

**EXAMINATIONS BY THE SECURITIES AND EXCHANGE
COMMISSION'S OFFICE OF COMPLIANCE
INSPECTIONS AND EXAMINATIONS
February 2012**

**I. EXAMINATIONS OF INVESTMENT ADVISERS,
INVESTMENT COMPANIES, BROKER-DEALERS,
MUNICIPAL SECURITIES DEALERS, TRANSFER
AGENTS, CLEARING AGENCIES, SELF-
REGULATORY ORGANIZATIONS, MUNICIPAL
ADVISORS, AND OTHERS**

A. Executive Summary

1. The Commission's Office of Compliance Inspections and Examinations ("OCIE") supports the SEC's mission to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation by conducting examinations through examination teams in the home office in Washington, DC and in regional offices located in Atlanta, Boston, Chicago, Denver, Fort Worth, Los Angeles, Miami, New York, Philadelphia, Salt Lake City, and San Francisco. Collectively, the examination staff in these offices carries out the Commission's National Examination Program ("NEP") for investment advisers, investment companies, broker-dealers, municipal securities dealers, transfer agents, clearing agencies, self-regulatory organizations ("SROs"), municipal advisors, and others.
2. The enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), Pub. L. No. 111-203, 124 Stat. 1376, on July 21, 2010, expands the Commission's examination authority to include several additional types of entities/persons. These are discussed in more detail below.
3. OCIE has continued to implement the recommendations of the top-to-bottom "self-assessment" that it began in 2010 of the strategy, structure, people, process, training and

technology improvements that should be made to the examination program. The results so far of this implementation are discussed in more detail below.

4. The goals of the examinations conducted by staff in the National Examination Program are to (1) improve compliance, (2) prevent fraud, (3) inform policy, and (4) monitor firm-wide and systemic risk. When the staff conducts special examinations to gather information about areas of interest or concern to the Commission, the findings of such examinations are occasionally summarized in a public report.
5. Given the number of registrants and the breadth of their operations, the staff continues to focus examination resources on those registrants and activities where staff in the NEP believes that the investing public or market integrity is most at risk.

B. New Developments in 2011

1. Enforcement Actions Resulting from National Examination Program Referrals.

As a result of close cooperation between the NEP and the Division of Enforcement, a number of significant enforcement actions were brought in 2011. These include cases that: stopped Ponzi schemes; highlighted material disclosure misrepresentations or omissions; identified undisclosed remuneration or hidden fees and expenses charged to investors; involved false and/or inflated valuations; and stressed the importance of effective compliance controls. Notable cases brought in FY 2011 resulting from NEP examination referrals include:

Morgan Asset Management Inc. and Morgan Keegan & Company Inc. The Commission, state regulators, and FINRA brought a settled action against Morgan Keegan and its asset management affiliate in which Morgan Keegan and its affiliate agreed to pay \$200 million to settle fraud charges related to subprime mortgage-backed securities. Two Morgan Keegan employees also agreed to

pay penalties for their alleged misconduct, and one was barred from the securities industry. According to the SEC's order, the case involved the false valuation of subprime MBS in five funds managed by Morgan Asset Management from January 2007 to July 2007. The Commission's Order found that Morgan Keegan did not employ reasonable pricing procedures and published inaccurate daily NAVs, selling shares to investors based on inflated prices. The case originated in an examination by the Atlanta Regional Office.

SEC v. H. Clayton Peterson. The Commission brought an insider trading action against a board member at Mariner Energy, Inc., H. Clayton Peterson, and his son, Drew Peterson. The Department of Justice also announced that Clayton and Drew Peterson both pled guilty in New York federal court to one count of securities fraud and one count of conspiracy to commit securities fraud based on the same conduct. The Commission alleged that Clayton Peterson learned details about Mariner Energy's upcoming acquisition by Houston-based Apache Corporation during various board meetings, and that he then conveyed the nonpublic information to his son. Drew Peterson then purchased Mariner Energy stock for himself, his relatives, his clients, and a close friend. Drew Peterson also tipped others, including a portfolio manager at a registered investment adviser. The Commission alleged that the insider trading by the Petersons and others generated more than \$5.2 million in illicit profits. This case originated from a referral from the Denver and San Francisco Regional Offices' exam staff.

Securities and Exchange Commission v. Stifel, Nicolaus & Co., Inc. The Commission brought an action charging Stifel, Nicolaus & Co. and registered representative David W. Noack with defrauding five Wisconsin school districts by selling them allegedly unsuitable structured products. The complaint alleges that the school districts contributed \$37.3 million toward the \$200 million investment and borrowed the remaining \$162.7 million, and that the heavy use of leverage and the structure of the synthetic

collateralized debt obligations (“CDOs”) exposed the school districts to a heightened risk of catastrophic loss. According to the Complaint, the school districts ultimately suffered a complete loss of their investment and correspondingly suffered credit rating downgrades. The case resulted from a referral from the Chicago Regional Office exam staff.

SEC v. AXA Rosenberg. The Commission brought a settled action charging three AXA Rosenberg entities (“AR”) with securities fraud for allegedly concealing a significant error in the computer code of the quantitative investment model that they use to manage client assets. The error caused \$217 million in investor losses. AR agreed to settle the SEC's charges by paying \$217 million to harmed clients plus a \$25 million penalty, and hiring an independent consultant with expertise in quantitative investment techniques who will review disclosures and enhance the role of compliance personnel.

According to the SEC’s Order, senior management at AR learned in June 2009 of a material error in the model's code that disabled one of the key components for managing risk. Instead of disclosing and fixing the error immediately, a senior AR official directed others to keep quiet about the error and declined to fix the error at that time. The SEC’s Order states that the SEC staff found that the error, which was introduced into the model in April 2007, was eventually fixed for all portfolios. However, according to the Order, knowledge of the error was kept from AR's Global CEO until November 2009. AR then conducted an internal investigation and disclosed the error to SEC examination staff in late March 2010 after being informed of an impending SEC examination. AR disclosed the error to clients on April 15, 2010. The case resulted from a referral from the Los Angeles Regional Office exam staff.

SEC v. Francisco Illarramendi. The Commission brought an action charging Illarramendi, a Stamford, Connecticut-

based investment adviser and related hedge fund entities, with allegedly engaging in a multi-year Ponzi scheme involving hundreds of millions of dollars (probably upward of \$200 million). According to the Commission's amended complaint, Illarramendi misappropriated assets and used two hedge funds for Ponzi-like activities in which they used new investor money to pay off earlier investors. The case has also produced criminal charges by the United States Attorney for the District of Connecticut. The fraud was first uncovered by Commission examiners during a risk-based exam of an SEC-registered adviser with which Illarramendi was affiliated. Despite efforts by Illarramendi to obstruct the examination and mislead the staff – conduct that led to a criminal charge of obstruction of justice – the examiners and their colleagues in the Enforcement Division obtained evidence of the fraud.

SEC v. Tamman. The Commission brought an administrative action against a lawyer for allegedly altering documents submitted to the Commission staff to conceal fraudulent conduct by his client, NewPoint Financial Services, Inc. Separately, the Commission brought an enforcement action against NewPoint for the alleged fraudulent offer and sale of over \$20 million of debentures to over 100 investors. The case arose from an unannounced cause exam of NewPoint that uncovered both the alleged fraud and the lawyer's alleged effort to conceal it.

SEC v. Paul George Chironis. The Commission brought an action charging that Chironis, a registered representative of a broker-dealer, allegedly churned two accounts owned by the Sisters of Charity – one account for care of nuns in assisted-living facilities and a second account to support the nuns' charitable endeavors.

Janney Montgomery Scott LLC (“JMS”). The Commission brought a settled action charging that JMS, a Philadelphia-based regional broker/dealer owned by Penn Mutual Insurance Company, allegedly failed to properly establish, enforce, and maintain policies and procedures

that were reasonably designed to prevent the misuse of material, nonpublic information.

JMS agreed to be censured and to pay an \$850,000 penalty to settle the SEC's administrative proceeding. It also agreed to cease and desist from committing or causing any violation of Section 15(g). The case resulted from a referral from the Philadelphia Regional Office exam staff.

SEC v. Raymond James Financial Services, Inc (“*Raymond James*”). The Commission instituted and settled an action with Raymond James and affiliated entities, based on alleged misrepresentations and omissions of material information in connection with the sale of over \$2.4 billion in market value of auction rate securities to their customers. The SEC's Order finds that the firm willfully violated Section 17(a)(2) of the Securities Act of 1933. The Commission censured Raymond James, ordered it to cease and desist from future violations, and reserved the right to seek a financial penalty against the firm. Without admitting or denying the SEC's allegations, Raymond James consented to the SEC's order and agreed to, among other things, repurchase over \$280 million in market value of auction rate securities (the remaining securities held by its customers).

Direct Edge ECN LLC (“*Direct Edge*”). The Commission instituted and settled an action against Direct Edge and its affiliates, comprising two electronic exchanges and a broker-dealer. According to the Commission's Order, Direct Edge is alleged to have committed violations of U.S. securities laws arising out of weak internal controls that resulted in millions of dollars in trading losses and a systems outage. The SEC's Order instituting administrative proceedings further stated that, in two incidents in 2010 and 2011, various technological and human failures resulted in significant trade errors and disruptions at the two exchange affiliates of Direct Edge, EDGA, and EDGX. The Commission also found that in resolving resulting overfilled trades in one of these

incidents, failures to mark orders as short, or mismarking of orders as long occurred, violating the SEC's Regulation SHO. On the other occasion, EDGX is alleged to have waited approximately 24 minutes after a trading outage to remove its quotations from public market data, and violated the SEC's Regulation NMS by failing to immediately identify its quotations as manual quotations. Direct Edge consented to an order censuring it and its affiliates and requiring them to cease and desist from further violations of U.S. securities laws and to take remedial efforts to strengthen their information technology systems and controls and compliance procedures.

Pipeline Trading Systems LLC. (Oct. 24, 2011). The Commission brought a settled action charging Pipeline and two of its top executives with failing to disclose to customers of Pipeline's "dark pool" trading platform that the vast majority of orders were filled by a trading operation affiliated with Pipeline. According to the SEC's Order, Pipeline described its trading platform as a "crossing network" that matched customer orders with those from other customers, providing "natural liquidity." The SEC's Order found that Pipeline's claims were false and misleading because its parent company owned a trading entity that filled the vast majority of customer orders on Pipeline's system. It said the affiliate, most recently known as Milstream Strategy Group LLC, sought to predict the trading intentions of Pipeline's customers and trade elsewhere in the same direction as customers before filling their orders on Pipeline's platform. The SEC's Order found that Pipeline generally did not provide the "natural liquidity" it advertised. According to the SEC's Order, Pipeline took certain steps to address the conflict of interest it created, including by paying the affiliate's traders using a formula that rewarded them in part for giving favorable prices to Pipeline's customers. The SEC's Order found that Pipeline failed to disclose the compensation formula or Milstream's activities to its customers or in its filings to the SEC. Pipeline agreed to pay a \$1 million penalty to settle the matter. Pipeline's founder and chief executive officer, Fred J. Federspiel, and

its chairman and former chief executive, Alfred R. Berkeley III, a former president and vice chairman of the NASDAQ Stock Market, each agreed to pay \$100,000.

2. Self-Assessment of the NEP. As a result of the recommendations made by multiple task forces of staff and managers from all Regions, NEP staff in the home and regional offices embraced the following core principles to guide them as a team.
 - a. Risk-Based Approach: The NEP is committed to strengthening its risk assessment processes so OCIE can allocate the limited resources of the NEP to their highest and best use.

The staff draws on numerous sources for identifying higher risk registrants and selected areas of focus. Sources include, among other things, tips, complaints, and referrals; analysis of outlier or aberrational information provided to investors; prior examination findings; significant changes in registrants' business activities; and registrant or registered representative disclosures regarding regulatory and other actions brought against them. OCIE staff works with the Division of Risk, Strategy, and Financial Innovation to develop models to identify registrants with anomalous characteristics; registrants that do not meet certain thresholds for established financial metrics; registrants that exhibit high-risk sales practice patterns; and relationships among registrants exhibiting similar characteristics. OCIE has established an Office of Risk Assessment and Surveillance ("ORAS") to evaluate risks across all of the markets and registrant categories that are examined by the NEP, and ORAS has launched a range of risk assessment models and tools to strengthen its risk-assessment capabilities. ORAS now plays a central role in determining which registrants to examine as well as the scope of examinations.

- b. Teamwork and Collaboration: OCIE, working

through the home and regional offices, is fostering a heightened culture of teamwork, collaboration, and consultation across the NEP and the SEC more broadly. This will enable the program to make the best informed decisions possible as it sets new standards and executes its mission. For example, OCIE has established regular monthly national teleconferences of examiners across regions and the home office, new processes for communicating with the Division of Enforcement about new or pending examination referrals, and mutual goal-setting between OCIE and the Divisions of Trading and Markets, Investment Management and Risk, Strategy and Financial Innovation.

- c. Ongoing Improvement and Accountability: The NEP is continuing to set high standards and expectations for the staff, and holds the staff accountable to each other for achieving goals and objectives, and then going further. OCIE is also providing more and better training to its examiners, including working on an examiner certification program.
- d. Focus: The examination staff will seek to pursue the facts where they lead, analyzing root causes, and executing plans with discipline and focus.
- e. Accomplishments to Date: During 2011 the following accomplishments in implementing the recommendations of the self-assessment, among others, were achieved:
 - i. As discussed above, an enhanced risk-focused examination strategy was implemented.
 - ii. Steps to improve teamwork and collaboration with other SEC divisions and offices have been adopted, as well as steps to improve coordination with regulatory partners, including SROs.
 - iii. Raised the level of dialogue with senior management and boards of directors of a number of registered entities.

- iv. Raised the level of staff engagement and transparency within the NEP through steps such as monthly video calls for the entire examination staff nationwide, focus groups, an NEP newsletter, and greater training in and use of SharePoint.
 - v. Enhanced industry engagement through conferences and transparency initiatives such as speeches, published sweep reports and risk alerts, improvements to our website, Webinars, and outreach programs.
 - vi. Developed a new national governance structure for the NEP to strengthen oversight, collaboration and decision-making. The governance model includes senior management from the home and all regional offices.
 - vii. Launched specialized working groups to concentrate and grow expertise in the following areas: New and Structured Products, Valuation, Equity Market Structure and Trading Practices, Fixed Income and Municipal Markets, Microcap Fraud, and Marketing and Sales Practices.
 - ix. Introduced project-based staffing to enable more dynamic resource allocation.
 - x. Strengthened the examination process by streamlining examination reports, collaborating with the policy divisions to recommend upgrading Forms ADV, BD, and FOCUS Part 5 to better capture risk information, and equipping examiners with appropriate technology tools.
3. New Governance of the NEP. As a result of the self-assessment, OCIE, working through the home and regional offices, adopted a new governance structure for the NEP that includes an Executive Committee (with members rotating on a staggered basis to ensure representation of the home and regional offices) and the following steering committees:

- a. Steering Committee on People
- b. Steering Committee on Risk and Exam Process
- c. Steering Committee on Technology
- d. Steering Committee on Compliance, Ethics, and Internal Controls

4. New Positions.

- a. The NEP is continuing to recruit and hire Senior Specialized Examiners, who are practiced industry professionals with specialized experience in trading, portfolio management, valuation, complex products, sales, compliance, and forensic accounting.
- b. The NEP has conducted targeted hiring in the following areas:
 - i. Clearing agencies
 - ii. Swap markets
 - iii. Swap intermediaries
 - iv. Trading
 - v. Fixed income
 - vi. Municipal advisors
 - vii. Private funds

5. The NEP has embraced “project-based” examination teams so that exam teams may be drawn from all available examiners based on expertise, rather than from a single “branch” of examiners.

6. Impact of the Dodd-Frank Act. The Dodd-Frank Act has had a significant impact on the NEP, increasing the NEP’s examination responsibilities in a number of ways. These responsibilities include examinations of, among others, municipal advisors, investment advisers to certain private funds (including certain foreign domiciled advisers with US investors), security-based swap dealers, security-based data repositories, major security-based swap participants, and securities-based swap execution facilities. In addition, it has provided OCIE with authority to obtain records from custodians of investment company and investment adviser

client assets.

- a. NRSROs: The Dodd-Frank Act strongly enhanced the Commission's oversight with respect to nationally recognized statistical rating organizations ("NRSROs"). In particular, it called for the formation of an independent Office of Credit Ratings ("OCR"), which is required to examine each NRSRO at least annually and issue an annual public report summarizing key findings from these examinations. OCIE has assigned examiners to details in order to commence these examinations until required Congressional approval of the OCR occurs.
- b. Clearing Agencies: The Dodd-Frank Act requires the SEC to conduct annual examinations of clearing agencies over which the Commission is the supervisory agency and that the Financial Stability Oversight Council has designated as systemically important.
- c. Private Fund Advisers: The Dodd-Frank Act requires SEC registration and provides the SEC with examination oversight of certain private fund advisers.
- d. Municipal Advisors: The Dodd-Frank Act requires SEC registration and provides the SEC with examination oversight of municipal advisors.
- e. Security-Based Swap Dealers, Security-Based Swap Execution Facilities, Data Repositories, and Major Participants: The Dodd-Frank Act requires SEC registration and examination oversight of, among others, security-based swap dealers, security-based swap execution facilities, security-based swap data repositories, and major security-based swap participants.
- f. Mid-Sized Investment Advisers: The Dodd-Frank Act amended the Investment Advisers Act to raise the asset threshold for SEC registration of advisers to

\$100 million (subject to certain other provisions described below). The examination staff is working with the SEC's Division of Investment Management and state securities regulators on the transition of mid-sized advisers from federal to state oversight.

- g. Custodians:** The Dodd-Frank Act authorized the Commission to examine records of persons having custody or use of the assets of registered investment companies and advisers' clients with respect to the extent such records relate to the custody or use of such assets.
- h. Rulemaking and Other Requirements:** The Dodd-Frank Act has mandated certain rulemaking by, among others, the Divisions of Investment Management and Trading and Markets that will impact the nature of certain examinations. The examination staff continues to coordinate with these divisions on such rulemaking efforts.

The examination staff also gave substantial input to several studies mandated by the Dodd-Frank Act. These included reports to Congress on: the obligations of investment advisers and broker-dealers, issued January 21, 2011, as required by Section 913 of the Act; the need for enhanced resources for examinations of investment advisers, issued on January 14, 2011, as required by Section 914 of the Act; and improving the common framework for designated clearing entity risk management., issued jointly with the CFTC and the Federal Reserve Board on July 21, 2011, as required by Section 813 of the Act.

- 7. Training.** Beginning in 2009 and continuing through 2011, the NEP has initiated significant reforms to its examiner training. It is maximizing its resources by increasing expertise through enhanced training.

 - a.** For example, the NEP has continued to strengthen the expertise of its staff through enhanced training and by

enrolling its examiners in other certification programs such as the Certified Fraud Examiner, Chartered Financial Analyst, and Chartered Alternative Investment Analyst certification programs. OCIE is also encouraging examiners to take Series examinations offered by the Financial Industry Regulatory Authority, Inc. (“FINRA”).

- b. Through SEC University, all examiners and managers receive extensive training in examination offices nationwide via classroom sessions and on-line training, and by live remote technology (*i.e.*, telecast or webcast). There is core training for both new and experienced examiners so that examiners are continually trained at all experience levels. OCIE’s comprehensive training program focuses primarily on fraud detection, examination procedures, securities industry topics (*e.g.*, financial products, trading strategies, hot topics), securities rules and regulations, and electronic resources. Training is provided by professionals from, among others, the SEC staff, the securities industry, other securities and banking regulatory agencies, academia, law enforcement agencies, accounting firms, and third-party administrators.
8. Risk Alerts and Sweep Examination Reports: In fiscal year 2011, the NEP issued a Risk Alert on master/sub-accounts and a sweep examination report on the sale of structured products to retail investors.

In fiscal year 2012 the NEP plans to issue a significantly greater number of Risk Alerts and sweep examination reports on a wide range of topics. These are intended to assist senior management, risk management, and compliance officers to better perform their functions in establishing, monitoring and updating critical risk management and compliance programs.

9. Compliance Outreach Program for Investment Adviser/Investment Company/Broker-Dealer SRO Chief

Compliance Officers. The mission of the Compliance Outreach Program is to improve compliance by opening the lines of communication between SEC staff, Chief Compliance Officers (CCOs), and other senior officers of registered investment advisers, investment companies, and broker-dealers. The program was redesigned in 2011 (it was formerly called the *CCOutreach Program*) and the intended audience was expanded from CCOs to all senior officers in order to emphasize the importance of compliance throughout firms' business operations. The program is designed to provide a forum to discuss compliance issues in a practical way, to share experiences, and to learn about effective compliance practices. The program features a number of events, including regional events at various locations across the country and national events sponsored in Washington, DC.

- a. *Compliance Outreach Program for Investment Advisers and Investment Companies:* This program, which is jointly sponsored by the NEP and the Division of Investment Management, began in 2005. In 2011, the staff sponsored one interactive broadcast session discussing valuation issues. The staff intends to sponsor a National Seminar on January 31, 2012.
- b. *Compliance Outreach Program for Broker-Dealers:* The *Compliance Outreach Program* for broker-dealers, which is jointly sponsored by the NEP, the Division of Trading and Markets, and FINRA, began in 2008. In 2011, the staff sponsored a National Seminar in March 2011. The staff plans to announce regional events for 2012.
- c. *SRO Outreach Program:* In January of 2012, OCIE will be jointly hosting with TM an SRO Outreach Conference. Topics include OCIE oversight of the SROs, such as the results of the baseline assessments of the SROs, as well as the future of exams and an SRO communication plan. Technological best practices, including systems compliance, will also be covered, as will SRO oversight of regulatory service

agreements.

C. 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 (“Investment Advisers Act”), 15 U.S.C. § 80b-1 *et seq.* As reflected below, the Dodd-Frank Act amended certain provisions of these statutes, the result of which expanded the types of entities subject to the Commission’s examination authority.

- 2.** Examinations pursuant to the Exchange Act are authorized by Section 17.
 - a.** Section 17(a) of the 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)** nationally recognized statistical rating organizations;
 - (10)** registered clearing agencies; and
 - (11)** 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.
 - (2) Rule 17a-4(j) requires brokers 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 or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this chapter.”
- 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.
- e. 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.

Dodd-Frank Act Amendments

- f. Clearing Agencies for Security-Based Swaps. Section 763 of the Dodd-Frank Act added Section 17A(g) to the Exchange Act, 15 U.S.C. § 78q-1, to require clearing agencies that perform the functions of a

clearing agency with respect to security-based swaps to register with the Commission. As a registered clearing agency, these entities are subject to the Commission's examination authority pursuant to Section 17(b) of the Exchange Act.

- g. Security-Based Swap Data Repositories.** Section 763 of the Dodd-Frank Act also added Section 13(n)(1) to the Exchange Act, 15 U.S.C. § 78m, to require security-based swap data repositories to register with the Commission, and amended the Exchange Act to add Section 13(n)(2) to authorize the Commission to examine such repositories.
- h. Security-Based Swap Dealers and Major Security-Based Swap Participants.** Section 764 of the Dodd-Frank Act amended the Exchange Act, 15 U.S.C. § 78a *et seq.*, by adding Section 15F(a) after section 15E, 15 U.S.C. § 78o-7, to require security-based swap dealers and major security-based swap participants to register with the Commission. Section 764 also amended the Exchange Act to add Section 15(F)(f) to authorize the Commission to examine these dealers and major security-based swap participants.
- i. Security-Based Swap Execution Facilities.** Section 763 of the Dodd-Frank Act added Section 3D(a) to the Exchange Act, 15 U.S.C. § 78a *et seq.*, to require that facilities for the trading or processing of security-based swaps must register as a security-based swap execution facility or as a national securities exchange.
- j. Other Individuals and Entities Involved in Security-Based Swap Transactions.** Section 766 of the Dodd-Frank Act amended the Exchange Act, 15 U.S.C. § 78a *et seq.*, to add Section 13A to authorize the Commission to examine certain other individuals and entities involved in security-based swap transactions.
- k. NRSROs.** Section 932 of the Dodd-Frank Act amended Section 15E of the Securities Exchange Act,

15 U.S.C. § 78o-7, to require the SEC to establish an independent Office of Credit Ratings, which must “administer the rules of the Commission.” Pursuant to Dodd-Frank, the OCR must conduct exams of each NRSRO at least annually and every exam must include a review of:

- (1) whether the NRSRO conducts business in accordance with its policies, procedures, and methodologies;
- (2) management of conflicts of interest;
- (3) ethics policies;
- (4) internal supervisory controls;
- (5) governance;
- (6) compliance officer activities;
- (7) complaints; and
- (8) policies governing post-employment activities of former NRSRO staff.

3. 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 registered 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 make available to the Commission or its representatives any copies or extracts from such records as may be prepared without undue effort, expense, or delay as the Commission or its representatives may reasonably request.”

- c. Section 32(c) of the Investment Company Act, 15 U.S.C. § 80a-31(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 the Commission or any representative of the Commission as the Commission may prescribe by rule, regulation, or order.

Dodd-Frank Act Amendments

- d. Custodians of Investment Company Assets. Section 929Q of the Dodd-Frank Act amended Section 31 of the Investment Company Act, 15 U.S.C. § 80a-30, to require that records of persons having custody or use of the securities, deposits, or credits of a registered investment company that relate to such custody or use, are “subject at any time, or from time to time, to such reasonable periodic, special, or other examinations and other information and document requests by representatives of the Commission” If such a custodian is subject to regulation and examination by a Federal financial institution regulatory agency (*e.g.*, the Board of Governors of the Federal Reserve System, “Federal Reserve”), that custodian may satisfy any request for information by “providing to the Commission a detailed listing, in writing, of the securities, deposits, or credits” of the registered investment company within the custody or use of such person.

4. Section 31(b)(3) of the Investment Company Act 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.
5. 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.”

Dodd-Frank Act Amendments

b. Advisers to Certain Private Funds

- (1) Section 403 of the Dodd-Frank Act amended Section 203(b) of the Investment Advisers Act, 15 U.S.C. § 80b-3(b), to eliminate the exemption from registration for advisers of certain private funds. Section 402 of the Dodd-Frank Act amended Section 202(a) of the Investment Advisers Act, 15 U.S.C. § 80b-2(a), to define “private fund” as “an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act . . . but for section 3(c)(1) or 3(c)(7) of that Act”.
- (2) Section 404 of the Dodd-Frank Act amended Section 204 of the Investment Advisers Act, 15 U.S.C. § 80b-4, to authorize the SEC to require registered private fund advisers to maintain certain records. The amendment also provided that the records and reports of any private fund to which a registered private fund adviser

provides investment advice are deemed to be the records and reports of the adviser.

The Dodd-Frank amendment to Section 204 also requires the Commission to conduct periodic examinations of the records of private fund advisers in accordance with a schedule established by the Commission. The section further authorizes the Commission to “conduct at any time and from time to time such additional, special, and other examinations as the Commission may prescribe as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk.”

- (3) Section 403 of the Dodd-Frank Act amends Section 203(b)(3) of the Investment Advisers Act to repeal the previous private adviser exemption and instead create a new foreign private adviser exemption applicable to certain investment advisers located abroad (*i.e.*, non-US advisers). Advisers that do not meet all of the following conditions for an exemption from SEC registration must now register: it has no place of business within the US; in total, it has fewer than 15 US clients and US investors in funds advised by the firm; the US clients and US investors in funds advised by the firm have in aggregate less than \$25 million in assets; it does not hold itself out as an investment adviser in the US; and it does not advise a registered investment company (as defined by the Investment Company Act).

- c. Mid-Sized Investment Advisers. Section 410 of the Dodd-Frank Act amended Section 203A(a) of the Investment Advisers Act, 15 U.S.C. § 80b-3a(a), to raise the asset threshold for SEC registration to \$100 million (subject to certain other provisions). This section provides an exception that permits (but does not require) such mid-sized investment advisers to register as investment advisers with the SEC if this

section would require them to register with 15 or more states. OCIE is working with the SEC's Division of Investment Management and state securities regulators on the transition of these investment advisers from federal to state oversight.

- d. Custodians of Assets of Investment Advisers' Clients.** Section 929Q of the Dodd-Frank Act amended Section 204 of the Investment Advisers Act, 15 U.S.C. § 80b-4, to provide that records of persons having custody or use of the securities, deposits, or credits of a registered investment advisers' clients that relate to such custody or use, are "subject at any time, or from time to time, to such reasonable periodic, special, or other examinations and other information and document requests by representatives of the Commission" If such a custodian is subject to regulation and examination by a Federal financial institution regulatory agency (*e.g.*, the Federal Reserve), that custodian may satisfy any request for information by "providing to the Commission a detailed listing, in writing, of the securities, deposits, or credits" of the registered investment adviser within the custody or use of such person.
- 6. Designated Financial Market Utilities.** Section 807 of the Dodd-Frank Act requires the Commission to conduct, on at least an annual basis, examinations of all designated financial market utilities ("FMUs") over which the Commission is the supervisory agency. Section 803(6) of the Act defines an FMU as "any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person." Each annual examination of an FMU must make determinations regarding:

 - a.** nature and operations of, and the risks borne by, the designated FMUs of which the Commission is the supervisory agency;

- b. financial and operational risks that the designated FMU presents to financial institutions, critical markets, or the broader financial system;
- c. the designated FMU's resources and capabilities to monitor and control such risks;
- d. safety and soundness of the designated FMU; and
- e. the designated FMU's compliance with the Act and any rules and regulations prescribed under the Act.

II. INSPECTIONS AND EXAMINATIONS: THE PROCESS

A. Overview

1. During examinations, the staff requests the entity's books and records, interviews management and firm employees, and analyzes the entity's operations. In many, but not all, cases, examinations include an on-site visit to the entity's offices.
2. Two of the goals of all examinations are to test the registrant's compliance with the federal securities laws and regulations and determine safety of client assets.
3. 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 identification of the risk areas warranting review.

The staff continues to work on the examination after they return to the Commission's offices following fieldwork. The examination team frequently consults with other staff or other divisions concerning matters that arose during the fieldwork. Opinions of legal and accounting personnel may be sought to ensure consistency, and preliminary findings of a particular examination may be compared to

those of similar firms.

B. Scope

1. Examinations generally focus on risks presented by the registrant. In some examinations, the staff focuses on particular risk or risks that led to the examination. In other examinations, 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. However, there are instances in which the staff conducts surprise examinations with no advance notice.
2. In some cases, the staff requests and reviews records from a sample of firms and then conducts 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 generally requests an interview with responsible management. The staff uses this entrance interview to, among other things, learn more about the firm, and get a sense of the compliance culture of the firm and the "tone at the top." Information obtained during this interview also helps to identify red flags and usually determines the tone and the focus of the examination.

2. In the interview, the staff provides the registrant with two 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.

In addition, 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 examination 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 examination 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.

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. OCIE encourages registrants to educate the examiners about their business to help the examiners understand the nature of the firm.
2. The staff may have questions of any type. They may 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 may clarify many matters that, at least initially, may appear suspicious. In addition, many questions are asked not because the staff suspects wrongdoing, but because the examiners need more information regarding certain records. Explaining matters to the staff allows the process to continue. Limited cooperation or answers on the part of the registrant may create an impression that the registrant has something to hide.
4. In addition, if a registrant has a question, complaint, or concern about the conduct of an examination, it is able to 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.

5. On occasion, the staff experiences serious intimidation or obstruction by a registrant during an examination. As a means by which to promote a positive cooperative environment and to prevent intimidation or obstruction from detracting from our work, OCIE established an internal Hotline that examination staff and their supervisors may call if the issue cannot be resolved in the usual course. The Hotline is answered by senior-level attorneys in OCIE's Office of the Chief Counsel in Washington, DC.

G. Exit Interviews/Exit Conference Calls

1. To foster and ensure the earliest possible implementation of corrective actions with respect to problems identified during an examination, the staff typically conducts an exit interview and/or exit conference call 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 appropriate, the staff generally offers registrants the

opportunity to participate in an exit conference (this could occur via conference call). During such meetings or calls, the staff generally brings all deficiencies identified during an examination 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 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 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

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

1. 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.
2. The staff may identify compliance deficiencies or internal control weaknesses. If this is the case, the staff generally will provide the registrant with a deficiency letter identifying the problems, asking the registrant to take remedial steps, and requesting that the registrant provide a written response. Examinations often conclude with a

deficiency letter.

3. When the staff identifies compliance deficiencies 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.
4. When the registrant's compliance or internal control failures are serious, such as when the staff believes 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 ultimately 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.
5. Where examinations identify recurring problems or gaps in regulatory coverage, the staff generally raises such issues with another office or division in the SEC, such as the Division of Trading and Markets or the Division of Investment Management. In these instances, a deficiency letter might be provided to the registrant. The staff may also provide additional support to the Commission's other regulatory operations.

III. CURRENT ISSUES AND 2012 PRIORITIES

OCIE has improved its risk assessment procedures and techniques to better identify areas of risk to investors. Such improvements include requiring routine outreach to third parties such as custodians, counter-parties, and customers during examinations to verify the existence and integrity of client assets managed by the firm; and conducting more

rigorous reviews of firms before the examiners enter the premises.

In addition to expanding upon the way the NEP selects registrants to be examined, the Program has identified specific strategic areas on which to focus when examining firms.

A. Select Areas of Focus

1. Investment Company/Investment Adviser Examinations

Consistent with the NEP's Strategic Objectives, in Fiscal Year ("FY") 2012, the staff will emphasize a risk-based exam strategy, aiding in the implementation of Dodd-Frank requirements, enhancing collaboration within the Commission and with other regulators; and implement organizational and process improvements. In FY2012, focus areas include the following priorities, among others:

- a. Complex Entities. Staff will examine for the risks and practices associated with the SEC's rapidly growing complex registrant population. Review areas may include:
 - (i) Newly registered, private fund advisers that may be unfamiliar with the Federal securities laws.
 - (ii) Complex relationships in the private equity space.
 - (iii) Model risk of quantitative investment decision, order routing, and trade execution models utilized by various industry participants.

- b. Sales Practice of New or Risky Products. The staff will review for the sale or recommendation of inappropriate investments by advisers. Among the areas of concern:
 - (i) The retailization of complex investments and smaller, niche-type products (*e.g.*, structured products, reverse convertibles bonds, alternative mutual funds, leveraged ETFs).

- (ii) Aggressive marketing of retirement/senior products and investments marketed as being “safe.”
 - (iii) Portfolio management activities that may increase the risk of investor loss or harm.
 - (iv) Lack of due diligence performed on underlying investment vehicles/managers and any undisclosed conflicts and/or fee arrangements.
 - (v) Valuation practices and any conflicts that exist in the pricing process.
- c. Fund Governance.** The NEP will evaluate practices or oversight weaknesses that may increase the risk of shareholder loss or harm, such as:
- (i) Mutual funds investing in a manner that is inconsistent with fund disclosures or engaging in activities that may pose higher risk.
 - (ii) Directors failing to satisfy fiduciary duties.
 - (iii) Systemic compliance breaches and processing issues that may have a significant impact on fund investors.
- d. Compliance, Supervision, and Risk Management.** The NEP will assess the appropriateness of compliance programs and risk management processes relative to business operations to identify potential weaknesses that raise investor protection concerns, such as:
- (i) Effects of cost-cutting, mergers and acquisitions, and aggressive business strategies to make up for losses and revenue cuts.
 - (ii) Lack of oversight of outside business activities and weak compliance of remote locations, branch offices, and independent contractor representatives.
 - (iii) Dual and affiliated registrants transitioning broker-dealer customers into advisory clients.
 - (iv) Ineffective compliance and risk management with respect to complex investments and/or investment strategies.

- e. Fraudulent Activities/Safety of Assets. The NEP continues its initiative to identify fraudulent, abusive, and manipulative activities surrounding the safety of client assets. Areas of focus include:
 - (i) Custody arrangements that increase the potential for misappropriation of assets.
 - (ii) Ponzi schemes or ponzi-like schemes.
 - (iii) Manipulative activity, such as front-running and insider trading.
 - (iv) Cyber security risks associated with malicious hacking and fraudulent schemes.

- f. Performance and Advertising. The NEP will assess performance characteristics and marketing practices that have been associated with an increased risk of misrepresentations and investor harm. For example:
 - (i) Aberrational performance that may be indicative of abusive valuation.
 - (ii) The use of solicitors to attract new clients, particularly when non-cash compensation is used by advisers.

2. Broker-Dealer Examinations

This program emphasizes eight broad themes to provide a risk-based focus to the program and also to assist in selecting particular broker-dealers for examination. Since broker-dealer examinations may involve activities by enterprises with related entities registered in multiple capacities and acting in concert (*e.g.*, broker-dealer, investment adviser, transfer agent, etc.), examination activities will be coordinated as appropriate.

Some of the areas of focus include:

- a. New issue diligence. This is based on certain weaknesses that the staff has noted in due diligence policies and procedures in connection with private placements and new issuances of municipal securities.

- b. Supervision of broker-dealer employees.** This is based on staff observations of weak supervision at some firms that are dually registered as broker-dealers and investment advisers (among other business models) and in situations where firms' registered representatives recommend complex and/or structured products and high commission products, such as private placements.
- c. Fraud.** The staff will continue to focus on uncovering activity designed to defraud investors, such as ponzi schemes and problematic activity based on tips, complaints and referrals ("TCRs") and other sources of information. Examiners may target firms and/or registered representatives ("RRs") with specific groups of customers that tend to fall prey to fraudulent affinity group schemes, such as seniors, and ethnic or religious communities. The staff will continue to conduct asset verification reviews to detect instances of fraud.
- d. Unregistered Activities.** Entities that avoid proper registration under the Federal Securities laws or misuse limited exceptions to securities registration requirements pose potential risks to fair and orderly markets as well as to the investing public. When appropriate, the examination staff may conduct voluntary inquiries at unregistered entities where a fraud is suspected. In particular, the staff intends to focus on the misuse of master-sub accounts as a way to avoid registration and therefore regulation of potentially harmful and fraudulent activities, such as excessive margin debt, money laundering, insider trading, and market manipulation.
- e. Trading Risks:** The staff intends to focus on certain trading risk areas, specifically those related to Alternative Trading Systems ("ATSs"), Exchange-Traded Funds ("ETFs"), and High Frequency Trading firms.

- f. New Regulatory Risks: The staff intends to examine firms for their supervisory and compliance procedures required under the new rules, related to the Dodd–Frank Act, or otherwise. In addition, the staff will focus on certain other potential high level risks, including the new Market Access Rule.
- g. “Large Firm” Risks. Large and complex firms may pose significant risk to the various markets and to their customers, due to their size, complexity and connectivity with other large firms and financial institutions. As a result, the staff is adopting an enhanced and collaborative approach to both monitoring and examining large firms. The staff’s focus on large firms will be risk-based and generally targeted on particular businesses or products or particular functions/processes at firms.

3. **Market Oversight Program**

Market Oversight is responsible for examining certain SROs and other entities to ensure that they comply with applicable federal securities laws and rules and the SRO’s own rules. As of September 2011, the population subject to oversight by Market Oversight includes 15 national securities exchanges, FINRA, MSRB, PCAOB, and SIPC. The priorities in FY2012 in this area include:

- a. Risk Assessment Examinations based on SRO Assessments. Based on prior risk examinations of SROs, Market Oversight has established a baseline for comparing the effectiveness of compliance programs across the SROs. We will be using that assessment to inform our exam plan and conduct risk targeted exams at certain SROs.
- b. Enhanced Oversight of FINRA. Market Oversight will continue to enhance the oversight of FINRA, with particular consideration given to the areas outlined in Dodd-Frank Section 964 and the recommendations of the Boston Consulting Group study related to SRO

oversight. The results of the Dodd-Frank Section 964 review will assist Market Oversight in identifying specific areas or risks at FINRA that may warrant review in future exams.

- c. Examinations of Potential New Registrants. During 2012, Market Oversight anticipates the need to make adjustments to its exam plan depending on the addition of new registrants to its registrant population. For example, it is possible that additional entities may register as exchange-based SROs. Also during 2012, in the event that the Commission adopts final rules for security-based swap execution facilities (SB SEFs) requiring registration with the Commission, Market Oversight would take on the responsibility within OCIE for conducting examinations of SB SEFs.

4. Credit Rating Agencies

- a. During FY 2011, an Office of Credit Ratings was created within OCIE to manage the annual examinations of National Statistical Rating Organizations (“NRSROs” or “credit rating agencies”) required under the Dodd-Frank Act.
- b. On September 30, 2011, OCIE staff issued its first annual report, required under the Dodd-Frank Act, summarizing its observations and concerns arising from the examinations of the ten credit rating agencies registered with the SEC as NRSROs and subject to Commission oversight.
- c. The report notes that despite changes by some of the examined credit rating agencies to improve their operations, Commission staff identified concerns at each of the NRSROs. These concerns included apparent failures in some instances to follow ratings methodologies and procedures, to make timely and accurate disclosures, to establish effective internal control structures for the rating process, and to adequately manage conflicts of interest. The report notes that the staff made various recommendations to

the NRSROs to address the staff's concerns and that in some cases the NRSROs have already taken steps to address such concerns.

5. Clearance and Settlement Program Examinations

The Clearance and Settlement Program currently oversees transfer agents and clearing agencies. In addition, Security-based Swap Data Repositories will also be part of this program once these entities begin to register with the Commission as required under the Dodd-Frank Act (which is anticipated sometime within FY 2012).

The priorities for the Clearance and Settlement Program currently include:

- a. Transfer Agent Program.** Examinations focusing on newly established or registered transfer agents to help determine if these transfer agents are complying with their regulatory obligations, transfer agents that service microcap securities to assess and help deter potential frauds, plans or services conducted by transfer agents that allow direct securities purchase or option plans for issuers to evaluate if the transfer agents are operating within the boundaries of the regulatory requirements, and transfer agents that have securities and funds in their possession as part of their services to determine that the transfer agents are appropriately safeguarding shareholders' assets.
- b. Clearing Agency Program.** Examinations focusing on risk management practices, control functions (*e.g.*, internal audit, compliance) and risks identified by changes in the processing environment, through ongoing monitoring efforts, or information sharing with other divisions/offices or regulators.

- c. Security-based Swap Data Repository Program – Until these entities begin to register with the Commission, the staff will be actively participating in reviewing draft rules and standards to provide the examination perspective, assisting with reviewing registration material, and developing the elements of the examination program.

6. Coordination with Other Regulators

- a. OCIE has intensified coordination efforts with domestic and foreign regulators and the regulated community.
- b. The staff at the home office 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.
- c. State securities regulators periodically attend videoconference training programs sponsored by OCIE. In addition, the examination staff in headquarters and the regional offices provide training to the states based on special requests. Additionally, the staff speaks at many state securities conferences.
- d. The staff in the home office and the regional offices continues to assist law enforcement agencies, including the United States Attorneys' offices and the Department of Justice, in bringing criminal actions.
- e. Examination staff has also 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 SEC, as well as in other jurisdictions.

- f. OCIE has entered into arrangements with the Federal Reserve and the New York State Department of Banking to increase coordination and information sharing regarding registered clearing agencies subject to joint or overlapping jurisdiction.
- g. OCIE has worked with representatives of the National Association of Insurance Commissioners and individual state insurance commissions to identify areas suitable for increased coordination.
- h. Examination staff works with representatives from the Department of Treasury and the Federal Reserve on a number of issues related to market events and the ongoing credit crisis, and works with the Department of Labor in connection with the SEC's MOU with that agency.
- i. As a result of the mandates under the Dodd-Frank Act, the SEC and other regulators are working together, as appropriate, to implement the changes required by the Act and sharing information as necessary.

B. Fiscal Year 2011 Examination Results

1. Investment Company Inspections

- a. In fiscal year 2011, the staff completed numerous inspections of investment company complexes, including third-party administrators. Most of these inspections were risk-based or cause examinations. The majority of these risk-based or cause inspections related to issues that included: compliance oversight; brokerage arrangements, trading, and execution; conflicts of interest; portfolio management; internal controls; pricing of fund assets and valuation; personal trading; disclosures and filings; 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) evaluating whether information that is created, recorded, maintained, and reported is accurate and protected from unauthorized alteration and destruction;
- (3) safety of clients' funds and assets;
- (4) fund asset pricing and fund NAV calculations;
- (5) personal trading of access persons;
- (6) order placement practices consistent with seeking best execution and disclosures;
- (7) accuracy and fairness of fund performance information;
- (8) fund corporate governance; and
- (9) independent, third-party control over periodic account statements to clients.

c. Enforcement Referrals

The matters referred to the Division of Enforcement most commonly involved the following issues, among others: breach of fiduciary duty, corporate governance, false and misleading disclosures, and conflicts of interest.

2. Third-Party Administrators

Approximately half of all mutual fund complexes use third-party administrators to perform their accounting and administrative functions. During fiscal year 2011, the examination third-party administrators remained a feature of the program as an adjunct to its mutual fund oversight function.

3. Variable Insurance Products

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 remain a feature of the examination program.

4. Investment Adviser Examinations

a. In FY 2011, the staff completed numerous investment adviser examinations. The staff focused on: compliance oversight; adviser adherence to fiduciary principles; misstatements or material omissions in disclosure documents and filings; investment offering fraud/fraud in pooled investment vehicles; conflicts of interest; portfolio management (*i.e.*, insider trading and front-running); performance and advertising issues; asset verification; and valuation.

b. Topics covered in an investment adviser examination included, but were not limited to, reviewing whether:

- (1) blocked trades and initial public offerings are allocated fairly and are consistent with disclosures;
- (2) client assets are priced accurately;
- (3) information that is created, recorded, maintained, and reported is accurate and protected from unauthorized alteration and destruction;
- (4) portfolio management decisions are consistent with client mandates;
- (5) clients' funds and assets are safely maintained;
- (6) the firm maintains a strong compliance culture;
- (7) the firm's control systems are subject to override by control persons; and
- (8) performance information provided to clients is presented fairly.

c. Enforcement Referrals

The matters referred to the Division of Enforcement most commonly involved: misappropriation of client funds, conflicts of interest; breach of fiduciary duty, misrepresentations to investors (including misleading disclosures); offering unregistered/fraudulent

securities; and material compliance program deficiencies/failures.

5. Broker-Dealer Examinations

- a.** In fiscal year 2011, the staff conducted numerous examinations of broker-dealers inspections of SROs pursuant to a risk assessment of a particular firm, business line or product.
- b.** Some key accomplishments include:
 - (1)** Broker-dealer examination efforts have identified the sale of millions of dollars of micro-cap securities through false and misleading statements, and resulted in emergency temporary restraining orders to freeze assets, as well as trading halts and/or fines. The microcap review demonstrates the benefits of a recent OCIE development, specialization groups that focus on specific subject matters such as microcap securities.
 - (2)** Developing new securities swap examination modules for swap market participants.
 - (3)** Conducting examinations of some of the most sophisticated algorithmic trading firms using new analytic capabilities.
 - (4)** Publication of a sweep report regarding the sale of structured securities products to retail investors.
 - (5)** Input on Commission rulemaking in the Dodd-Frank process, as well as other rulemaking, including:
 - i. Rules under Title VII covering swap dealers;
 - ii. Registration of municipal advisers;
 - iii. The “Volcker Rule” restricting proprietary trading by certain financial institutions;
 - iv. Development of the proposed new consolidated audit trail rules;

- v. Development of the new large trader reporting rules; and
 - vi. Informing the external business conduct rules applicable to swap trading under Dodd-Frank.
- c. 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;
 - (6) order handling and execution; and
 - (7) underwriting and distribution issues.

d. Enforcement Referrals

The most common problems referred to the Division of Enforcement were those related to fraudulent transactions, misrepresentations and omissions, employment of manipulative and deceptive devices, inadequate supervisory practices, inadequate information barriers, unregistered distributions of securities, and unsuitable transactions.

6. Clearance and Settlement Program.

In fiscal year 2011, the staff completed several risk-based examinations, cause or referral examinations, and special examinations of registered transfer agents and clearing agencies. It also provided the examination perspective on rule-writing teams with other divisions drafting rules and standards regarding security-based swap data repositories,

and developing the elements of an examination program. Other achievements included:

- a. As part of ongoing monitoring of clearing agencies, had continual dialogue with clearing agencies and other regulators throughout the period leading up to extending the federal debt ceiling and including through market reaction to the credit downgrade of U.S. government bonds.
- b. Developing new securities swap examination modules for swap market intermediaries.
- c. Participating with other divisions in rulemaking related to Title VIII of the Dodd-Frank Act (Payment, Clearing and Settlement Supervision).
- d. Played a principal role within the Commission in preparing a recent report to Congress under Title VIII of the Dodd-Frank Act, jointly with the CFTC and the Federal Reserve Board, on improving the common framework to identify risks within and across designated clearing entities as well as to assess risk management at those designated clearing entities.

7. Nationally Recognized Statistical Rating Organizations

The Dodd-Frank Act requires the Commission to establish an independent “Office of Credit Ratings,” to administer the Commission’s rules with respect to credit rating agencies registered as NRSROs. The specific duties of this new office include annual examinations of each NRSRO and an annual report summarizing the examinations.

The Commission has not yet received required Congressional approval to establish the office. However, OCIE and the Commission’s Division of Trading and Markets (“TM”) have worked closely together to achieve the office’s goals. In particular, OCIE has created an office within the NEP for NRSRO examinations. This office, with help from examiners from other OCIE examination areas and from members of TM’s NRSRO monitoring unit, successfully completed the first set of

annual examinations of each NRSRO, and the Commission approved publishing the staff's summary report of those examinations.

8. Market Oversight Inspections

Oversight inspections of SROs are generally conducted on a risk assessment basis. In fiscal year 2011, the staff conducted inspections of SROs pursuant to a risk assessment of a particular SRO or a particular SRO regulatory program. Rather than inspecting an entire SRO, the staff generally focused on a specific regulatory program. These inspections test the SROs' compliance with their regulatory duties.

In FY 2011, the Market Oversight program also completed development of risk profiles of each of the 21 national securities exchanges and SROs, enabling NEP to understand risks within each, and among the exchanges as a group.