.
5. OCIE provides both training for all staff and liaison functions with the Divisions of Enforcement, Investment Management, Trading and Markets, and Corporation Finance, as well as other Commission offices and financial regulators regarding findings and regulatory concerns arising out of examinations. OCIE examination training provides extensive program training to the staff in regional and headquarters offices. Training involves both core and special programs. It is conducted through field office workshops, senior level conferences, and videoconference programs.

In 2008, OCIE coordinated three large training events with other securities regulators:

- a. Anti-money Laundering Joint Regulatory Examination Training: In April 2008, OCIE coordinated this event for SEC and the Financial Industry Regulatory Authority ("FINRA") examiners. The purpose of this training was to ensure that broker-dealer examiners involved in anti-money laundering ("AML") examinations were knowledgeable about AML compliance requirements, to share examination techniques and to discuss coordination between the SEC and FINRA. The topics included: (i) AML rules, (ii) Suspicious Activity Reports ("SARs"), (iii) examinations and enforcement, (iv), SRO and SEC interaction with the Financial Crimes Enforcement Network ("FinCEN"), (v) information sharing with FINCEN regarding the USA PATRIOT Act ("PATRIOT Act"), (vi) The U.S. Treasury Department's Office of Foreign Assets Control, (vii) clearing firm and introducing firm relationships, (viii) compliance programs, (ix) independence testing, (x) customer identification programs, (xi) law enforcement and terrorist financing, (xii) banking and bank affiliates, (xiii) Patriot Act Section 312 due diligence requirements, and (xiv) case studies on Park Financial and Banc of America.
- b. 11th Annual Joint Regulatory Examination Training: In July 2008, OCIE coordinated this event for state, federal and SRO securities examiners. The purpose of the training was to share examination techniques with other securities regulators and to ensure that examiners throughout the regulatory community were well trained and knowledgeable regarding current broker-dealer regulatory issues and examination techniques. The topics included: (i) a focus on seniors issues, (ii) variable annuities, (iii) communications and advertising, (iv) viatical and life settlements, (v) supervisory control issues, (vi) collateralized mortgage obligations ("CMOs"), (vii) collateralized debt obligations ("CDOs"), (viii) subprime issues, (ix) combined broker-dealer and investment adviser examinations, (x) branch office auditing, (xi) preparations for becoming a staff witness, (xii) Regulation S-P, (xiii) data integrity, (xiv) outsourcing, (xv) special purpose acquisition companies ("SPACS") and blind pools, and (xvi) AML issues.
- c. Net Capital Joint Examination Training Program: In August 2008, OCIE coordinated this event for SEC and FINRA examiners. The purpose of this training was to teach experienced broker-dealer examiners how to compute and use net capital, as defined in the Investment Company Act, while conducting examinations and to discuss net capital in light of the current credit crisis. The topics included: (i) a focus was on the 2 importance of capital, (ii) liquidity, (iii) risk

Division of Trading and Markets issues, (v) small- and mid-sized broker-dealer capital issues, (vi) large broker-dealer capital issues, (vii) risk management: examination focus areas and techniques at large- and mid-sized firms, (viii) funding and liquidity, (ix) capital alert lists, (x) product control and valuation issues, and (xi) current industry developments.

6. OCIE conducts special examinations to gather information about areas of interest or concern to the Commission. Occasionally, the examination reports summarizing findings are released publicly. Recent reports include: *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies* (July 2008); *Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors* (September 2008); *Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars* (September 2007); *Report on Refunds, Sales Practices, and Revenues from Periodic Payment Plans* (March 2007); and *Report Concerning Examinations of Options Order Routing and Execution* (March 2007).
7. ComplianceAlerts: In July 2008, OCIE issued its second *ComplianceAlert* on its public website, which highlighted recent, significant examination findings. OCIE expects to issue similar alerts from time-to-time each year.
8. CCOutreach Program for Investment Adviser/Investment Company Chief Compliance Officers: The staff continued to sponsor the *CCOutreach* program designed to assist fund and adviser chief compliance officers ("CCOs") in performing their important responsibilities and, ultimately, to help ensure strong compliance for the protection of investors. This program includes National, Regional, and Interactive Broadcast Seminars that address current compliance risk areas and developments. In addition, OCIE periodically posts *ComplianceAlerts* on the SEC's website to provide information about recent examination findings and problem areas.

In fiscal year 2008, the staff sponsored one National Seminar and the regional office staff held 26 seminars across the country, including two *CCOutreach* seminars held abroad for SEC-registered advisers located in Asia and the Far East. More than 3,000 compliance professionals viewed the National Seminar and over 2,550 CCOs attended the regional seminars in fiscal year 2008. In addition, the staff expanded its initiative to encourage compliance by introducing Interactive Broadcast Seminars, which are designed to address the unique compliance risks and issues facing niche market sectors or products. The first of these seminars, which focused on issues applicable to small investment advisory firms, was viewed by approximately 2,800 compliance professionals.
9. CCOutreach Program for Broker-Dealers: In October 2007, the SEC announced that due to the popularity of the *CCOutreach* program for investment adviser/investment company CCOs, it would expand this approach in 2008 to broker-dealer CCOs, in conjunction with the FINRA, and in coordination with the Division of Trading and Markets. The first successful National Seminar was held on March 7, 2008, and 14 regional seminars were held across the country throughout 2008. OCIE is currently planning the second year of *CCOutreach* broker-dealer programs. The National Program will be held on March 10, 2009 at the SEC in Washington, and 2009 regional programs are currently being planned.
10. Rating Agencies: In 2008, the staff of OCIE's Office of Market Oversight ("OMO") conducted examinations of the three principal nationally recognized statistical rating organizations ("NRSROs"), in coordination with other SEC staff. The staff reviewed their processes for rating subprime residential mortgage backed securities ("RMBS") and related CDOs. Due to the importance of these types of securities in the current financial crisis, this was a significant examination focus area in 2008. As part of its ongoing NRSRO examination program, OCIE's OMO will initiate reviews of the seven other NRSROs during FY 09. These examinations will focus on these firms' compliance with the law and rules with respect to the integrity of the credit rating processes, the policies and controls the firms have adopted to address conflicts of interest in the rating process, and the quality and breadth of their compliance control systems generally.

B. Statutory Authority

1. The Commission's statutory authority to conduct examinations is drawn from three statutes: the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. 78a, et seq.; the Investment Company Act of 1940 ("Investment Company Act"), 15 U.S.C. 80a-1, et seq.; and the Investment Advisers Act of 1940 ("Invest Advisers ACT"), 15 U.S.C. 80b-1 et seq.
2. Examinations pursuant to the Securities Exchange Act are authorized by Section 17.
 - a. Section 17(a) of the Securities Exchange Act, 15 U.S.C. 78q(a), states that the following entities "shall make and keep for prescribed periods such records [and] furnish such copies thereof ... as the Commission, by rule, prescribes as necessary or

appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title."

- (1) national securities exchanges;
- (2) members of national securities exchanges;
- (3) brokers or dealers transacting a business in securities through the medium of a member of a national securities exchange;
- (4) registered securities associations;
- (5) registered brokers or dealers;
- (6) registered municipal securities dealers;
- (7) registered securities information processors;
- (8) registered transfer agents;
- (9) registered clearing agencies; and
- (10) the Municipal Securities Rulemaking Board.

b. The Commission has implemented this section by requiring registered entities to produce copies of records to Commission representatives upon request.

- (1) Rule 17a-1(c) requires SROs to promptly furnish copies of required records to any representative of the Commission. The Commission has indicated that the staff's authority to obtain copies of SRO records under Section 17(a) and Rule 17a-1(c) is independent of its examination authority under Section 17(b) (see below). Securities Exchange Act Release No. 16598 (February 21, 1980), 19 SEC Docket 699, 700-01.
- (2) Rule 17a-4(j) requires broker and dealers to promptly furnish legible, true, and complete copies of required records to representatives of the Commission.

c. Section 17(b) of the Exchange Act, 15 U.S.C. 78q(b), authorizes the Commission to conduct "reasonable periodic, special, or other examinations," of "[a]ll records" maintained by entities described in Section 17(a) (see above). These examinations may be conducted "at any time, or from time to time," as the Commission "deems necessary and appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title." The Commission has taken the position that the statutory grant of authority contained in this section "is unconditional except for the requirement that any such record examination be 'reasonable.'" Securities Exchange Act Release No. 16278 (October 12, 1979), 18 SEC Docket 670, 671.

d. Pursuant to Section 17(b), when the Commission examines a registered clearing agency, registered transfer agent, or registered municipal securities dealer for which it is not the "appropriate regulatory agency," as defined in Section 3(a)(34) of the Exchange Act, 15 U.S.C. 78c(a)(34), it also notifies the appropriate regulatory agency and engages in certain consultations.

3. Section 13(h)(4) of the Exchange Act, 15 U.S.C. 78m(h)(4), authorizes the Commission to examine broker-dealer records relating to large trader reporting. The Commission has stated that "the legislative history indicates that this examination authority would be complementary to the examination authority provided in Section 17(b) of the Securities Exchange Act." Securities Exchange Act Release No. 29593 (August 22, 1991), 49 SEC Docket 1018, 1024 n.67.

4. Examinations pursuant to the Investment Company Act are authorized by Sections 31 and 32.

a. Section 31(a) of the Investment Company Act, 15 U.S.C. 80a-30(a), requires the following entities to maintain and preserve records as prescribed by the Commission:

- (1) registered investment companies;
- (2) underwriters, brokers, dealers, and investment advisers that are majority-owned subsidiaries of an investment company; and

- (3) investment advisers (not majority-owned by a registered investment company), depositors, and the principal underwriters of investment companies other than closed-end companies, in regards to their transactions with investment companies.
 - b. Section 31(b) of the Investment Company Act, 15 U.S.C. 80a-30(b), authorizes the Commission to conduct "reasonable periodic, special, and other examinations," of the "records required to be maintained and preserved" pursuant to Section 31(a). These examinations may be conducted "at any time and from time to time." Section 31(b) also states that anyone covered by the record keeping requirements: "shall furnish to the Commission, within such reasonable time as the Commission may prescribe, copies of or extracts from such records which may be prepared without undue effort, expense, or delay, as the Commission or its representatives may reasonably require."
 - c. Section 32(c) of the Investment Company Act, 15 U.S.C. 80a-1(c), authorizes the Commission to require accountants and auditors to keep reports, work sheets, and other documents and papers relating to registered investment companies and to make them available for inspection by representatives of the Commission, as the Commission may prescribe by rule, regulation, or order.
- 5. In the National Securities Markets Improvement Act of 1996, two new provisions were added to the Commission's authority to examine investment companies.
 - a. Section 31(b)(3) of the Investment Company Act now states that the Commission shall exercise its inspection authority with due regard for the benefits of internal compliance policies and procedures and the effective implementation and operation thereof.
 - b. The legislative history of this provision (H.R. Rep. No. 104-622 at 49), indicated that:
 - (1) In exercising "due regard," the Commission would review fund internal audit and similar compliance-related reports on a selective basis.
 - (2) Specifically, the Commission is expected to request and review internal audit and similar reports only insofar as necessary to determine whether the internal compliance policies of the fund or other examined persons are in place, whether procedures to effect and enforce those policies have been implemented, and whether the compliance policies and procedures are reasonably designed to detect compliance problems and address them in an appropriate fashion.
 - (3) Thus, in a routine examination, the Commission staff seeks to review a sample of an examined person's internal audit reports adequate to form a basis for concluding that the compliance policies and procedures are achieving these objectives. The House Committee indicated that it believed the goal of examinations effected by the Commission staff should not be simply to duplicate the role played by a fund's internal compliance staff. If a fund has a well-functioning system of internal controls, the Commission's limited resources can be directed to other areas of fund operations, or to other funds.
 - c. Section 31(c) of the Investment Company Act now states that notwithstanding any other provision of law, the Commission shall not be compelled to disclose any internal compliance or audit records, or information contained therein, provided to the Commission during examinations.
- 6. Examinations pursuant to the Investment Advisers Act are authorized by Section 204.
 - a. Section 204 of the Investment Advisers Act, 15 U.S.C. 80b-4, authorizes the Commission to conduct "reasonable periodic, special, or other examinations," of "[a]ll records" maintained by investment advisers. These examinations may be conducted "at any time, or from time to time," "as the Commission deems necessary or appropriate in the public interest or for the protection of investors."

II. INSPECTIONS AND EXAMINATIONS: THE PROCESS

A. Overview

- 1. During inspections and examinations, the staff reviews the books and records of regulated entities, interviews management and firm employees, and analyzes the entity's operations. In many cases, examinations include an on-site visit to the regulated entity's offices. In addition, the staff also conducts examinations that do not include on-site visits. The goal of all examinations is to test the registrant's compliance with the federal securities laws and regulations.

2. Much of the staff's examination work is accomplished in the Commission's offices.
 - a. Advance preparation for an examination is essential for effective fieldwork. Advance preparation includes research in SRO records and other automated data libraries, review of the registrant's filings with the Commission, and formulation of the risk areas warranting review.
 - b. The staff continues to work on the examination after they return to the Commission's offices. The examination team frequently consults with other staff or other divisions concerning matters that arose during the fieldwork. Legal and accounting opinions may be sought to ensure consistency, and preliminary findings of a particular examination may be compared to those for similar firms.

B. Scope

1. All examinations are focused on risk. In a risk-focused examination, the staff focuses on the particular risk that led to the examination. In other reviews, the staff seeks to identify risks requiring attention, and also seeks to obtain a more general understanding of the entity's compliance and internal control environment.
2. In most cases, the staff considers the quality of the registrant's compliance systems and its internal control environment when determining the scope of the examination and the areas to be reviewed.

C. Scheduling Fieldwork

1. Depending on the nature of the examination, the staff will often contact a registrant in advance before beginning fieldwork. Prior notice can range from a few days to a few weeks.
2. However, when the staff conducts cause examinations, the first examination of a registrant, an examination of a sales office, or certain focused examinations, the staff may not provide notice. Under these circumstances, the staff may arrive unannounced, thus providing a candid look at the registrant's operations.
3. When a registrant is contacted in advance of an examination, notice of the areas on which the staff intends to focus may not be provided in order to ensure that books, records, and activities are not altered or destroyed to prevent the staff from detecting problems.
4. In some cases, particularly in risk-focused reviews, the staff will request and review records from a sample of firms, and then conduct on-site reviews of a sub-set of the sample. A variety of methods are used for selecting the sub-set for on-site review.

D. Entrance Interviews

1. Upon arriving at a registrant's offices, the staff will request an interview with responsible management. This interview is critical because it usually determines the tone and the focus of the examination.
2. In the interview, the staff provides the registrant with three documents:
 - a. A brochure prepared by OCIE describing the examination process.
 - b. A copy of SEC Form 1661, which contains information on the Freedom of Information Act, the Privacy Act, and other applicable laws. When conducting a study or other review that involves the registrant's voluntary participation, a copy of SEC Form 1662 is provided.
 - c. Finally, the staff shows identification cards. These cards certify that the staff members are, in fact, representatives of the Commission.
3. The substance of the entrance interview will be determined by the nature of the examination. In general, the staff will ask about the registrant's organization, affiliations with other entities, operations, key personnel, supervisory systems, compliance systems, customers, sources of revenue, major liabilities, and so on.

4. Following the interview, the staff will frequently ask for a tour of the registrant's offices and operations. For example, the staff may ask to observe how the registrant handles an individual trade from the time the order is received. As with the interview, observing the registrant's operations gives the staff some insight into how the registrant conducts its business.

E. Document Requests

1. Much of the staff's time when conducting fieldwork is spent reviewing documents. The specific documents requested will vary depending on the nature of the examination. When the staff reviews records, they will take reasonable steps to minimize disruption to the registrant's operations. Similarly, the staff is ready to work with the registrant to set priorities for record copying. However, if necessary, the staff will require that records be immediately provided.
2. Registrants are often given a list of records the staff intends to review during the examination. Lists will vary depending on the nature and focus of the examination.

F. Questions

1. The staff will frequently have questions while they review the registrant's books and records. Registrants frequently designate a liaison to the examination team, and, in those circumstances, the staff will direct questions to the liaison.
2. The staff may have questions of any type. They include very specific inquiries about the registrant's record keeping or accounting practices. The staff sometimes raises more general questions about operations or practices revealed by the records.
3. The dialogue between the staff and registrants helps both parties. Obtaining answers to their questions helps the staff accomplish their mission. Answering questions helps the registrant explain itself to the staff. Candid and complete responses to the staff's questions clarify many matters that, at least initially, may appear suspicious. In addition, many questions are asked not because the staff suspects wrongdoing, but because he or she simply does not understand what a record means. Explaining matters to the staff's satisfaction allows the process to continue. Stonewalling merely creates an impression that the registrant has something to hide.
4. In addition, if a registrant has a question or concern about the conduct of an examination, it should contact either the staff's supervisor, or the Examination Hotline. The OCIE Examination Hotline, which was instituted in 2005, offers the registrant a choice to speak with either a senior-level attorney in OCIE's Office of the Chief Counsel in Washington, DC, *or* a staff member in the SEC's Office of Inspector General. The Office of Inspector General is an independent office within the SEC that conducts audits of Commission programs and investigates allegations of employee misconduct. The Hotline number is (202) 551-EXAM, or (202) 551-3926.

G. Exit Interviews/Exit Conference Calls

1. To foster and ensure the earliest possible implementation of corrective actions with respect to problems identified during examinations, the staff conducts exit interviews and/or exit conference calls as part of the examination process.
2. Before leaving the offices of a registrant, the staff will consider conducting a preliminary exit interview with a registrant. The staff frequently requests the attendance of registrant personnel with personal knowledge about or responsibility for the entity's operations, such as the Chief Compliance Officer or General Counsel. During exit interviews (or at an earlier time during fieldwork), the staff may discuss some or all of the deficiencies that were identified. During an exit interview, the staff also obtains agreement on any outstanding document or information requests and a schedule for providing such information.
3. When most work on an examination has been completed but before a deficiency letter is sent, if such a letter is necessary, the staff will offer registrants the opportunity to participate in an exit conference call. During such meetings or calls generally all deficiencies found during an examination will be brought to the attention of the registrant. During an exit conference the registrant may bring to the staff's attention information that is helpful to the examination, such as facts not known by the staff and/or the existence of additional documents or information. The staff will consider any information provided during an exit conference call and whether such information alters any examination findings. This process also provides the registrant the opportunity to advise the staff of corrective actions or improvements undertaken or planned by the firm.
4. Registrants' responses to concerns in an exit interview/conference call are not intended to substitute for their written responses to deficiency letters. Registrants are asked to inform the staff 7 in writing of how they have remedied, or plan to remedy,

the deficiencies identified, including deficiencies that the registrants orally stated had been or would be corrected.

H. Results

The examination concludes when the staff determines the action that should be taken as a result of the findings. Possible outcomes of an examination include:

- a. Some examinations conclude with no findings of deficiencies and no further action by the staff. In these circumstances, registrants are provided with a brief letter informing them that the examination has been closed. Registrants should note that this letter is not a "clean bill of health" and should not be viewed as such. The staff only indicates that no deficiencies were identified during their examination.
- b. When the staff identifies compliance failures or internal control weaknesses, the registrant is generally provided with a deficiency letter identifying the problems and requiring the registrant to take remedial steps. The deficiency letter also asks for a written response. Most examinations conclude with a deficiency letter. In FY08, OCIE implemented processes to standardize deficiency letters across examinations, and to better ensure that discussions of deficiencies were consistent with applicable law and rules.
- c. When the staff identifies compliance failures or internal control weaknesses that appear too serious for a deficiency letter alone, but do not yet warrant referral to the enforcement staff, they may hold a special meeting or conference call with the registrant to emphasize the seriousness of the staff's findings. The staff will discuss the registrant's compliance problems, and the remedial steps the registrant intends to take. This is followed up with a deficiency letter.
- d. When the registrant's compliance or internal control failures are serious, such as when investor funds or securities are at risk, the staff may refer the matter to the Division of Enforcement. The Division of Enforcement then determines whether to investigate the matter further and whether to recommend an enforcement action to the Commission. Each year, cases against regulated entities constitute a significant portion of the Commission's enforcement actions. Many of these cases are derived from the examination program's enforcement referrals. Examinations of broker-dealers may also be referred to the appropriate SRO for further investigation.
- e. Where examinations identify recurring problems or gaps in regulatory coverage, the issue may be referred to another office or division in the SEC, such as the Division of Trading and Markets or the Division Investment Management, or to other Commission offices. The staff also provides additional support to the Commission's other regulatory operations. In these instances, a deficiency letter might be provided to the registrant.

III. CURRENT ISSUES AND 2008 RESULTS

A. Select Areas of Focus

1. **Investment Company/Investment Adviser Examinations:** The staff conducted examination activities to respond to the following risks, among others. These activities might have included risk-focused reviews, regular examinations, or other types of reviews.
 - a. Portfolio Management: Examinations reviewed whether the securities recommendations and investments made for clients and funds were consistent with the adviser's disclosures and the client's investment objectives and restrictions; whether processes and procedures related to risk management, valuation, accounting, and other back office functions were adequate given the types of investments made on behalf of clients; and whether reviews were conducted to determine the appropriateness of selecting separately managed accounts for those clients. The staff placed particular emphasis on the use of complex investment products, the management of money market funds, and policies and procedures surrounding malicious rumors.
 - b. Brokerage Arrangements and Best Execution: Examinations reviewed whether brokerage arrangements were consistent with disclosures, whether the adviser sought best execution, whether it used soft dollars consistently with its disclosures, and whether the adviser periodically and systematically evaluated the costs and benefits of its brokerage

arrangements.

- c. Allocations of Trades: Examinations reviewed whether the adviser had effective policies and procedures for fairly allocating initial public offerings, block trades, and investment opportunities among clients; whether these policies were adequately disclosed; and whether actual practices were consistent with both policies and disclosures. The staff was looking for “cherry picking” practices and favoritism in allocations, among other things.
- d. Personal Trading: Examinations reviewed whether funds and advisers had effective codes of ethics that were designed to prevent inappropriate trading by insiders in their personal accounts (front-running, insider trading, market timing), whether these policies were fairly disclosed, and whether actual trading practice by insiders comports with the policies and disclosures.
- e. Pricing of Clients' Portfolios and Calculation of Net Asset Value: Examinations reviewed whether funds and advisers had effective policies and procedures for determining the value of portfolio holdings and calculating net asset value (“NAV”), particularly when “fair value” prices were used, and with respect to errors, and whether actual practices were consistent with these policies and procedures.
- f. Information Processing and Protection (Books and Records, Disclosures, and Filings): Examinations reviewed whether funds and advisers had effective policies and procedures for capturing, compiling, maintaining, and reporting relevant and timely information to clients and regulators. Additionally, the examinations considered whether unauthorized persons had unwarranted access to this information and whether it was effectively protected against untimely destruction under the firms’ business continuity plan.
- g. Performance Advertising, Marketing, and Fund Distribution Activities: Examinations reviewed whether funds and advisers had effective policies and procedures to make sure performance claims, advertisements, and other marketing materials contained accurate information; whether conflicts of interest had been effectively disclosed; and whether funds’ distribution activities were consistent with Rule 12b-1 of the Investment Company Act.
- h. Safety of Clients' and Funds' Assets: Examinations reviewed whether funds and advisers had effective policies and procedures for safeguarding their assets from theft, loss and misuse, including reviews of the firm's custodial arrangements, the firms’ independent custodial account statement system and the processes by which client and fund balances are reconciled with those of the custodians.
- i. Fund Shareholder Order Processing: Examinations reviewed whether funds and their agents had effective policies and procedures to ensure those shareholders' transactions were processed timely and accurately, and whether actual fund shares outstanding can be reconciled to the number of shares used to calculate the fund’s NAV.
- j. Anti-money Laundering: Examinations reviewed whether funds were complying with obligations under the securities laws, the PATRIOT Act and Bank Secrecy Act to have effective policies and procedures to detect and deter money-laundering activities, whether these policies and procedures were regularly tested for continued effectiveness, and whether required AML processes were consistent with the policies and procedures.
- k. Compliance, Supervision, and Corporate Governance: Examinations reviewed whether funds and advisers have a chief compliance officer, have conducted an internal risk-assessment, have adopted appropriate compliance policies and procedures given compliance risks; whether funds have appropriately constituted boards, whether boards met regularly to consider matters required, for example, approval of the advisory contract, the independent auditor, and fair value procedures; whether firms have implemented an effective internal disciplinary process; and whether boards appeared to be effectively carrying out their fiduciary duties to fund shareholders.

2. **Broker-Dealer Examinations**: The staff conducted examination activities to respond to the following risks, among others. These activities might have included risk-focused reviews, 9 oversight examinations, or other types of reviews.

- a. Sales to Senior Citizens: This continues to be a focus in examinations. Examinations focused on abusive and fraudulent sales activities, including deceptive marketing seminars and unsuitable recommendations made to senior investors.
- b. Separately Managed Accounts: Examinations reviewed firms that offer separately managed accounts ("SMAs") to customers. The examinations focused on the supervision of SMAs, potential overcharging of fees, and potential undisclosed conflicts of interest and best execution.
- c. Mortgage-Backed Securities: Several examinations were conducted of broker-dealers that sell mortgage-backed securities. The examinations focused on pricing, valuation, mark-ups sales practice; suitability, and supervisory issues.
- d. Misuse of Non-public Institutional Order Information: These examinations are intended to detect the misuse of customer order information and to evaluate the adequacy of information barriers and controls to prevent insider trading and leakage of non-public information.
- e. Application Way Business: Examinations reviewed the adequacy of firms' supervisory procedures and systems when selling products that are processed on an application way basis. Particular focus includes review of books and records requirements, suitability, and supervision.
- f. Anti-money Laundering: The staff spearheaded an Anti-Money Laundering Examination Coordination Committee with the SROs to coordinate and conduct AML examinations. The examinations continued to review the compliance practices of broker-dealers regarding AML rules of the SEC, SROs, and the U.S. Department of the Treasury. OCIE also met regularly with FinCEN, banking regulators, and industry representatives to discuss AML issues.
- g. Internal Controls: The staff continues to conduct periodic reviews of mid-sized firms' internal controls and risk management systems and procedures regarding market, credit, operations, compliance, funding, and liquidity. Examinations of these firms have also focused on AML controls, data integrity, the effectiveness of business continuity plans, and the internal audit function.
- h. Outsourcing: The staff reviewed firms' programs for outsourcing functions to unaffiliated third parties. The examinations focus on the steps that firms are taking to ensure that customer information shared in an outsourcing relationship is being protected.
- i. Business Continuity Planning: Examinations focused on the validity of business continuity plans that broker-dealers have in place.
- j. Information Barriers: Examinations focus on systems and controls firms have in place for the protection of material non-public information. Such systems include, among others, trading, client contact, and technology.
- k. Fee-Based Accounts: Examinations focused on how firms have changed their customers' fee-based brokerage accounts to commission-based brokerage or advisory accounts. The examinations looked at the range of alternatives offered to customers, the process for determining the appropriateness of alternatives, whether disclosures provided to the customer were adequate and in accordance with the Investment Advisers Act, and whether regulatory requirements were observed regarding effecting principal trades.

3. Coordination with Other Regulators

- a. OCIE has intensified coordination efforts with domestic and foreign regulators and the regulated community.
- b. In July 2008, OCIE coordinated the Eleventh Annual Joint Regulatory Training Seminar for state, federal, and SRO securities examiners. This year's seminar focused on senior issues, variable annuities, advertising, viatical and life settlements, supervisory controls, combined broker-dealer/investment adviser examinations, CMOs, CDOs, subprime issues, Regulation S-P, data integrity, outsourcing, SPACs, and AML.
- c. The staff at headquarters and in the regional offices periodically holds national and regional summit meetings with the SROs and state securities regulators to discuss issues and concerns regarding registrants, current regulatory developments, and upcoming examination schedules.
- d. State securities regulators periodically attend OCIE 10 videoconference training programs; and OCIE and the

regional offices provide training to the states based on special requests. Additionally, the staff speaks at many state securities conferences.

- e. OCIE and the regional offices continue to assist law enforcement agencies, including the United States Attorneys' offices and the Department of Justice, in bringing criminal actions.
- f. OCIE also has worked with foreign regulators on a number of matters and has conducted coordinated examinations with foreign regulators of investment advisers and investment companies registered with the Commission, as well as in other jurisdictions.
- g. OCIE has entered into arrangements with the Federal Reserve Board and the New York State Department of Banking to increase coordination and information sharing regarding registered clearing agencies subject to joint or overlapping jurisdiction.
- h. OCIE has worked with representatives of the National Association of Insurance Commissioners and individual state insurance commissions to identify areas suitable for increased coordination.
- i. OCIE works with representatives from the Department of Treasury and the Federal Reserve Board on a number of issues related to market events and the on-going credit crisis, and is working with the Department of Labor in connection with the SEC's FY08 MOU with that agency.

B. Fiscal 2008 Examination Results

1. Investment Company Inspections

- a. In fiscal year 2008, the staff completed numerous inspections of investment company complexes, including third-party administrators and variable life and variable annuity separate accounts. Some of these inspections were risk-focused or cause examinations. The majority of these risk-focused or cause inspections related to issues that included valuation procedures, suitability, disclosure, revenue sharing, performance representations, and misappropriation of fund assets.
- b. Topics covered in an investment company inspection included, but were not limited to:
 - (1) Regular reconciliation of custodial records with fund and investment advisers' records that resolve all discrepancies;
 - (2) Ensuring that information that is created, recorded, maintained, and reported is protected from unauthorized alteration and destruction;
 - (3) Fund/shareholder order processing and cash-book reconciliations;
 - (4) Safety of clients' funds and assets;
 - (5) Fund asset pricing and fund NAV calculations;
 - (6) Personal trading of access persons;
 - (7) Fair allocation of blocked and initial public offerings ("IPO") trades;
 - (8) Order placement practices consistent with seeking best execution and disclosures;
 - (9) Accuracy and fairness of fund performance information;
 - (10) Fund corporate governance; and
 - (11) Independent, third-party control over periodic account statements to clients.
- c. Enforcement Referrals:
 - (1) The matters referred to the Division of Enforcement most commonly involved issues regarding business development companies, conflicts of interest, corporate governance, books and records, and pricing of fund assets.

2. Third-Party Administrators

- a.** Approximately half of all mutual fund complexes use third-party administrators to perform their accounting and administrative functions. During fiscal year 2008, the staff conducted examinations of administrators as an adjunct to its mutual fund oversight function.
- b.** Topics covered in an administrator examination included, but were not limited to:
 - (1) The contractual relationship between the administrator and the investment company;
 - (2) The administrator's internal controls as they relate to its work for investment companies;
 - (3) Distribution services where the administrator is also a distributor;
 - (4) Budgeting and fund expenses; and
 - (5) Client investment companies' books and records maintained by the administrator.

3. Variable Insurance Products

- a.** In response to continued growth in variable insurance product assets and the emergence of new channels of distribution, examinations of variable life and annuity contract separate accounts became a regular feature of the examination program.

4. Investment Adviser Examinations

- a.** In fiscal year 2008, the staff completed numerous investment adviser examinations. The staff continued to target for examination those advisers whose characteristics or activities tend to pose a higher risk to clients, such as those with actual custody of clients' funds and securities and those with discretionary management authority over clients' cash and securities.
- b.** Topics covered in an investment adviser examination included, but were not limited to reviewing whether:
 - (1) Blocked trades and IPOs are allocated fairly and are consistent with disclosures;
 - (2) Client assets are priced accurately;
 - (3) Clients receive periodic account statements from third parties;
 - (4) Information created, recorded, maintained, and reported is protected from unauthorized alteration and destruction;
 - (5) Portfolio management decisions are consistent with client mandates;
 - (6) Clients' funds and assets are safely maintained;
 - (7) The firm maintains a strong compliance culture;
 - (8) The firm's control systems are subject to override by control persons;
 - (9) Orders are placed in ways that result in best execution; and
 - (10) Performance information provided to clients is presented fairly.
- c.** Enforcement referrals:
 - (1) The matters referred to the Division of Enforcement most commonly involved conflicts of interest, misappropriation of client funds, brokerage and execution practices, personal securities transactions, material compliance program deficiencies, and books and records concerns.

5. Broker-Dealer Examinations

- a.** In fiscal year 2008, the staff completed numerous oversight and cause or risk-focused broker-dealer examinations.
- b.** Topics covered in a broker-dealer examination included, but were not limited to:
 - (1)** Reserve formula and net capital computations;
 - (2)** Proper accounting for, and safekeeping of, customer funds and securities;
 - (3)** Internal controls issues, including trading risk management, credit risk management, operational and legal controls, and internal auditing;
 - (4)** Supervision;
 - (5)** Sales practice issues, including suitability, churning, misrepresentations, cold calling, and unauthorized trading; and
 - (6)** Underwriting and distribution issues.
- c.** Enforcement Referrals:
 - (1)** The most common problems referred to Division of Enforcement were those related to unsuitable transactions, misrepresentations and omissions, employment of manipulative and deceptive devices, inadequate supervisory practices, inadequate preservation of books and records, and inadequate net capital.

5. Transfer Agents and Clearing Agencies

- a.** During fiscal year 2008, the staff completed routine examinations, cause or risk-focused examinations, and special examinations of registered transfer agents.
- b.** In fiscal year 2008, the staff completed several routine clearing agency examinations. These examinations focused on three areas, including liquidity, value at risk models, and information leakage.