

TARGETING IA/IC COMPLIANCE EXAMINATIONS

EXECUTIVE SUMMARY

We conducted an audit of the Commission's targeting of Investment Adviser (IA) and Investment Company (IC) examinations. The Examination program consists of the Office of Compliance Inspections and Examinations (OCIE) and the Examination staff in the field offices.

Prior to September 2003, the Examination program focused primarily on the securities in a mutual fund (i.e., the mutual fund's purchases and sales of portfolio securities on behalf of its investors). This included evaluating issues such as: portfolio management, order execution, pricing and calculation of net asset value, performance advertising, and safeguarding investor assets from theft. The primary risks identified at the time were: inappropriate securities purchases, mispricing, lack of best execution, inappropriate use of mutual fund assets, inappropriate allocations, misrepresentations about mutual fund performance and theft. Examinations did not focus on shareholder's or insider's trading in a mutual fund's shares, and the Examination program did not incorporate the risk of late trading or market timing of mutual fund shares in targeting IC examinations.

The Commission and the Examination program initiated numerous actions in response to the late trading and market timing violations involving mutual funds (see section on "Trading of Mutual Fund Shares"). Many of these actions were beyond the scope of this audit (e.g., enforcement, regulation, or congressional). Moreover, the initiatives related to targeting IA/IC examinations are either in the process of being implemented, or have only recently been implemented. As a consequence, we did not evaluate or test any of the initiatives.

With the notable exception of late trading and market timing, we found that the IA/IC targeting process was generally effective and efficient.¹ In 1998, OCIE established a targeting goal of examining every registrant² that was registered with the Commission at the beginning of 1998 and remained registered over a five year period. According to OCIE, this targeting goal, referred to as the five year cycle, was achieved. We also note that the IA/IC targeting process continues to innovate (e.g., experimenting with continuous monitoring and implementing risk-based targeting).

¹ Other deficiencies and violations have also recently been identified involving mutual funds and Broker-Dealers (e.g., breakpoints, shelf space). We will consider these issues as part of an ongoing audit involving the targeting of Broker-Dealer Examinations.

² Throughout this audit report, the term registrant includes both IAs and ICs.

We are making several recommendations to improve the IA/IC targeting process. The recommendations involve: conducting the fieldwork at the registrant, improving the use of Form ADV³ to target IAs examinations, consulting with the Office of Risk Assessment (ORA) with respect to unregistered IAs/ICs and foreign IAs, reviewing the Examination program's testing procedures, and clarifying and modifying the 90 day goal for issuing deficiency letters.⁴ During the audit, we also discussed other issues with senior management.

Commission management generally concurred with our recommendations.

SCOPE AND OBJECTIVES

Our audit objectives were to determine the effectiveness and efficiency of the IA/IC targeting process (*i.e.*, which registrants were selected for examination and the scope of the examination). Prior to September 2003, the Examination program did not target for late trading and market timing. The Commission and the Examination program initiated numerous actions in response to the late trading and market timing violations involving mutual funds (see section on "Trading of Mutual Fund Shares"). Many of these actions were beyond the scope of this audit (*e.g.*, enforcement, regulation, or congressional). Moreover, the initiatives related to targeting IA/IC examinations are either in the process of being implemented, or have only recently been implemented. As a consequence, we did not evaluate or test any of the initiatives.

During the audit, we interviewed IA/IC Examination management throughout the Commission. We also analyzed IA/IC examinations, and reviewed supporting documentation, among other procedures. Our analysis was mainly limited to IAs. Routine IC examinations are driven by the IA examinations. Hence, the targeting of routine IA examinations results in the targeting of routine IC examinations. Also, more information was readily available for IA examinations than for IC examinations. We do not believe that focusing on IA examinations adversely affected our audit results.

We did not evaluate the adequacy of the Examination program's testing procedures. However, in obtaining our understanding of how the scope of an examination is developed, a few issues came to our attention. These issues are discussed later in this report (see the section on "Examination Testing Procedures"). In addition, we did not evaluate the targeting process involving mutual fund transfer agents. According to OCIE, a comprehensive compliance examination of transfer agents is conducted during routine IC examinations.

We initially planned to evaluate whether the Examination program could continuously monitor information from registrant filings (*e.g.*, identifying risks) to improve the targeting process. However, in response to late trading and market

³ Form ADV is the IA registration application form. The Commission and states use this form for regulation purposes. Investors also use the form to obtain information about IAs in order to make well-informed investment decisions.

⁴ This letter describes the violations found and requests that the registrant implement corrective actions.

timing, the Chairman formed a task force (the “Mutual Fund Surveillance Task Force”) to study a new surveillance system for improving the information that the Commission receives from mutual fund filings. A senior OCIE staff member leads the task force. The objective of the surveillance system would be to identify industry-wide or particular mutual fund problems in order to allow the Examination staff to better target its examinations. Since the Commission was addressing this issue, we decided to discontinue our analysis.

The audit was performed from December 2003 to May 2004 in accordance with generally accepted government auditing standards, with two exceptions. Because of time constraints, we did not evaluate the validity and reliability of data from the Examination program’s Super Tracking and Reporting System (STARS) or the Investment Adviser Registration Depository system (IARD).

STARS provides a historical record of the Examination program’s examinations. IARD is used by IAs registered with the Commission and some states to file their ADV forms electronically. The National Association of Securities Dealers (NASD) administers the IARD, which was implemented in January 2001.

We are unaware of any material errors or irregularities involving STARS or IARD. A non-material issue involving STARS is discussed later in the report (see the section on “Deficiency Letter- 90 Day Goal”).

BACKGROUND

General Information

The IA/IC Examination program has approximately 35 staff in headquarters (OCIE) and 465 staff in the field offices. The field offices perform most IA/IC examinations. OCIE provides overall program direction and performs some examinations, including all of the foreign IA examinations.

The main types of examinations are:

- Routine: These examinations are conducted according to a cycle that is based on the registrant’s perceived risk.
- Cause: These examinations are initiated for a reason (*e.g.*, an investor complaint) specific to a particular registrant.
- Sweeps: These examinations are focused on a specific industry issue (*e.g.*, soft dollars), rather than an issue specific to a particular registrant. The objective is to determine how the industry is handling the specific issue.

The Division of Investment Management (IM) is responsible for the regulations pertaining to IAs/ICs. The Enforcement program is responsible for bringing enforcement actions against IAs/ICs. In fiscal year 2003, the Examination staff performed 1,556 IA examinations, of which 1,441 were routine, 77 were cause, and 38 were sweeps. They also performed 265 IC examinations, of which 233 were

routine, 27 were cause, and 5 were sweeps. Currently, the Examination program is conducting many mini-sweeps. These are similar to regular sweeps but involve fewer registrants, thereby allowing the Examination program to gather information more quickly.

Registrant Universe

At the end of fiscal year 2003, there were 995 IC complexes and between 8,000 to 8,200 mutual funds. Only a few new ICs register each year. Approximately, \$6.3 trillion of assets were invested with ICs.

In addition, 7,965 IAs managed \$21.3 trillion of assets (which includes the \$6.3 trillion invested with ICs). Approximately, 800 new IAs register with the Commission annually, while about 400 to 500 IAs withdraw their registration. As a result of the National Securities Market Improvement Act (NSMIA), enacted in 1996, most small IAs (those with less than \$25 million of assets under management) are now regulated by the states.

Approximately, 25% of IAs and 12% of the ICs registered as of December 2003 have never been examined. These are registrants that became registered since 1998 and were not included in the five year cycle plan. According to Form ADV filings, the unexamined recently-registered IAs managed approximately 7.5% of the total IA assets under management. According to OCIE, in 2002 they considered adding as a goal that all unexamined registrants be examined, but concluded that existing resources did not allow for examining these registrants and the registrants that were scheduled for a routine cycle examination in 2002. Consequently, the newly-registered registrants would be included in the next cycle examination plan.

Scorecard Approach

After completion of the five year cycle in September 2002, the Examination program adopted an approach (the "Scorecard Approach") for routine examinations that was designed to assess each registrant's process for assessing and controlling compliance risks. This process incorporates a risk based methodology that influences the timing and scope of the examination. The Examination program concluded that those registrants most at risk of having compliance problems were those that lacked strong controls, and accordingly, should be subjected to more examination attention. To ensure a consistent approach throughout the Examination program, each registrant's compliance controls were to be assessed by the Examination staff by using a risk "scorecard."

Under the scorecard approach, the Examination staff focuses on the registrant's "culture of compliance" (*i.e.*, internal controls) in ten strategic areas (see below). If the Examination staff believes that a registrant's internal controls can be relied upon, the Examination staff typically perform less testing than they would have previously. If the Examination staff subsequently discovers that the internal control are deficient, additional testing would be performed. Other factors, such as materiality of the strategic area and prior experience with the registrant, also affect the amount of testing performed.

The ten strategic areas reflect the key areas of any asset management function and also include areas of past material and reoccurring violations found by the Examination staff. Some of the areas are:

- Consistency of portfolio management decisions with client mandates;
- Order placement practices consistent with seeking best execution and disclosures;
- Fair allocation of blocked and IPO trades;
- Personal trading of access persons is consistent with code of ethics;
- Fund advisory client's assets are priced and fund net asset values are calculated accurately;
- Regular reconciliation of custodian records with fund and IA's records; all reconciling items resolved; and
- Accuracy and fairness of performance information.

For each scorecard area, OCIE has identified the potential risks to investors, key controls, and the types of documentary evidence to review. Once a scorecard area is examined, a risk rating is assigned. Afterwards, an overall risk rating for the registrant is assigned based on all the scorecard area risk ratings. The overall risk rating affects the timing of an IA's next routine examination, including the IC's next routine examination. Routine IC examinations are conducted as the associated IA is examined because the IC contracts with an IA for advisory services.

To evaluate the scorecard approach methodology, the Examination program plans to perform a few "wall-to-wall" (comprehensive) examinations annually. Any issues identified and lessons learned from these examinations will be incorporated into the scorecard approach.⁵

The Examination staff documents the scope of the examination when preparing the examination report.⁶ The scope of an examination might be modified during the examination (*e.g.*, as new risks are identified). However, a written document is not prepared during the examination recording all of the thought processes that eventually led to the final scope of the examination. We did not find widespread instances of the Examination program missing material violations by registrants involving the purchases and sales of portfolio securities on behalf of its investors.

Examination Cycles Under the Scorecard Approach

As of October 2002, the 100 largest IAs had approximately 61% of the total assets under management. Under the new risk based approach, the 20 largest IAs would be examined every two years. The remaining 80 large IAs would be examined every two to four years.

⁵ Some experts believe that many of the recent accounting frauds went undetected by the independent auditors because the auditors adopted risk-based auditing techniques. OCIE's plan to implement "wall to wall" examinations should help minimize this risk.

⁶ The report includes background information on the registrant, particular risks involving the registrant, scope of the examination, deficiencies from prior examinations, work performed, and deficiencies found. The deficiency letter is based on the examination report.

The IAs not among the 100 largest and rated as high risk would be examined every two years. Medium and low risk IAs would be examined every four years. ICs are examined when the related IA is examined.

New IAs are assigned an initial risk rating based on their Form ADV filing. New high risk IAs would be examined within their first year of registration. New medium and low risk IAs would be examined within four years of registration.

Each year, the Examination staff selects registrants from each of the various examination cycles to examine. According to OCIE, the Examination staff have the ability to adjust the timing of an examination based on their knowledge of the registrant.

After our fieldwork was completed, OCIE stated that the information presented above was no longer totally applicable. During the audit, OCIE informed us that changes were likely with respect to the timing of registrant examinations. These proposed changes were prompted by the late trading and market timing violations involving mutual funds, and the general evolution of the Examination program. We believe that our findings and recommendations are still applicable.

OCIE now envisions fewer routine examinations based solely on the passage of time. Examinations will be further risk based due to various initiatives (e.g., obtaining risk based information from the mutual fund task force and ORA, and the increased use of sweeps and mini-sweeps).

AUDIT RESULTS

Prior to September 2003, the Examination program focused primarily on the securities in a mutual fund (*i.e.*, the mutual fund's purchases and sales of portfolio securities on behalf of its investors). This included evaluating issues such as: portfolio management, order execution, pricing and calculation of net asset value, performance advertising, and safeguarding investor assets from theft. The primary risks identified at the time were: inappropriate securities purchases, mispricing, lack of best execution, inappropriate use of mutual fund assets, inappropriate allocations, misrepresentations about mutual fund performance and theft. Examinations did not focus on shareholder's or insider's trading in a mutual fund's shares, and the Examination program did not incorporate the risk of late trading or market timing of mutual fund shares in targeting IC examinations.

The Commission and the Examination program initiated numerous actions in response to the late trading and market timing violations involving mutual funds (see section on "Trading of Mutual Fund Shares"). Many of these actions were beyond the scope of this audit (*e.g.*, enforcement, regulation, or congressional). Moreover, the initiatives related to targeting IA/IC examinations are either in the process of being implemented, or have only recently been implemented. As a consequence, we did not evaluate or test any of the initiatives.

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the Commission at the beginning of 1998 and remained registered over a five year period. According to OCIE, this targeting goal, referred to as the five year cycle, was achieved. We also note that the IA/IC targeting process continues to innovate (*e.g.*, experimenting with continuous monitoring and implementing risk-based targeting).

We are making several recommendations to improve the IA/IC targeting process, as discussed below.

TRADING OF MUTUAL FUND SHARES

Background

In September 2003, based on a tip from an informant, the Attorney General of New York filed a case against a hedge fund manager for arranging with several mutual fund companies to trade the shares of the mutual funds improperly. As a result, the Examination program performed mini-sweep examinations. Also, the Commission's Enforcement program, the NASD, the New York Attorney General, and others conducted investigations and filed enforcement actions against numerous securities firms and individuals. The violations involved late trading and/or market timing.

- Late trading involves allowing an investor to trade mutual fund shares after the close of the US securities markets (4 PM EST) and receive the current day's closing price (the net asset value (NAV)⁷ of the mutual fund shares), instead of receiving the next day's closing price. Most mutual funds calculate their NAV once a day as of 4 PM.
- "Market timing includes (a) frequent buying and selling of shares of the same mutual fund or (b) buying or selling mutual fund shares in order to exploit inefficiencies in mutual fund pricing. Market timing, while not illegal per se, can harm other mutual fund shareholders because it can dilute the value of their shares, if the market timer is exploiting pricing inefficiencies, or disrupt the management of the mutual fund's investment portfolio and cause the targeted mutual fund to incur costs borne by other shareholders to accommodate frequent buying and selling of shares by the market timer."^{8 9}

Prior to the first case being filed by the Attorney General of New York, the Examination program focused primarily on the securities in a mutual fund (*i.e.*, the mutual fund's purchases and sales of portfolio securities on behalf of its investors). This included evaluating issues such as: portfolio management, order execution, pricing and calculation of net asset value, performance advertising, and

⁷ The NAV is based on the net assets (*i.e.*, the value of securities, cash, etc. less any liabilities) that the mutual fund owns divided by the number of shares distributed to investors.

⁸ This is standard language used in Commission enforcement actions involving market timing.

⁹ The Investment Company Act of 1940 requires mutual funds to calculate their NAV based on the fair value of the underlying securities, if a market quote of a security is either unavailable or unreliable. IM issued guidance in April 2001 concerning fair value pricing.

¹⁰ The Commission adopted a compliance rule in December 2003. The accompanying release stated that, "a fund must have procedures reasonably designed to ensure compliance with its disclosed policies regarding market timing. These procedures should provide for monitoring of shareholder trades or flows of money in and out of the funds in order to detect market timing."

safeguarding investor assets from theft. This is in contrast to the trading by investors or insiders in the shares of the mutual fund itself, which would include late trading and market timing.

Commission Action

The Commission initiated numerous actions in response to late trading and market timing violations involving mutual funds and to reduce the possibility of future scandals. The following is a description of some of the actions taken:¹¹

Examination

The Examination program took several actions in response to late trading and market timing, including:

- The Examination program initiated a mini-sweep examination of mutual fund complexes, broker-dealers, transfer agents and variable annuity sponsors, and obtained information from unregistered mutual fund intermediaries. Many cause examinations and enforcement referrals resulted from these mini-sweeps;
- The Examination program also conducted mini-sweeps designed to promptly detect emerging compliance problems, and conducted examinations regarding the fair valuation procedures at over 900 mutual funds that invest a majority of their assets in foreign securities;
- The Chairman formed a task force to study a new surveillance system for improving the information that the Commission receives from mutual fund filings.¹² The objective of the surveillance system would be to identify industry-wide or particular mutual fund problems in order to allow the Examination staff to better target its examinations;
- The Examination program implemented a new policy of providing the deficiency letter to the mutual fund's board of directors, in addition to its IA;
- The Examination program implemented a new policy of reviewing registrant e-mails in order to help identify violations;
- According to OCIE, the Examination program has increased its coordination with Enforcement and IM to ensure that serious examination problems, are investigated timely, and that emerging issues and trends are identified for policy and rule-making staff; and
- The Examination program plans to conduct a few "wall-to-wall" (comprehensive) examinations annually. Any issues identified and lessons learned from these examinations will be incorporated into the Examination program.

¹¹ The Commission recently received a significant funding increase. This resulted in additional staffing, including staff involved in the regulation, enforcement, and examination of mutual funds. Despite the increased funding for the Commission's Examination program, it still uses risk based examination techniques because it lacks the resources to conduct comprehensive examinations at each registrant every year.

¹² Task forces on Soft Dollars, 529 tuition savings plans, and disclosures to investors (by mutual funds, brokers, and issuers) have also been established.

Enforcement

The Enforcement program has filed numerous actions related to late trading and market timing. According to the Division of Enforcement, they also strengthened their complaint handling procedures as part of an overall review of their procedures; and are working closely with the Examination staff regarding complaints.

Regulation

The Commission proposed or adopted numerous rules (or amendments) in response to late trading and market timing. For instance;¹³

- In June 2004, the Commission adopted a rule requiring mutual funds to increase their percentage of independent directors (to 75%). The mutual fund Chairman is also required to be independent;
- In June 2004, the Commission adopted a rule requiring the mutual fund's board of directors to disclose information regarding the approval of the IA contract;
- In April 2004, the Commission adopted amendments to require mutual funds to disclose their policies and procedures regarding: market timing, for using fair value pricing, and disclosure of portfolio holdings;
- In February 2004, the Commission proposed a two percent mandatory redemption fee for all mutual fund sales (with a few exceptions) made within five days of purchase;
- In December 2003, the Commission proposed a 4 PM "hard close". This would require that all mutual fund orders be received by 4 PM in order to receive that day's NAV; and
- In December 2003, the Commission adopted rules to require IAs/ICs that are registered with the Commission to adopt, and implement policies and procedures reasonably designed to prevent violations of the federal securities laws. These policies and procedures must be reviewed annually. Also, a Chief Compliance Officer must be appointed.

Office of Risk Assessment

In 2003, the Commission announced the creation of ORA. Its purpose is to identify emerging risks affecting the securities markets in a timely manner. A director was recently hired. According to recent testimony by the Chairman, each of the Commission's main programs has organized internal risk teams. ORA will coordinate with these internal risk teams. Also, according to ORA, they will be developing additional tools and approaches to enhance the risk assessment efforts currently underway throughout the Commission.

Congressional Action

The Congress held numerous hearings on late trading and market timing violations involving mutual funds. Legislation was drafted; however, no legislation has been enacted at this time.

¹³ The Commission is also considering whether to require hedge fund managers to register with the Commission and be subject to examinations, in part because of their involvement with mutual funds.

Our Assessment

As described above, the Commission has initiated many actions in response to late trading and market timing. Many of these actions were beyond the scope of this audit (*i.e.*, enforcement, regulation, or congressional). Moreover, the initiatives related to targeting IA/IC examinations are either in the process of being implemented, or have only recently been implemented. As a consequence, we did not evaluate or test any of the initiatives.

We believe that ORA could enable the Commission to detect and mitigate securities industry risks before they become widespread. Effective operation of ORA should assist in identifying emerging risks to incorporate into the Examination program's targeting process. Our office is planning a future audit of ORA, once ORA has had some time to develop.

ROUTINE EXAMINATIONS

Conducting the Fieldwork at the Registrant

We found that the field offices, when conducting a routine IA examination, differed on whether they performed the majority of the examination fieldwork at the registrant or at the field office. A major factor appeared to be the geographic location of the registrant. We were told that, if the registrant was located close to the field office, the Examination staff was more inclined to work at the registrant.

Most of the field offices believed that the quality of the examination was improved when the fieldwork was performed at the registrant because:

- The Examination staff might identify material deficiencies that they would not otherwise identify. For instance, at the registrant, the Examination staff has the ability to observe operations. Based on our analysis, the field offices performing most of the fieldwork at the registrant during routine IA examinations generally had more enforcement referrals.¹⁴ While numerous factors affect whether an enforcement referral is made, the location of the fieldwork appears to be a relevant factor;
- A key component for developing an understanding of the registrant's internal control structure is assessing the control environment (*e.g.*, the integrity of management, the value management places on internal controls). Conducting the fieldwork at the registrant enhances the Examination staff's assessment of the control environment because the Examination staff spends time in the midst of that environment; and
- It is harder for the registrant to delay document requests and ignore questions, if the Examination staff is at the registrant.

At a 1997 securities industry conference, the Co-Chair of the conference (a securities industry person) offered the attendees the following advice:

¹⁴ We analyzed 5,445 routine IA examinations conducted between fiscal years 1998 and 2003; and 167 enforcement referrals made between fiscal years 1998 and 2003 that resulted from routine IA examinations.

“...if the inspection staff continues an inspection long enough, it is likely to find some violations by the registrant. As a general rule, the longer the inspection staff stays at the registrant, the more violations they are likely to find. Because of this, a registrant should take every step to conclude the inspection as quickly as possible.”

On the other hand, some field offices stated that, in recent years, many registrants (especially the larger registrants) have begun to isolate the Examination staff from the registrant’s staff and appoint a contact person (who is responsible for all document and information requests). Thus, the value of working at the registrant has been reduced to some degree. However, the field offices’ estimates of the reduced value differed. In addition, conducting more fieldwork at the registrant would increase Commission travel expenses.

Recommendation A

OCIE, in consultation with the field offices and the Office of the Executive Director, should perform more detailed analysis into the costs and benefits of increasing the amount of fieldwork conducted at the registrant.¹⁵

Providing the Registrant with Notice of a Pending Examination

The field offices generally provide the registrant with advance notice that a routine examination is going to be conducted. However, cause examinations are generally unannounced. The amount of advance notice that given is for routine examinations is between a few days to a few weeks, depending on numerous factors (*e.g.*, the size of the registrant, the volume of documents to be requested, the travel distance to the registrant, and the preference of the field office). Routine examinations are announced, in part, because:

- It is inefficient for the Examination staff to travel to a registrant only to find that registrant staff are not available;
- Many of the documents are generally not readily available (including e-mails, which are now generally reviewed during examinations), and require that the registrant locate and produce them; and
- It is harder to conduct pre-examination planning (*i.e.*, developing the scope of an examination) without obtaining certain registrant documents prior to the examination.

However, advance notice of an examination provides the registrant with an opportunity to alter, conceal, or destroy documents. OCIE stated that alteration, concealment, or destruction of relevant documents is difficult to detect. Examiners now may ask the registrant if all relevant documents have been produced, and if relevant documents have been lost, destroyed or are otherwise not available. However, registrant staff might not honestly admit this, if they were intent on concealing violations. Examiners routinely obtain documents directly from third parties in order to confirm the registrant’s books and records. Such third parties

¹⁵ According to OCIE, as a result of certain targeting initiatives under consideration, it is expected that the Examination staff will be spending more time at registrants.

include custodians, transfer agents, administrators, and data service providers. In addition, examiners routinely assess the registrant's document control processes that support the maintenance of accurate documents. Further, as part of the mutual fund's external audit, the auditors consider the adequacy of document-retention procedures.

The Examination staff stated that conducting unannounced examinations would not totally eliminate the risk of alteration, concealment or destruction because registrants do not provide the Examination staff with all the requested documents immediately. OCIE also stated that many registrants insist on reviewing all documents prior to their production to examiners, including identifying any documents that may be subject to attorney-client privilege. This can substantially increase the amount of time it takes the registrant to produce documents (sometimes by weeks or longer), and that it would be inefficient to have examiners wait in the registrant's offices for these documents to be reviewed and produced.

We could not readily analyze the potential effects of this issue on the Examination program because the relevant information is not recorded in STARS (*e.g.*, whether an examination was announced, the number of days notice that was given).

Recommendation B

OCIE, in consultation with the field offices, should consider whether there are additional methods to detect altered, concealed, or destroyed documents in high risk examination areas that could be incorporated into the Examination program.

Recommendation C

OCIE should consider recording in STARS whether or not a routine examination was announced, and the number of days notice that was given (if the examination was announced). This could allow OCIE to evaluate whether and how advance notice affects examinations.

FORM ADV

OCIE'S ADV Risk Rating Methodology

Upon adopting the scorecard approach, OCIE staff reviewed each IA's most recent Form ADV filing. They judgmentally assigned, based on their experiences, point values to the various questions and possible answers in Part I of the Form ADV. Based on the total number of points, the IA was assigned a high, medium, or low risk rating.

This method is also currently used for new IAs. This risk rating affects the timing of the IAs initial examination. The field offices primarily rely on OCIE's ADV risk rating for new IAs.

IAs that have custody of investor funds or have prior disciplinary violations pose a greater risk to investors. However, we believe that OCIE's ADV risk rating

methodology may not be adequately reflecting the importance of these risk criteria. For instance, as of December 2003, of the 1,917 IAs that had not been examined:

- 186 were rated as either medium or low risk although they have custody of investor funds according to their Form ADV filing; and
- 136 were rated as either medium or low risk although they disclosed a disciplinary violation in their Form ADV filing.

According to OCIE, Form ADV also has many other items that may indicate that an IA poses a higher risk, such as having side-by-side management of hedge funds or other fee inducements, and the amount of assets under management. OCIE believes that a risk rating process that uses responses to Form ADV should consider all of these variable risk areas, in combination. Furthermore, an IA that has custody but no other risk attributes may have a lower risk profile than an IA that does not have custody, but has many other risk attributes.

According to the Office of Economic Analysis (OEA), an analytical approach could be performed in order to determine the appropriateness of OCIE's ADV risk rating methodology (*e.g.*, the point weighing of each question and possible answer). OCIE supports having OEA assist in developing a risk weighting methodology that would consider all relevant risk attributes.

Recommendation D

OCIE should consult with OEA concerning possible improvements to the Form ADV risk rating methodology.

Reviewing Amended Form ADVs

IAs are required to file an annual updated Form ADV within ninety days of the end of their fiscal year. In addition, if certain material events occur during the year, an amended Form ADV must be filed "promptly". Notice of an amended Form ADV could affect the timing of the IA's next examination.

According to OFIS, they review amended Form ADVs. If a disciplinary violation is disclosed, they notify the appropriate field office. They do not currently notify the field offices of other amended Form ADVs.

Some of the field offices stated that the following are material events (other than disciplinary violations) that could affect the timing of an IA's next examination:

- An IA obtains custody of investor funds;
- An IA changes its address;
- An IA starts or advises a hedge fund; and
- An IA has a material change in either the number of investors or the amount of assets under management.

Some of these events do not require an amended Form ADV to be filed, but rather the event must be disclosed in the annual updated Form ADV.

A report can be created from IARD indicating amended Form ADVs. However, this report has limitations that adversely affects its usefulness. For example, the report does not identify whether the Form ADV is an amended filing or the annual

updated. In addition, the report does not identify the type of material event being disclosed, if it is an amended Form ADV filing.

Recommendation E

OCIE, in consultation with the field offices and IM, should identify all material events (which are not currently required to be disclosed) that could affect the timing of an IA examination.

Recommendation F

IM should propose to the Commission (see Recommendation E) that it consider modifying the disclosure requirements for Form ADV to include the additional material events.

Recommendation G

IM should request that the NASD create an IARD report that readily identifies amended Form ADVs and the type of event being disclosed (see Recommendations E and F).

Recommendation H

OFIS should notify the field offices of all amended Form ADVs and the type of material event being disclosed, until the IARD report described in Recommendation G is available.

Monitoring Form ADV-E

Certain IAs (depending on how their business processes are structured) with custody of investor funds are required to have an annual surprise audit performed by an independent public accountant. Upon completing the audit, the accountant is required to file Form ADV-E with the Commission.¹⁶ We found that the Examination program does not ensure that the Form ADV-E was filed. The absence of a Form ADV-E filing could indicate that the annual surprise audit was not performed.

However, in September 2003, the Commission adopted a new custody rule for IAs. As a result, the number of IAs required to have an annual surprise audit is expected to be reduced from approximately 700 to 100. Thus, this issue has somewhat been mitigated by the rule change.

Recommendation I

OCIE, in consultation with the field offices, IM and OFIS, should develop a method to ensure that required Form ADV-E filings are submitted.

¹⁶ The Form ADV-E is filed on paper. There are no plans to have it filed on the IARD system.

OFFICE OF RISK ASSESSMENT

We identified two issues where we believe ORA can provide assistance in order to help protect investors.

Unregistered IAs/ICs

Some IAs/ICs fail to register as required. The IA might be unregistered with a state or the Commission. States do not register ICs. If an IA/IC fails to register with the Commission, the Examination program will not know it exists and thus cannot conduct an examination.

The number of unregistered registrants is unknown. Unregistered registrants are sometimes identified through a Broker-Dealer examination, enforcement action, newspaper article, investor complaint, etc. However, the Examination program does not proactively search for unregistered registrants.

The field offices believe that most of the unregistered IAs are small. Thus, as a result of NSMIA (see Background Section), they are a state examination responsibility. If an IA is not registered with a state, the field offices generally believe that investors are at risk. However, the level of risk depends on the quality of the state's examination program. According to the field offices, the quality of the state examination programs vary.

Foreign IAs

Approximately, 343 foreign IAs are registered with the Commission. This represents 4.3% of all IAs registered with the Commission. Foreign IAs manage approximately 9% of all the assets invested with IAs registered with the Commission. The assets managed by foreign IAs are both foreign and US investors. The amount of assets from US investors is not readily known.

Foreign IAs are not examined as often as US IAs partially because of the travel required. Since 1998, approximately 85% of the foreign IAs have not been examined. Based on OCIE's ADV risk rating methodology, 19% of the non-examined foreign IAs are high risk.

Recommendation J

OCIE should discuss the risks resulting from unregistered IAs/ICs and foreign IAs with ORA and the Office of International Affairs to determine whether (and possibly how) these risks could be mitigated. One way to increase examination coverage for foreign IAs while limiting travel costs would be using Focus Area Correspondence Examinations.¹⁷

¹⁷ Focus Area Correspondence Examinations involve sending the registrant a letter asking about its compliance in an area. The registrant's response is reviewed. Depending on the adequacy of the response, appropriate action is taken (e.g., a deficiency letter is sent, the matter is closed, an on-site examination is conducted, a follow-up letter is sent to the registrant requiring additional information). According to the field offices, Focus Areas Correspondence Examinations are rarely used for routine examinations.

EXAMINATION TESTING PROCEDURES

According to the field offices, under the scorecard approach, they perform testing of transactions. However, the extent and nature of the testing depends on various factors including:

- The examiner's assessment of the internal control structure;
- The materiality of the scorecard area; and
- Prior experience (*e.g.*, the type of the deficiencies that were cited), if any, with the registrant.

While some testing is still generally performed, we identified (primarily based on our discussions with the field offices) some potential areas of concern:

- The Examination staff typically only review records from recent years, as opposed to the entire timeframe since the last examination (as much as five years). If a registrant is aware of this, it might feel comfortable overriding internal controls or engaging in violations immediately after its examination for about one to three years because of the reduced likelihood of detection. The field offices generally believe that reviewing only recent records is a risk. However, older records are difficult to obtain; registrant staff with knowledge of these records may no longer be available; and the Examination staff may lack the necessary technological capabilities (*e.g.*, staff does not have the necessary computer skills or software to handle such large amounts of data). According to OCIE, the Examination staff generally review all the records (*i.e.*, since the last examination) in certain areas (*e.g.*, IC board of director minutes, account performance, and material NAV errors);
- The Examination staff regularly reviews registrant exception reports (*e.g.*, to determine whether the registrant was identifying exceptions, and how the registrant handled the exception). According to OCIE, the Examination staff tests the accuracy of the exception reports to determine whether certain data were included in the analysis and/or factored into the exception reporting process (*e.g.*, requesting registrants enter inappropriate securities transactions into their trading systems and cross-checking the securities on restricted trading lists with personal securities transactions). However, the Examination staff does not generally have the expertise to perform any testing regarding the software programming for the exception report (*e.g.*, were all exceptions captured by the exception report); and
- The Examination staff could possibly improve their testing for altered, concealed, or destroyed documents (see section on "Providing the Registrant with Notice of a Pending Examination").

OCIE believes that the risk of fraud occurring immediately after an examination will be mitigated to the extent that more examinations in the future will be random. In addition, the risk of fraud and the adequacy of software programming for exception reports might be mitigated by mutual funds and IAs having Chief Compliance Officers (a requirement that goes into effect on October 5, 2004), and the implementation of the mutual fund surveillance program.

Recommendation K

OCIE, in consultation with the field offices, should incorporate the issues and risks identified above into the Examination program, including the “wall-to-wall” examinations.

Recommendation L

OCIE, in consultation with the field offices, ORA, and OIT, should: (1) evaluate whether technology can be improved to expand the Examination program’s ability to test large quantities of data; and (2) consider the costs and benefits of improving the technological capabilities of the Examination program.

DEFICIENCY LETTER- 90 DAY GOAL

OCIE has established a goal of issuing the registrant a deficiency letter (if applicable) within 90 days of completing the fieldwork. According to OCIE, the end of the fieldwork represents the date when the Examination staff leave the registrant’s office.

OCIE stated that the purpose of the goal is to provide registrants a sense of when the examination is likely to conclude (the goal is noted in the brochure that the Examination staff provide to registrants at the start of the examination), and to set a goal for the examination. However, many examinations may not be conducted within the goal timeframe due to the complexity of the issues, the availability of documents, or the level of cooperation received.

As discussed above (see section on “Conducting the Fieldwork at the Registrant”), the amount of fieldwork completed at the registrant varies (especially based on the proximity of the registrant to the field office). The Examination staff typically continue to analyze documents and data, after leaving the registrant. Distant registrants would likely get their deficiency letter sooner than nearby registrants. Moreover, some field offices believe that some Examination staff might be misrepresenting the date that they leave the registrant, in order to delay the beginning of the 90 day period. Compliance with the 90 day goal is tracked in STARS.

According to OCIE, it has reminded the field offices about the 90 day goal policy. Most of the field offices appear to understand the policy.

Recommendation M

OCIE should clarify and modify its 90 day goal policy for deficiency letters, as appropriate. Any modification of the policy should not discourage the Examination staff from conducting fieldwork at the registrant.