

OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS
PROGRAM GOALS FOR FISCAL 2010

August 7, 2009 *draft*

This non-public memorandum provides guidance to SEC examination staff concerning examinations and inspections of registered investment advisers, investment companies, broker-dealers, transfer agents, clearing agencies, self-regulatory organizations (SROs), and nationally recognized statistical rating organizations (NRSROs) for fiscal year 2010 (FY 2010). Examinations have three broad goals: (i) to detect fraud and other violations of the securities laws and rules, (ii) to foster strong compliance and risk management practices, and (iii) to provide the Commission and its staff with information about the industry’s compliance and the implementation of rules and laws.

Over the past year, examinations have focused on emerging risks due to the market and credit crisis and the incidence of fraud. We made significant changes and enhancements to examinations in FY 2009. This memo summarizes these changes, as well as overall goals and priorities for the examination program for FY 2010 in light of current risk issues. Areas of priority have been formulated in part based on the 2009 *Risk Assessment Database for Analysis and Reporting (RADAR)* risk assessment process, by trend analysis of prior OCIE examinations, and regulatory and market events. This memo also summarizes new exam procedures, the greater use of technology in examinations, new measures of exam results, and examiner training for FY 2010. Finally, it lists anticipated SRO, NRSRO and other inspections, and risk-targeted exam sweeps completed in FY 2009 and those currently underway.

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I. Summary of FY 2010 Program Priorities

In the past year, we implemented numerous changes to examinations and conducted examination sweeps and other targeted examinations focused on risks in the current environment – these initiatives were directly aimed at emerging risks in light of the market and credit crisis and the incidence of fraud. In FY 2010, because only a small portion of the large number of SEC-registered firms can be examined each year, examinations will continue to be driven by a focus on identifying and addressing areas of emerging risk. The primary focus in prioritizing risks for examination attention is the risk of harm to investors.

We anticipate that examinations based on tips, complaints and other indications of possible violations will be a significant component of FY 2010 examinations. The number of cause examinations increased in the second half of FY 2009, as the Commission received a large number of tips and complaints, which resulted in cause examinations being the leading type of exam conducted. We anticipate that, with improvements in risk assessment and surveillance activities, combined with other initiatives aimed improving the agency’s intake of tips, complaints, and referrals and incentivizing whistleblowers, the number of cause exams may increase in FY 2010. Because they are conducted based on indications of violations, cause examinations continue to remain the program’s first priority, and the number of cyclical and other examinations that OCIE will perform will necessarily decrease as a result.

In addition to cause examinations, we anticipate conducting an increased number of examinations that are targeted to particular risk issues. These may be “sweep” examinations of a discrete risk conducted “horizontally” across a number of firms, and they also may be individual examinations conducted as a result of the greater use of data analysis and surveillance that indicates a higher risk of a firm having unusual or possibly violative activity.

To improve the risk-targeting efforts, OCIE has established complementary risk assessment and surveillance groups to help assess risks of advisers, registered funds, privately offered pooled vehicles, and broker-dealers. A primary goal of this program is to identify firms that have unusual or “outlier” attributes. A variety of projects are currently underway that aim to enhance the data available to SEC staff for risk assessment and surveillance. Significant time and resources will be devoted to improving the SEC’s surveillance and risk assessment functions in FY 2010 and FY 2011.¹ In FY 2010, we anticipate providing regional offices with lists of firms that have various risk characteristics, to enable the program to conduct more targeted examinations based on the risk of harm to investors.

The key focus areas for FY 2010 will be to examine firms and areas within firms that have higher fraud potential. We anticipate that verifying assets and confirming the appropriate safeguarding of customer assets will continue to be a priority in examinations of certain advisers and broker-dealers. SRO inspections, clearing agency exams, and transfer agent exams will be risk-focused on issues and risks that exist in current environment. OCIE will implement routine examinations of

¹ In order to establish a fully effective surveillance and risk assessment function, registered entities will need to provide additional data to the SEC. Rulemaking by the Commission will be required to obtain this additional data periodically and in a standard format to allow for analysis.

NRSROs in a dedicated branch of examiners, and will expand its examination function to include new clearing agencies for credit default swaps (CDS).

The staff will continue proactive efforts to encourage improved compliance practices through the *CCOutreach* program, the publication of “*ComplianceAlerts*,” and other initiatives. OCIE will continue efforts to enhance examiner training and expertise and expects to start development of a targeted training program for examiners.

II. Landscape of Registrants and Program Resources

Changes in the last year have been significant. Many firms struggled financially as assets under management declined, and revenue from new products, underwriting and trading declined substantially. Many firms merged or acquired other firms, creating risks that merged operations may not be operating with strong controls. Some firms reduced resources available for compliance programs. Trading continues to be highly automated, with a significant growth in “low touch” automated trading strategies. A significant number of Ponzi schemes and other frauds were revealed. Challenges to valuation abounded and revealed that improvements could be made in the processes used to value securities. Many investors lost confidence in the markets and market participants, and the number of arbitrations filed with FINRA’s arbitration program increased substantially.

At the start of FY 2010:

Advisers and Funds: there are approximately 11,500 registered investment advisers, an estimated 29,000 privately offered funds sponsored by these advisers, and 860 fund complexes (including third-party administrators) with over 8,000 mutual fund portfolios. The registered adviser population continues to be highly transient: it is estimated that approximately 1,100 advisers will register and 900 will de-register in FY 2009.

Broker-Dealers: there are approximately 5,300 broker-dealers, 173,000 branch offices, and 649,000 registered representatives. As more firms have consolidated, the broker-dealer registrant pool has declined slightly in recent years, while the number of branch offices has increased dramatically.

Transfer Agents and Clearing Agencies: there are approximately 408 SEC-registered transfer agents and 174 transfer agents registered with bank regulators that we examine, as well as 10 entities subject to regulation as clearing agencies.

SROs: there are 11 exchanges, the Financial Industry Regulatory Authority (FINRA) with its 14 district offices, the Public Company Accounting Oversight Board (PCAOB), and the Municipal Securities Rulemaking Board (MSRB).

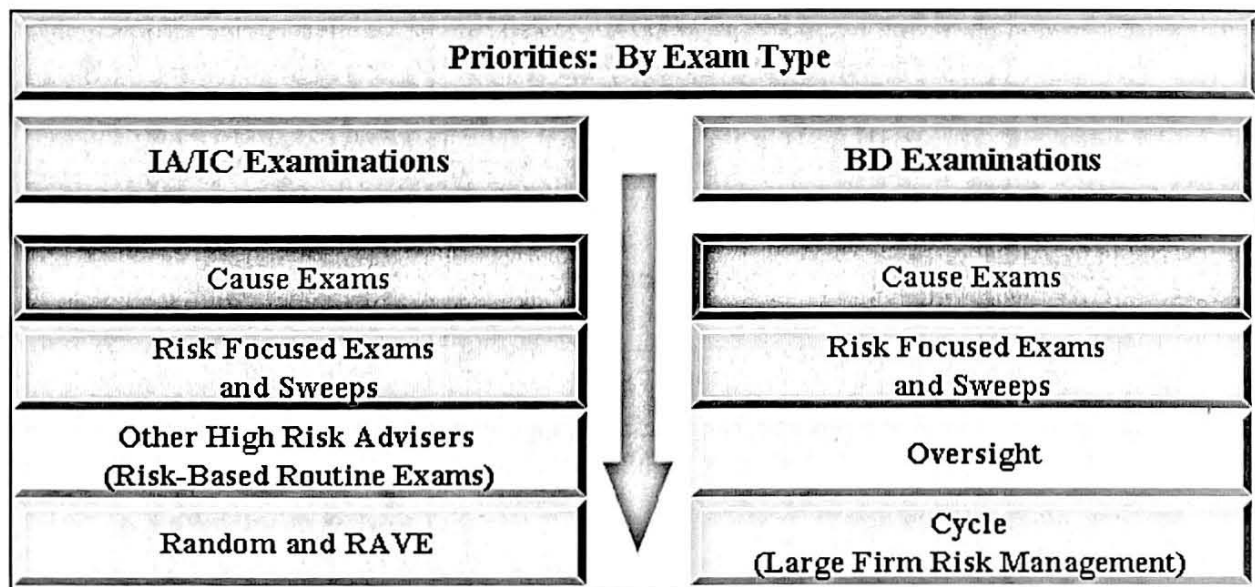
NRSROs: 10 credit rating agencies have registered as NRSROs with the Commission since September 2007.

In FY 2010, we anticipate total overall staffing levels to remain relatively consistent with FY 2009 levels: approximately 376 staff for examinations of broker-dealers, transfer agents, clearing agencies, SROs and PCAOB, and approximately 452 staff for examinations of advisers, funds and affiliated transfer agents. The resources we have available will continue to be a highly significant factor in exam selection and focus.

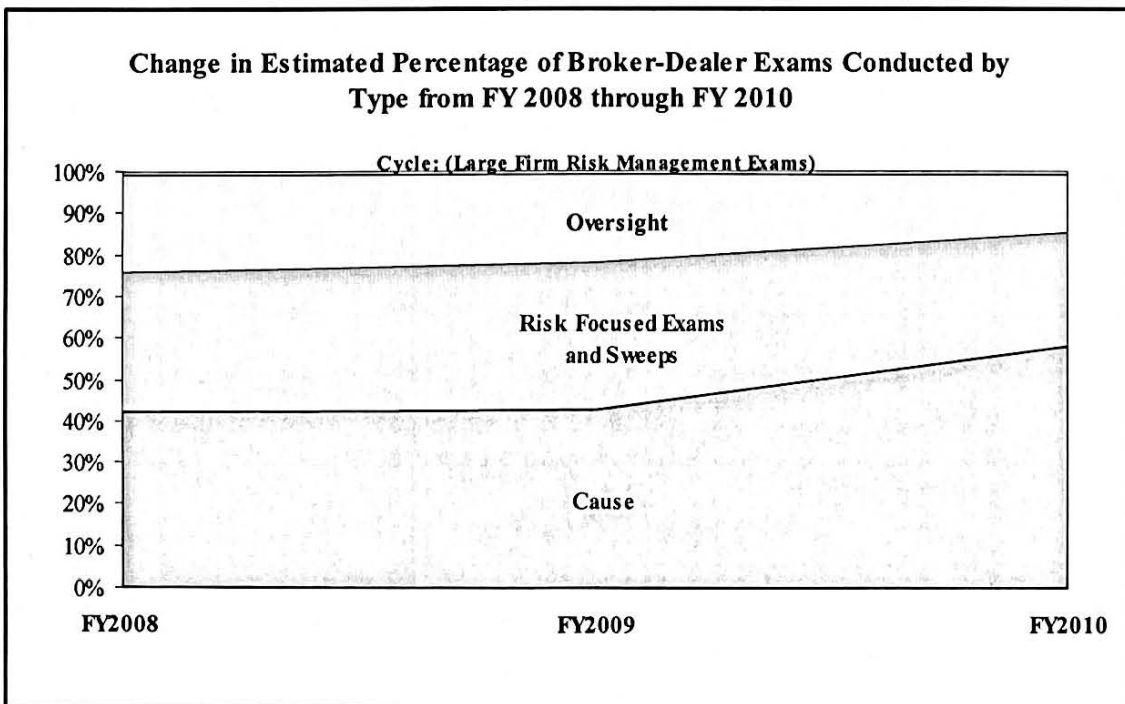
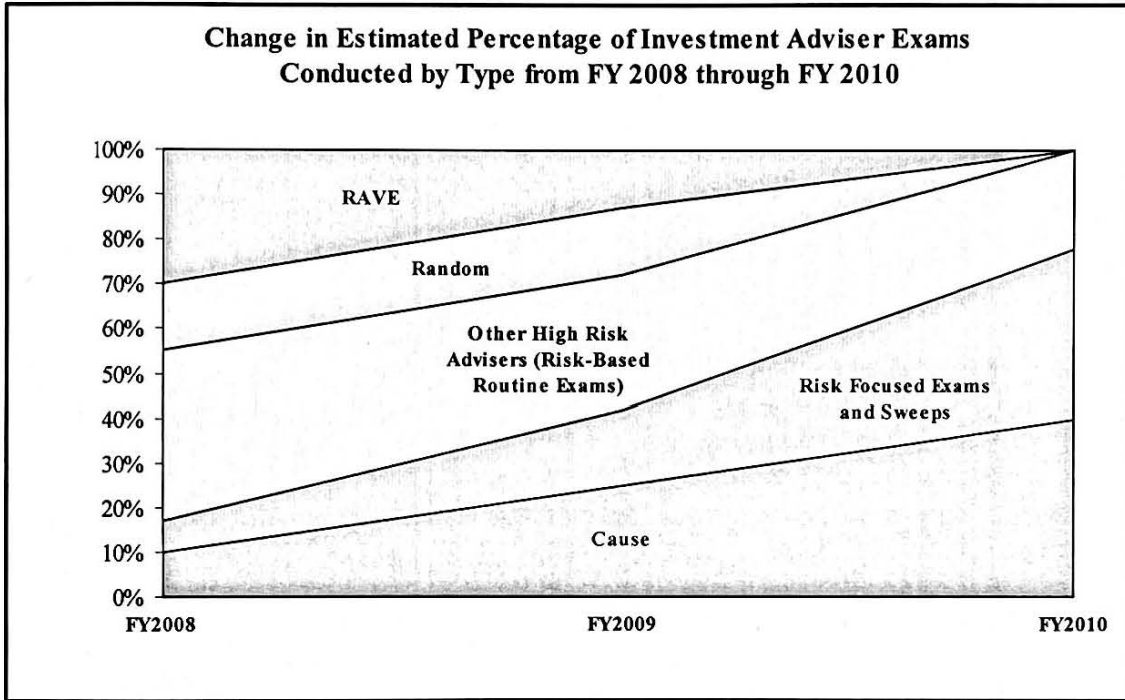
III. Priorities in Examinations of Investment Advisers, Investment Companies and Broker-Dealers

As summarized above, in light of the increase in the number of cause examinations and the need for the examination program to quickly identify and examine risks that could indicate harm to investors, OCIE will prioritize cause examinations and risk-targeted exams and exam sweeps in FY 2010. As a result, other types of examinations will have lower priority and fewer will be performed. With respect to advisers, we anticipate conducting fewer routine cyclical examinations of “high risk” advisers, random examinations of “low risk” advisers and risk-validation examination visits (or “RAVEs”). With respect to broker-dealers, we anticipate conducting fewer oversight examinations and internal controls examinations.

These changes in examinations from FY 2008 (and estimated) through FY 2010, relative to the types of examinations performed, are shown in the charts below.²



² The numbers in the charts are estimates. Actual numbers will vary by office and may vary substantially going forward depending on the number of cause exams, the time taken to complete examinations and other factors.



1. Top Priority Examinations and Initiatives

Cause Exams: In the coming year, examiners will need to continue to rapidly initiate cause exams as needed. In particular, examiners should be alert for indications of fraud and “acts of desperation”

by individuals and firms that are under financial duress. We will remain especially attentive to changing economic and market conditions, complaints, tips, press reports, and information from industry sources that indicate possible fraudulent activities, potential customer harm, or other compliance or operational problems. OCIE will continue to strengthen its risk assessment and surveillance activities, and continue to hold quarterly conference calls with FINRA and OIEA to discuss customer complaint statistics and trends. We may also receive valuable information for cause examinations from our daily review of Suspicious Activity Reports and the weekly Risk Assessment Reports. OCIE anticipates that these measure and other agency initiatives will necessitate the allocation of significant resources (likely 50% or more) to cause examinations in FY 2010.

Risk-Targeted Examinations and Sweeps: During the past five years, we have initiated a number of risk-targeted sweeps, focused on particular compliance risks. These exam initiatives have been very valuable in identifying and investigating particular risk issues quickly. OCIE is streamlining the process for initiating and concluding sweeps to facilitate more timely initiation and disposition of examinations.

Our risk assessment and surveillance staff, using *RADAR* and other means, have identified risks that may indicate the need for new risk-targeted examinations or sweeps. Current market conditions and expanded registrant activities have raised the potential for significant new risks. OCIE plans to address these new risks, as well as other risks inherent in particular business models and operations, by undertaking risk-targeted examinations and sweeps, as resources permit. For example, we are considering risk-targeted examinations or sweeps in various areas, including serial offerings used in frauds, the operations of independent contractor advisers and brokers, anti-money laundering programs of mutual funds, suspicious activity reporting by broker-dealers, sales of municipal securities, target-date funds, and multiple-level trading firms.

While sweeps traditionally focus on discrete issues and have a more defined exam scope that is relatively consistent across sweep candidates, risk-targeted examinations are individual examinations initiated based on analysis of surveillance and other data that indicates heightened risk (e.g., firms that use a little-known auditor, sell certain products, have a declining number of assets under management or declining revenues). Examinations may also be initiated based on general concerns that arise as a result of financial and market events, such as the restructuring of market participants. For example, as a result of recent merger and acquisition activity at some of the larger firms, exams will be initiated to assess the newly formed organizations and their new compliance and internal controls framework.

Candidates for these risk-targeted examinations and sweeps will be selected based on information available via internal and commercial databases, information filed by registrants with the Commission and SROs, internet research, news sources, etc. While selected for review based on specific activities or characteristics, examiners will conduct on-site, risk-based examinations tailored to individual registrants and their activities.

Joint and Coordinated Examinations of Advisers/Funds and Broker-Dealers: Based on continued convergence in the industry and the anticipated change in regulations for advisers and broker-dealer regulations, we will continue and expand coordinated and joint examinations of SEC-

registrants. These exams should aid examination teams in integrating relevant information, forming a more complete picture of the activities of the organization, and spotting potential conflicts and issues. We anticipate implementing a new examination module to aid exam teams in conducting coordinated or joint exams. If legislation or rules are adopted to harmonize broker-dealer and investment adviser regulations, OCIE will develop new examination protocols and training.

2. Routine, Cyclical and Other Examinations

Due to resource limitations and the need to focus on higher priority cause and targeted examinations as described above, we anticipate that fewer resources will be available to conduct routine cyclical examinations of advisers with higher risk factors (and their affiliated investment companies), random exams of advisers, risk assessment “visits” to certain registered advisers, broker-dealer oversight exams, and other types of routine examinations. These examinations, and the changes to them, are summarized below.

Routine Adviser Examinations: For advisers with higher-risk profiles based on information in Form ADV and the results of a recent examination, (traditionally about 10% of the adviser population), our goal has been to conduct an on-site, comprehensive, risk-based examination of the adviser and its affiliated investment companies every three years.³ Risk profiles of advisory firms have been determined based primarily on filing information, staff evaluations of other risk criteria, and evaluations of compliance programs during on-site inspections. While these criteria continue to be used to determine candidates for risk-targeted examinations, given current staffing levels, the staff will not be able to perform cyclical examinations of all firms (and their affiliated mutual funds) that may have higher-risk characteristics and profiles. We estimate that we will examine approximately 2/3 of the firms that were scheduled for completion in FY 2009, and a similar number in FY 2010. Such firms will instead be prioritized for risk-targeted examinations after the highest priority examinations, such as those resulting from tips, complaints, or referrals, are conducted.

Broker-Dealer/SRO Oversight Examinations: Oversight examinations of broker-dealers serve the dual purposes of evaluating the quality and effectiveness of the SRO’s examination of its member firms, as well as detecting violations or compliance risks at broker-dealers. The scope of oversight examinations will be risk-based, with a focus on those issues that are most likely to impact investor protection. OCIE will obtain additional information from SROs in an effort to continue to make oversight examinations more efficient and productive.

In light of resource limitations and the need to conduct higher priority cause, targeted and sweep examinations as described above, we have reduced the number of oversight examinations targeted for completion in FY 2009 and FY 2010. The goal is now for all regional offices to cover approximately 3-5% of SRO exams conducted (or approximately 80-100 exams). Guidelines for conducting these examinations are available on OCIE’s website.

³ Higher risk firms are those that appear to engage in activities associated with emerging or resurgent risks or that simply manage such large amounts of investor assets that if something should go wrong there could be significant harm to both investors and investor confidence. Higher risk activities include those where there are significant conflicts of interest coupled with weak or non-existent compliance policies and procedures to mitigate and manage those conflicts.

Reducing the overall number of oversight examinations will make our inspections of District Offices particularly important. We expect to conduct several District office inspections in FY 2010 and will continue to focus on determining and highlighting the underlying causes of deficiencies and analyzing the findings from recent oversight exams. We will also again review FINRA's internal audit reports related to its Member Regulation programs to help risk-focus the inspections.

Broker-Dealer Risk Management Examinations: In FY 2010, we will conduct examinations of the internal controls and risk management systems of certain select large broker-dealer firms. In the past, OCIE had targeted the top 20 wholesale and retail firms for examination every 3 years, and the next 10 firms for examination every 4 years. We anticipate conducting approximately 8 of these examinations in FY 2010, and we anticipate that they will be targeted to particular areas, which may include the controls for the protection of customer assets, customer reserve calculations, the valuation process, emerging or significant business lines, appropriateness of margin and collateral, data integrity, and activities and controls in recently-merged firms.

We expect to leverage to a greater extent off the work of FINRA in FY 2010. In FY 2010, we will continue to share reports of our internal controls examinations with the Federal Reserve Board and the Division of Trading and Markets (T&M) with respect to broker-dealers for which the FRB is the consolidated or holding company regulator. Regular meetings and information sharing between T&M and OCIE have been implemented.

Random Exams and "Visits" to Advisers and Broker-Dealers: From FY 2005 through FY 2009, our examination oversight work of advisers with lower risk profiles included routine examinations of a relatively small number of advisers that were randomly selected from the population of lower risk firms. Lower-risk advisers also may be subject to limited scope visits/contacts (called risk-validation examinations or "RAVEs"). These brief, limited scope exams represented a resource-effective way to allow the exam staff to gain some understanding of a firm's compliance culture and risks. They were also used to further risk-rate the advisory firm and serve to determine if firms should be considered for a more immediate examination. Given resource limitations, we do not expect that it will be possible to conduct many examinations of lower-risk advisory firms in FY 2010.

Transfer Agents to Mutual Funds and Third-Party Fund Administrators: To provide oversight of outsourced investment company back-office activities, routine, cyclical exams have in the past been conducted of the 43 transfer agents that provide services to at least one unaffiliated registered investment company.⁴ In addition, on-site visits were made to third-party fund administrators (OCIE has identified 56 of these unregistered entities). OCIE endeavored to examine approximately 1/3 of these entities each year, focusing on the compliance programs, controls and operational activities each of these firms. In light of resource constraints and the need to focus on higher priority cause and risk-targeted and sweep examinations, OCIE anticipates that it will be unable to achieve this cyclical goal. Examinations will be conducted as resources permit.

⁴ Examinations of affiliated transfer agents are conducted in conjunction with examinations of the affiliated funds and their investment advisers. Staff time spent on these exams is accounted for as part of the related fund exam.

3. Critical Programs

CCOutreach: Our *CCOutreach* program for adviser/fund CCOs and for broker-dealer CCOs has proven successful in helping improve compliance programs, for the protection of investors. In FY 2009, we held two national seminars, and a total of 16 regional seminars – all of which were very well-received. We anticipate that in FY 2010, we will hold regional seminars for local CCOs, and national seminars at Station Place for both IA/IC *CCOutreach* (in November) and for BD *CCOutreach* (likely in March). We will issue a fourth *ComplianceAlert* in FY 2010.

Compliance Monitoring: We have “monitoring” programs for certain designated advisory firms and broker-dealers. These programs are intended to allow SEC exam staff to monitor compliance activities of certain large firms more closely than a normal examination frequency would allow.

- *Investment adviser monitoring:* The current program for monitoring large advisory groups consists of 4 firms. The program includes obtaining an understanding of monitored firms’ risk and compliance infrastructure and monitoring and reporting procedures. We expect to continue to communicate regularly with the monitored firms and evaluate information received. We will continue to evaluate the effectiveness of this pilot program and assess its impact on program resources.

In an effort to further improve oversight of regulated entities, the staff has begun planning for the potential implementation of a modified registrant monitoring program. Under this program, every registered adviser would be assigned to a staff member for monitoring, and each staff monitor would be expected to become familiar with the activities and associated entities and persons of each monitored adviser. Staff monitors would be the foundation of a new approach to oversight of advisers and funds built on the principle of creating and keeping current a portfolio of intelligence for each firm. Monitors would facilitate the SEC’s ability to analyze information and to respond effectively to tips, complaints and other communications concerning advisers and their affiliated entities and persons.

- *Broker-dealer monitoring:* We will continue our compliance monitoring program for certain large broker-dealer organizations. The program is intended to allow our exam staff to understand large firms’ compliance risks and cultures, have a more open dialog with compliance personnel at large firms, take a risk-based, centralized approach to exam oversight, and ensure coordination of examinations. For 2010, the monitoring program includes eight large broker-dealers (less *Bear Stearns*, *JP Morgan* has been added). Monitors will assess all SRO/SEC examination and enforcement information, news, and other data about the broker-dealer organization and will periodically meet with the firms and FINRA. We will continue to post information to OCIE’s intranet summarizing the information compiled for each firm by monitors.

Assisting Enforcement Staff and Consulting with Other Commission Staff: We will continue to work closely with enforcement staff, particularly on examinations that have been referred for enforcement investigation. In addition, the Enforcement Referral Review Committees and the

current enforcement referral review process will continue. OCIE also intends to work with Enforcement staff to bring cases in areas that have the greatest potential to send a “message” in areas of frequent or serious non-compliance.

We will also continue to communicate and coordinate with other Commission staff – exam reports and draft exam modules will continue to be shared with the Divisions of Trading and Markets and Investment Management and other relevant staff. Exam staff is encouraged to bring any questions concerning the law/rules to appropriate staff in the Divisions of Trading and Markets, Investment Management and Corporation Finance. We will continue to work with the Office of Risk Assessment in surveillance, monitoring and risk assessment programs. Training and other initiatives, including “*Topical Conference Calls*” between examination staff and staff from other divisions and offices will continue.

Coordination and Information-Sharing with Other Regulators: In FY 2010, we will continue the many cooperative efforts with other securities regulators – with the SROs to minimize duplication in the broker-dealers and issues examined and with state securities regulators in exam summits and training efforts, as well as special projects. OCIE held a number of “brainstorming” sessions with senior staff of FINRA throughout FY 2009 to develop better examination process to detect fraud, and we will continue our collaboration in those efforts. We will gain further experience with our shared database of broker-dealer branch office examinations conducted by the SROs and the SEC. We will continue to coordinate review of particular risk issues with SROs to coordinate exam sweeps, as appropriate (and will continue our monthly calls with FINRA to discuss the status of ongoing sweeps, as well as new sweep initiatives).

We expect to further our information-sharing related to financial services firms where we have shared oversight responsibilities with the Commodity Futures Trading Commission (CFTC) and with the Federal Reserve Board, consistent with recently signed MOUs. We will continue our information-sharing with the Department of the Treasury’s FinCEN pursuant to our 2006 MOU, and with the Department of Labor pursuant to our new MOU executed in July 2008. We will also continue coordination with foreign regulators with respect to SEC registrants.

4. Focus Areas for Examinations of Advisers/Funds and Broker-Dealers

Both when selecting firms for examinations, and when selecting the areas of the firm to examine, the priority will be to focus on firms and areas that present the greatest risk of having violative activities that can harm investors. In assessing particular areas for examination scrutiny, examiners should bear in mind the risk issues that have been identified and prioritized, which are set forth below.

These risk issues were identified and prioritized in OCIE’s Spring 2009 risk assessment process. Using *RADAR*, examination staff and managers identified risk issues. These and other risk issues were analyzed and prioritized.⁵ These areas may be assessed in cause examinations, risk-targeted examinations, sweeps, or routine examinations, depending on examiners’ risk

⁵ Resource constraints do not allow OCIE to follow up on or investigate every risk indicated in *RADAR*. Risks are prioritized and selected for focus based primarily on judgments about the severity and likely impact of the risk (were it to manifest) on investors.

assessments of registrants and as resources permit. Exam staff must also be alert to the possibility of compliance risks that have not been previously identified, or that have not been identified as a “focus” area.

Fraud, Abuse, Misappropriation and Manipulation: This is the key risk issue for examinations. Examiners should be alert to indications of fraud, and the new “Fraud Module” will be introduced to aid exam staff in identifying indicia of fraud. Examiners should focus particular attention on: verifying the existence of client/customer assets; obtaining confidence that books and records appear to be accurate and not falsified; reviewing firm financials and other records for indications of suspicious receipts and transfers; and reviewing controls to prevent fraud.

OCIE’s risk assessment process identified the possibility of fraud, abuse, misappropriation and manipulation in a number of specific areas:

- the ponzi-like nature of serial offerings involving privately placed real-estate funds and private funds affiliated with broker-dealers or investment advisers;
- oil-and-gas schemes;
- pump-and-dump schemes;
- promoters that purchase “sponsored links” on financial websites to link to less-than-reputable offerings; and
- hedge funds’ manipulation of markets, including exchange-traded funds (ETFs).

In addition to the areas identified in OCIE's risk assessment process, SAR reports will continue to be used as leads. In addition, OCIE is working to identify specific data points that would help examiners to target particular firms for examination based on the risk of fraud. Staff in headquarters will provide regional offices with lists of firms that have various characteristics, including:

- *For broker-dealers:* criminal disclosures, regulatory action disclosures, excessive or outlier trading gains or losses, relatively high debt-to-equity ratios, abnormal profits or losses potentially due to excessive leverage, and net capital levels that could soon fall below the net capital requirements. The list of firms will include data points to highlight the firms’ business activities, previous examination findings and Enforcement or AML referrals, last SEC examination date, last FINRA examination date, auditor, total representatives at all branches, FINRA risk ratings, FINRA peer group, and SEC region. The list will also distinguish firms that are dually registered, provide clearing/custody services, or are a hedge fund.
- *For advisers:* criminal disclosures, regulatory action disclosures, affiliated entities with custody of client assets, and aberrant performance returns. The list of firms will include data points to highlight the firms’ business activities, previous examination findings, last SEC examination date, material changes in operations (based on available filing information) and SEC region. The list will also distinguish firms that are dually registered, advise an investment company, or manage or sponsor a hedge fund

Compliance, Supervision and Risk Management: The largest number of risks identified in *RADAR* in 2009 involved inadequate compliance programs, supervision and risk management processes by registered firms. For example, risks identified included:

- concerns about firm cost-cutting, the effects of mergers and acquisitions, and aggressive business strategies to make up for recent losses and revenue cuts;
- lack of controls over activities of a dominant control person;
- aggressive recruiting efforts and compensation schemes offered to top producers/managers may incentivize them to act not in the best interests of customers/clients;
- firms that outsource important compliance functions to the lowest bidder or that develop electronic systems to perform compliance functions but fail to monitor or oversee the systems;
- newly registered investment advisers (such as hedge fund managers or broker-dealers) that may not understand their fiduciary duty or be able to implement effective compliance programs;
- ineffective risk management with respect to increasingly common investments in credit-default swaps, options, reports and other OTC derivatives; and
- weak compliance of remote locations and branch offices and independent contractor representatives.

As a result, the adequacy of firms' compliance, supervision and risk management will continue to be a focus area for examinations in FY 2010.⁶

Suitability: The sale of unsuitable or inappropriate investments by broker-dealers and advisers is a high-risk issue. As there may be increased investor interest in "safe" investment products, examiners should focus on products marketed as being safe, and review the adequacy of disclosures concerning credit risk, liquidity, and investment risk. Conversely, investors may be looking to recoup losses, and may be more vulnerable to sales of high-risk, high-return products. Particular concern is aggressive marketing efforts aimed at retiring baby-boomers with roll-over assets.

Among the products of concern noted were:

- unregistered products, such as equity-indexed annuities, church bonds, life-settlements and viaticals;
- high-yielding, yet "safe" products, such as municipal bonds, variable annuities, principal protected notes, and non-exchange-traded REITs; and

⁶ We will also seek to strengthen our comments to firms concerning compliance programs: OCIE will update the deficiency letter template to include stronger language regarding these deficiencies (in recognition of the fact that advisers have been subject to Compliance Rule obligations for more than five years, and broker-dealers have been subject to FINRA supervisory obligations for much longer). In addition, examination staff should expand the use of "compliance conferences" between examination program managers and firm senior management following examinations that find particularly weak compliance programs, to highlight the deficiencies in the firm's program and stress the importance of a vigorous, effective compliance program. Examiners should refer egregious lapses in compliance and supervision to Enforcement.

- complex structured products, hedge funds, and leveraged ETFs with inadequate disclosures of fees and terms.

Given these investor dynamics, firms will be producing new investment products to respond to the marketplace. To facilitate expertise in new products and earlier review of their introduction to the market, we have created a *New Products Committee*, consisting of relevant experts throughout the Commission. The Committee will work to identify and understand new products, the firms selling the products, the fees associated with the product, and any disclosure or sales practice issues. The goal is to communicate with firms early in their process of creating and introducing products in order to correct sales practice, supervisory, disclosure or other issues before a large number of investors are harmed.

Custody/Customer Protection: Throughout much of FY 2009, the examination program has expended significant resources to verify custody of customer assets, and we expect that these efforts will continue in FY 2010. There are significant risks associated with custody – particularly the risk of misappropriation and theft. At particular risk are assets custodied at affiliated entities, brokers that have custody/control of customer assets, funds of funds, assets of multiple funds managed by the same adviser, and automatic deductions of advisory fees and other expenses – these risks justify the focus on ensuring that customer assets are safe.

The staff faces significant hurdles in verifying the safe custody of customer assets, namely:

- forgery by registrants is easy to accomplish, so examiners must go to the source (either the custodian or the customer) and cannot rely on the registrant's records;
- trades are conducted and held in broker-dealer records on an omnibus basis, making tracing to individual account-holders difficult;
- many custodians, especially U.S. banks and most non-U.S. entities, decline to share details on customer assets held with them, ostensibly to protect customer privacy;
- certain investments that involve a contractual arrangement, such as OTC derivatives and FX trades, are difficult to verify as the asset (a contract) is not held in custody;
- feeder funds and funds-of-funds (and their auditors) are reliant on the underlying manager and do little of their own verification; and
- investments made via special-purpose vehicles (SPVs) are often done on an omnibus basis.

Because of these hurdles, asset-verification examinations are time and labor-intensive. OCIE recently provided a report to the Commission outlining firm custody practices, the risks identified, the obstacles to verifying custody on a regular, routine basis, and recommended actions for the future, including seeking to leverage from the work performed by the firm's independent auditor.⁷

⁷ Information Memorandum to the Commission: "*Non-Public Summary Report Concerning Examinations With Respect to the Custody of Client Assets*", dated August 7, 2009.

Portfolio Management: The risks identified in the management of client/customer portfolios include, e.g.:

- lack of due diligence performed by fund-of-fund managers and unified managed account platforms on underlying investment vehicles/managers and any undisclosed conflicts that may exist between the two sets of managers;
- firms and funds investing client assets in increasingly more complex derivative products with risks that may not be fully understood or disclosed;
- managers that may deviate from stated investment styles and objectives (*e.g.*, window-dressing and style drift); and
- asset allocation strategies in target-date funds and loss-mitigation strategies in stable-value funds.

Throughout FY 2009, OCIE has been working on targeted examinations of firms and managers that report aberrational performance to determine whether performance figures are contrived or the result of fraudulent activity, or whether the firm may be taking out-sized, undisclosed risks in their investments. We will continue to monitor commercial databases for registrants who demonstrate aberrational performance and conduct additional risk-targeted examinations in FY 2010. We will also attempt to identify money managers that may be winning mandates based on inflated performance or other violative conduct. In addition, OCIE is considering a sweep of unified managed accounts, to gain an understanding of this new product and any potential due diligence and disclosure issues.

Finally, reforms to money market fund regulations will require additional review by the staff during examinations. Information derived from anticipated monthly holdings reports filed by these funds will also need to be effectively managed to maintain data quality and integrity and analyzed to identify potential problems and high-risk investments and portfolios.

Disclosure: Disclosure deficiencies often involve:

- lack of disclosure of illicit revenue sources (*e.g.*, excessive fees or revenue-sharing arrangements);
- lack of disclosure of conflicts of interest;
- lack of disclosure of the risks (*e.g.*, liquidity, market and other risks) inherent in investments;
- late and poor disclosure in the municipal securities market, where issuers are frequently late in their prospectus disclosures and investors are forced to trade based on out-dated information and out-dated pricing; and
- inadequate or late filings in forms (such as Form ADV, Form BD and FOCUS) that examiners routinely rely on for risk-targeting and examination-scoping purposes.

Examiners should continue to focus on the adequacy of disclosure in these and other areas.⁸

⁸ OCIE plans to collect a list of common disclosure deficiencies for inclusion in an upcoming *ComplianceAlert* and to be discussed at *CCOutreach*. In addition, OCIE will continue to work with FINRA to develop validity checks at the data-entry point in CRD and IARD to assist firms in identifying and correcting inadvertent errors in filings before they are filed.

Financial Solvency: Solvency concerns exist for a wide range of registrants. A risk is that firms may fail to disclose their financial condition, or fail to compute and maintain adequate net capital and customer reserves, and that firms in dire financial straits may become desperate enough to borrow or steal from customer accounts, or to engage in business practices that harm investors and other market participants. Accordingly, OCIE will use broker-dealer FOCUS reports and other information and adviser Form ADVs to identify firms that may be experiencing financial hardship and target them for examination when resources permit (using the *RRAD* system, discussed below, to generate alerts). In addition, regular access to information filed by large firms under Rule 17(h) will enhance examiners' ability to identify firms in danger of failure more readily.

Unregistered Firms and Offerings: The highest-ranked category of risk was unregistered firms and unregistered product offerings. These firms and activities are at the forefront in OCIE's risk assessment because of the risk that fraudulent activities will be conducted in unregistered entities, and due to the very real risk that potentially violative or harmful activities will be undetected because they fall outside the jurisdictional reach of the SEC's examination program.

Particular scenarios identified include:

- hedge funds and private-equity funds;
- regulated activities that may be outsourced to unregistered entities;
- day-trading firms with multiple levels of partners and customers;
- foreign exchange products and trading platforms; and
- activities of finders and solicitors and marketing organizations for various products.

During examinations of registrants, examiners may see red flags that indicate fraud or other problems in an unregistered entity or with respect to an unregistered activity. Examiners should follow up on these issues by making inquiries of the firm. Examiners may be unable to pursue these issues, however, because the books and records needed to examine the issue are kept at an unregistered entity (or the suspicious activities are conducted at an unregistered entity), or they involve products that registrants claim are not securities. Because of jurisdictional limitations, examiners are often then forced to end their inquiry, despite the fact that grave concerns about potential investor harm exist regarding a practice or product. As a new policy, OCIE intends to more aggressively refer these matters to Enforcement when registrants and unregistered entities decline to provide information responsive to examiners' concerns or suspicions.

IV. Priorities in Examinations of Transfer Agents and Clearing Agencies

1. Transfer Agent Examinations

As noted, at the start of FY 2010, there are approximately 408 SEC-registered transfer agents (separately, there are approximately 174 transfer agents registered with banking regulators). Of these, 405 are non-fund transfer agents, 145 are fund transfer agents, and 42 are mixed fund/non-fund transfer agents.

Cause, Sweep and Routine Examinations: Mutual fund transfer agents will continue to be examined as the affiliated fund group is examined; however, as discussed above, we anticipate conducting fewer such examinations. In FY 2010, cause examinations will continue to play an important role in transfer agent compliance, and will be priority, given that indications of violations have already been identified. Staff should continue to identify cause examinations based on complaints, tips, press reports, and information that indicates possible fraudulent activities or other compliance problems (*e.g.*, information from the Division of Enforcement that indicates a higher risk of manipulation of an issue).

Each region, in conjunction with staff from headquarters, will analyze its transfer agent population for the upcoming fiscal year and amend examination schedules to reflect risk levels. Transfer agents are analyzed based on criteria from three information sources: STARS, EDGAR, and RADAR, in addition to first-hand examination knowledge of the registrant population. Risk-targeted examinations or sweeps that focus on particular transfer agent types or practices should be considered (past examination sweeps regarding AML, lost securityholder searches, third-party administrators, and others, have been important in understanding changes in the industry and areas of concern relevant to rulemaking).

As resources permit, non-fund transfer agents will also be routinely examined on a one- to five-year schedule derived from risk-based criteria (similar information sources as above). In addition to these criteria, examination frequency should be based on: the time of transfer agent registration (*i.e.*, newly registered transfer agents will continue to be examined within two years of registration); the time of the last examination; and information gathered from other sources.

Focus Areas: The focus areas listed below cover the typical business activities of a transfer agent. In addition to focus areas listed below, examination staff should continue to be alert to new types of compliance risks not yet identified, and also to be aware of and monitor risk areas identified during the RADAR process.⁹

- **Safeguarding Shareholder Securities and Funds:** Whether transfer agents are safeguarding securities and shareholder funds from theft, loss or misuse. Transfer agents that pay dividends or debt payments may have custody of shareholders funds, possibly for long periods for lost securityholders or un-cashed funds. Examination staff should review payment procedures, account control, and lost securityholder and escheatment records for account totals and verify against custodial-bank statements.
- **Turnaround/Processing/Forwarding:** Whether transfer agents are meeting three day turnaround requirements for 90% of routine transactions; small transfer agents are handling items promptly. Particular risk as-of trades or error trades by fund transfer agents and whether they are used in connection with late trading or other fraudulent conduct.

⁹ Some of these risks have been included in previous years' focus areas and sweep examinations, however, the conditions that created the risks have not changed and the risks should still be reviewed during examinations.

- **Recordkeeping and Internal Controls:** Whether the transfer agent maintains required books and records.
- **Stock Manipulation/PIPES/Rule 144/Form S-8 Offerings:** Exam staff have identified instances where a transfer agent, either conspiring or facilitating, allowed securities transfers that circumvented existing rules or enabled fraudulent schemes. In particular, focus on transfer agents that allow the distribution of unregistered securities into the market, looking for suspect stock promoters, control persons, and patterns in transfer activity. Review attorney opinion letters for specialized transactions (e.g., Securities Act Rule 144 and Rule 504 offerings) looking for suspect individuals, repetitive patterns, and the transfer agents' procedures and policies for receiving and checking such letters (*i.e.*, due diligence).
- **Accountant's Report:** Whether independent accountants are performing annual studies of transfer agents' systems of internal accounting control and safeguarding of related securities and funds, and filing timely reports with the Commission. The objective of the annual study is to ensure the transfer agent's system of internal controls provides reasonable assurance that securities and funds are safeguarded against loss from unauthorized use or disposition and that transfer agent activities are performed promptly and accurately.
- **Direct Security Purchases:** Whether transfer agents are complying with no-action relief and not required to register as broker-dealers for non-traditional transfer agent activities in which the transfer agents permit customers direct access to the purchase of securities (*e.g.*, DRIPS, employee stock purchase plans, and odd-lot programs). Transfer agents should establish proper safeguards to prevent fraud or inadvertent mishandling of funds or records.

2. Clearing Agency Examinations

An effective clearance and settlement process is vital to the functioning of the U.S. securities markets. Clearing agencies process over one quadrillion dollars in securities transactions each year, making them systemically important to the securities markets. The current credit and liquidity crisis, and focus on areas of potential systemic risk, reinforces the need for intensive examination scrutiny and ongoing monitoring of these important industry utilities.

In FY 2010, the examination program will continue to conduct risk-based examinations of clearing agencies, leveraging available resources as appropriate (including clearing agency internal audits and joint work with other federal regulators). Two of the largest clearing agencies will be examined in FY 2010. In FY 2010 and 2011, the SEC examination staff will be challenged by expanding its examination function to include five examinations of new clearing agencies for credit default swaps (CDS).

Routine Examinations: Based on an examination cycle coordinated with T&M, the largest clearing agencies are examined every two years. In FY 2010, the two major divisions of the *Fixed Income Clearing Corporation (FICC)* (the Government Securities Division (GSD) and the

Mortgaged Backed Securities Division (MBSD)) are scheduled for examination. Since *FICC* is in the process of establishing a central counterparty function for mortgaged-backed securities in the MBSD, that new initiative will be the subject of significant examination review and testing. Examiners will also follow up on the use of fines to address persistent Treasury fails in GSD.

In addition to the scheduled examinations for FY 2010, examination staff expect to continue ongoing monitoring work with staff from the Federal Reserve Board on two ongoing projects relating systemic risk. These two projects involve: (i) an ongoing review of the liquidity needs of the three major clearing agencies affiliated with the *Depository Trust & Clearing Corporation (DTCC)*; and (ii) a review of *DTCC* corporate governance, with a focus on its overall risk management function, including systemic risk.

Focus Areas: For clearing agency examinations, examiners use an examination approach that focuses on: (i) review and assessment of clearing agency internal controls; (ii) new products and services; and (iii) risks identified on-site by examiners through risk information compiled through OCIE's *RADAR* system.

Among the key risk areas reviewed and tested during clearing agency examinations are the following: (i) safeguarding of securities and funds; (ii) clearing agency systems for prompt and accurate clearance and settlement of transactions; (iii) clearing agency risk management and risk assessment functions, including the adequacy of margin and liquidity; (iv) membership and member surveillance functions; (v) the internal audit function, including Board oversight of audit processes and findings; (vi) clearing agency corporate governance and compliance functions; and (vii) business continuity planning and related issues (in coordination with Trading & Markets, as appropriate). While not always an examination focus area, examiners assess generally whether firms are in compliance with AML rules/OFAC guidance.

In addition, due to the current international focus on clearing agencies, examiners will consider how clearing agencies meets applicable international standards, such as those established by the Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commission (IOSCO) report called "Recommendations for Central Counterparties." Finally, in FY 2010, examiners will continue their ongoing examination work to follow up on previous examination findings relating to mutual fund late trading.

CDS Clearing Agency Initiative: Clearing agencies are increasingly playing a key role in providing stability to the largely unregulated market for credit default swaps. In FY 2010, the exam staff expects continuing interest in this area by Congress and by the Commission as the debate continues over devising an appropriate regulatory scheme for CDS derivative instruments. Legislation is pending that would provide the Commission with express authority to oversee various aspects of the CDS market, including CDS clearing agencies. Pending legislative action, the Commission has been using its limited existing authority to approve temporary exemptions for several clearing agencies that are providing central counterparty services for CDS transactions.

In FY 2010, OCIE will continue to conduct clearing agency-style examinations of the new CDS clearing agencies. Because the SEC temporary exemptions have a pendency of nine months, the

examination staff expects to conduct examinations of 3 new CDS clearing agencies in FY2010, with continuing work in the CDS clearing area continuing into FY 2011. Several of the new CDS clearing agencies are located in Europe and thus will require international coordination and cooperation, as well as work related to the CPPS/IOSCO standards. With respect to these examinations, we will continue to coordinate examinations, as appropriate under recently signed MOUs, with the CFTC and the FRB, and work with the international CDS CCP Regulators' Workshop.

V. Priorities in Inspections of ATs, SROs, NRSROs and PCAOB

In FY 2010 inspections, we will focus on issues of greatest priority in the current market environment. For example, particular risk-based focus areas will include: algorithmic/high frequency trading and direct market/sponsored access, market center trading systems compliance with the options firm quote, priority, and order exposure rules, new NRSROs, FINRA's market regulation activities to monitor equities trading, including its responsibilities under multiple regulatory service agreements and 17d-2 plans, and its Member Regulation programs, including examination and disciplinary programs. In conjunction with these reviews, the Staff will focus on improving Regional Office access to information regarding FINRA's programs and technologies. In light of the increasing caseload, the Staff is also reviewing FINRA's Dispute Resolution program.

The inspection plan includes both periodic (cyclical) inspections, as well as special inspections to address unique current issues. The focus and priorities of both cyclical and special inspections are informed by past inspections, enforcement actions, SRO internal audit and independent consultant reports, discussions with other Divisions, risks identified in RADAR, and tips and other information obtained from discussions with the industry, SROs, news reports, and other sources. The SRO inspections planned in FY 2010 and ongoing inspections are set forth below.

FY 2010 Planned SRO Inspections:

- *ISE Regulatory Programs for Options Trading:* The Staff plans to review the ISE's surveillance, investigation, and enforcement programs for options trading activity.
- *NYSE Regulatory Programs for Equities Trading Activity and Systems Compliance:* The Staff plans to review the NYSE's surveillance, investigation, and disciplinary programs for equities trading activity, and NYSE's policies and procedures for ensuring its trading system operates in accordance with SRO and SEC rules.
- *Nasdaq Systems Compliance:* The Staff plans to review Nasdaq's policies and procedures for ensuring its trading system operates in accordance with SRO and SEC rules.
- *BATS' Regulatory Programs for Equities Trading:* The Staff plans to review BATS' surveillance, investigation, and enforcement programs for equities trading activity. Because BATS launched exchange operations in late 2008 and has quickly become the

fourth largest equities market, the Staff plans to initiate this inspection in mid-2010 to allow for the accumulation of at least one year of SRO activity.

- *Nasdaq OMX PHLX's Regulatory Programs for Options Late Trade Reporting:* The Staff plans to review the PHLX's surveillance, investigation, and enforcement programs for options trading activity.
- *Options Floor-Based Markets - Firm Quote and Priority Rule Regulatory Programs:* The Staff plans to review the regulatory programs of the NYSE Arca, NYSE Amex, and Nasdaq OMX PHLX to assess whether they adequately detect and deter options firm quote and priority rule violations (the Staff has already initiated a similar inspection of the CBOE).
- *SRO Section 31 Compliance:* The Staff will continue its annual risk-based evaluation of the SROs' compliance with Section 31 of the Exchange Act that requires the payment to the Commission of certain fees on covered sales.
- *FINRA Member Regulation Programs –* The Staff will conduct inspections of the regulatory programs of various FINRA District Offices, including the Districts' examination and enforcement programs. The Staff will hold a training session for Regional Office staff regarding recent developments and enhancements in the FINRA District Office inspection and broker-dealer oversight examination programs.
- *FINRA Broker-Check/CRD Program –* The Staff will conduct an inspection of FINRA's BrokerCheck and CRD systems, to assess whether the information gathered and disseminated is timely, complete and accurate.
- *CBOE Fin/op Examination Program –* The Staff will conduct an inspection of CBOE's financial and operational examination programs, to assess whether CBOE is adequately examining and monitoring members for compliance with financial responsibility rules.

Ongoing SRO Inspections:

- *CHX's Investigation and Enforcement Programs:* The Staff is reviewing whether the CHX's investigation and enforcement programs adequately regulate trading activity.
- *NSX's Surveillance, Investigation, Enforcement, and Systems Compliance Programs:* The Staff is reviewing whether the NSX's surveillance, investigation, and enforcement programs adequately regulate trading activity, and whether it maintains an adequate program to ensure that its trading systems operate in conformity with its rules.
- *SRO Section 31 Compliance:* As part of the Commission's financial control framework, the Staff is conducting a risk-based evaluation of the SROs' compliance with Section 31 of the Exchange Act that requires the payment to the Commission of certain fees on covered sales.

- *NYSE Arca's Regulatory Programs for ETFs*: In conjunction with OCIE's overall review of issues related to ETFs, the Staff is reviewing the NYSE Arca's regulatory programs for monitoring trading in ETFs, as well as NYSE Arca's listing programs for Exchange Traded Products, including ETFs.
- *CBOE's Firm Quote and Priority Rule Regulatory Programs*: The Staff is reviewing whether the CBOE's firm quote and priority rule regulatory programs adequately detect and deter such violations.
- *CHX's Validated Cross Regulatory Program*: The Staff is reviewing whether the CHX adequately enforced its rules governing its validated cross functionality.
- *ISE's Options Order Exposure Rule Regulatory Programs*: The Staff is reviewing whether the ISE adequately enforced its rules governing order exposure.
- *FINRA's Regulatory Programs for Equities Trading Activity*: The Staff is reviewing whether FINRA's surveillance, investigation, and enforcement programs adequately regulate equities trading activity.
- *Nullified Trades Review*: The Staff is reviewing Nasdaq and NYSE Arca's procedures for the cancellation of transactions.
- *FINRA Front End Cause Unit* – The Staff is conducting an inspection of FINRA's Front End Cause Unit, a group which processes all complaints, tips, etc. received by FINRA.
- *FINRA Arbitration* – The Staff is conducting an inspection of FINRA's Dispute Resolution program, focused on whether FINRA has sufficient resources to handle its increasing caseload and on FINRA's arbitrator pool.
- *FINRA and NYSE Internal Audit programs* – The Staff is conducting inspections of FINRA's and the NYSE's Internal Audit Departments
- *NASDAQ Listing Program* – The Staff is conducting an inspection of NASDAQ's listing programs for issuers.

Examinations of Alternative Trading Systems: OCIE will continue to review ATSS and their role in market structure. Some ATSS trade 5% or more of certain equity securities, which triggers the fair access requirement of Regulation ATS. In addition, many dark pools send indications of interest (IOIs) to other market participants, alerting them to possible trading opportunities in the dark pool. Depending on the information contained in the IOI, they could be viewed as firm quotations, subject in some cases to the display rule. In FY 2010, OCIE's Market Oversight staff will implement a periodic (cyclical) examination program for alternative trading systems (ATSS) with significant transaction volume. The cyclical examination will focus on the ATSS's compliance with the provisions of Regulation ATS. Generally, the staff will plan to examine the top 10 equity trading systems and the top 3 debt trading systems over a rolling four year cycle. The Staff will also continue to examine any ATSS when it has reason to believe that

wrongdoing may exist. Broker-dealer exam staff in the regions may examine the remaining ATSS as their resources and schedules permit. OCIE Market Oversight staff is finalizing a Regulation ATS examination module for use by examination staff in Regulation ATS exams. In FY 2010, the Staff plans to initiate exams of *Sigma ATS*, *Credit Suisse Securities*, *eBX LLC*, and *Brokertec USA, LLC*.

NRSROs: There are 10 NRSROs registered with the Commission. OCIE completed examinations of the three largest NRSROs in FY 2008, began routine examinations on four other NRSROs in FY 2009, and will begin examinations on the remaining three NRSROs in FY 2010. The FY 2010 plan for examinations of NRSROs will include both cyclical and special examinations. These examinations will be conducted by the recently created NRSRO examinations branch. The planned cyclical examinations will review the NRSROs' overall regulatory compliance and include issues such as required public disclosures, records creation and retention and management of conflicts of interest. A list of NRSRO examinations both planned and ongoing is set forth below:

FY 2010 Planned NRSRO Examinations:

- *Fitch, Inc.* – Cycle/Special Examination
- *Japan Credit Rating Agency, Ltd.* – Cycle Examination, First Examination
- *Rating and Investment Information, Inc.* – Cycle Examination, First Examination
- *Standard & Poor's Rating Services* – Cycle/Special Examination
- *Realpoint LLC* (June 23, 2008) – Cycle Examination, First Examination

Ongoing NRSRO Examinations

- *A.M. Best Company, Inc.* – Cycle Examination, First Examination
- *DBRS Ltd.* – Cycle Examination, First Examination
- *Moody's Investor Services, Inc.* – Special Examination
- *Egan-Jones Rating Company* – Cycle Examination, First Examination
- *LACE Financial Corp.* – Cycle Examination, First Examination

PCAOB: The Public Company Accounting Oversight Board (PCAOB) was established by the Sarbanes Oxley Act of 2002, and plays a self-regulatory type role over auditors of public companies. There is current interest in Congress and by the Commission in expanding the PCAOB's role to include oversight of auditors of SEC registered entities, such as non-public broker-dealers.

OCIE has begun a program of periodic inspections of the PCAOB, focusing on key risk areas such as registration, fee collections, and its inspection program. PCAOB examinations are conducted jointly with staff from the Office of Chief Accountant. Inspection activities in FY 2010 will include follow-up of findings and recommendations from the staff's most recent inspection of the PCAOB's Inspection Program, and the staff will also begin planning for the next inspection of the PCAOB set for FY 2011.

VI. New/Updated Examination Procedures and Modules

In FY 2010, OCIE will implement many enhancements to processes and procedures. These changes include post-Madoff enhancements, and a variety of other improvements.

- *Enhanced Training for Examiners in Fraud Detection:* OCIE will continue its efforts to enhance training for examiners in fraud detection. We will expand cross-training to specifically train a group of examiners so that they are able to conduct exams for compliance with the Advisers Act and the Exchange Act and SRO rules. We will also continue to encourage examiners to pursue other privately-provided certifications – such as the *Certified Fraud Examiner, Chartered Alternative Investment Analyst, Certified Public Accountant, and Chartered Financial Analyst.*
- *Enhanced Examiner Expertise in Complex Financial Products, Trading and Other Areas:* OCIE is recruiting additional individuals with experience in different facets of the industry, in trading, operations, portfolio management, options, compliance, valuation, new instruments and portfolio strategies, and forensic accounting. Newly created *Senior Specialized Examiner* positions have been created to bring and maintain specialized experience to the examination program. *Senior Specialized Examiners* will conduct examinations in the field and serve as a resource for other exam staff on issues within their experience. We are also enhancing examiners' training and expertise in particular key areas – such as, for example, options, derivatives, trading, anti-money laundering, and financial and net capital issues. And, to mirror the increasing overlap between advisers and brokers, we increased training for examiners to enable us to better conduct examinations of firms that are registered as both broker-dealers and investment advisers – so that issues that overarch registrant “lines” are effectively examined. Taken together, these steps allow us to further enhance our expertise in complex financial products, trading and other areas, better enabling us to conduct oversight of today's securities firms, trading strategies and products.
- *Improved Standard Pre-Exam Work Methodology:* Prior to examinations, examiners will perform a more thorough pre-review of the firm. Pre-exam steps include more thorough research and due diligence of registrants, their affiliates, and related persons prior to fieldwork for all examinations, regardless of scope or exam-type. The objective is to obtain a better understanding of the firm's business and risk characteristics before examiners arrive, and to better utilize resources on-site.
- *Obtaining a Greater Understanding of Firms On-Site:* Examiners will seek greater knowledge of the firm's business model, operations, and revenue sources to put practices in perspective and to identify activities or affiliations that may potentially impact the safety of

client assets or otherwise pose investor harm. Examiners will be encouraged to make increasing use of interviews with staff at various levels within the organization and/or perform comprehensive walkthroughs of key business areas or those areas that may be opaque.

- *New Fraud Modules:* A new examination module will provide guidance for examiners in identifying “red” and “yellow” flags of fraud and strategies for additional investigation. Red flags may be obvious, but yellow flags will not be – and the goal of this module is to help examiners see the sometimes subtle indicia that something may not be quite right with the firm.
- *Improved Surveillance and Risk-Based Targeting:* OCIE will continue to improve its risk assessment and surveillance processes to assist with risk-based examination targeting. We will work together with other agency staff (in the Office of Risk Assessment and in other offices and divisions) as well as FINRA staff to identify the key data points that would facilitate an improved risk-based oversight methodology to allow the staff to identify and focus on those firms and issues presenting the most risk.
- *Provide Examiners with Greater Discretion to Expand Exam or to Follow-Up on Issues:* With managers’ input and approval, examiners should feel comfortable to expand the scope of the exam; the scope process should be planned but flexible enough to evolve during the course of the examination.
- *Reinforce/Create New Referral Policies:* We will reinforce our existing OCIE/Enforcement policy regarding the prompt referral, decision-making and documentation process. We will create a new policy that provides consistent guidance about when to refer a registrant to enforcement for delayed or non-production of documents in examinations. In addition, for referrals from exam team-to-exam team, we will create a new policy to assure that referrals are effectively made and received.

In FY 2010, we will continue to review, modify and improve examination modules. We anticipate introducing new examination modules to address new rules adopted by the Commission, including with respect to dual broker-dealer/investment adviser registrants, and any new rules regarding money market funds, and required surprise audits by audit firms of investment advisers.

VII. Use of Technology

In FY 2010, we will continue to focus on ways that technology can be used to streamline tasks, to assist in risk assessment, as well as to improve productivity and the analysis of examination results. We have prioritized initiatives to use technology to facilitate examinations. Several are described below:

- *RADIUS:* We have conceptually developed and received funding for a new automated exam tool (RADIUS) that would guide examiners through the risk assessment and scoping process, provide automated access to exam modules and other guidance, and help the examiner to conduct, document, and report the results of the exam. A first phase of this

product was piloted by exam staff in FY 2009, and we anticipate expanding its use in FY 2010.

- *RADAR*: As described in this memo, we conducted a new risk-assessment process in the Spring of 2009, and the identified risks were used to develop the focus areas outlined above. In addition, we continue to conduct analysis of all “significant” examination findings to determine to what extent we have addressed risk areas identified in our most recent *RADAR* process.
- *RRAD*: Registrant Risk Assessment Database (RRAD) is a database that identifies broker-dealers that are exhibiting financial risks. RRAD performs electronic analysis and generates alerts based on established criteria such as net capital, total asset or debt levels, etc. using financial information from firm FOCUS filings. If one of the criteria occurs, an alert triggers for the firm and OCIE can consider scheduling an examination of the firm. RRAD also helps OCIE narrow in on firms that could be the subject of a routine or oversight exam. OCIE plans to populate RRAD with additional, non-financial data to enable electronic analysis and exception reporting based on more data points.
- *OCIE Intranet*: We will continue to enhance our internal website, which currently provides staff with readily available access to previous examination reports, modules, guidance, and other reference materials as well as wealth of valuable information helpful to selecting higher-risk exam candidates.
 - *Broker-Dealer Data*: We continue to work on a long term project to direct all risk information relating to broker-dealers into an integrated site: Phase I will include timely risk reports analyzing broker-dealer FOCUS filings and CRD risk information, and Phase II will involve other risk information to enable us to create a risk classification database. Ultimately, we hope that this system will assist us to determine the appropriate level of oversight for each firm by using automated analytics that will allow for analysis of data from a variety of sources, including data from FINRA.
 - *Funds/Adviser Data*: We hope to expand our subscriptions to private databases that will provide us with better information about mutual funds, privately offered investment funds and their advisers. Additionally, we will look to acquire or subscribe to databases or services that will give us access to social networks. All of these data will allow us to better identify and classify firms by risk levels.
 - *Search Tools*: We are upgrading our search tools on our website.

VIII. Measuring Results

We continue to expand our analysis of various performance measures of our national program as well as individualized regional office results. In this regard, we will continue to focus on numerous measures of our impact, including the actions taken by the firm as a result of the examination (including corrective actions and improved compliance controls).

We expect to complete a significant portion of our tracking system upgrade by the end of the fiscal year, which will provide enhanced ability to create management reports. In addition, we continue to perform analysis of “significant” examination findings at the end of FY 2009, which will allow us to assess coverage of our examination focus areas (many determined by our *RADAR* risk analysis), as well as to monitor exam trends. Thus far, we have reviewed and analyzed over 680 significant findings for examinations closed between October 1, 2008 and June 30, 2009. OCIE’s Risk Assessment staff mapped each significant finding to the categories of risks that had been identified by examination staff and managers in *RADAR*. The attached chart (*Attachment A*) ranks the categories of significant examination findings as compared to the ranking assigned to each category of risk during the *RADAR* risk assessment process.

IX. Examiner Training

Examiner training is a high priority. We have five employees fully dedicated to this effort. Our training priorities are based on the results of surveys of examination staff concerning their training needs, input from managers, recommendations from OCIE’s risk assessment group, and ongoing research by our training branch staff. All examiner training events currently planned for FY 2010 are listed in the chart below. Also, vendors are hired through SEC University (SECU) to conduct courses to supplement OCIE’s examiner training program. Ad hoc requests for examiner trainings will also be implemented during FY 2010, as additional training needs arise.

Examiner training is provided thru a combination of videocast programs to the regional offices, “in-person” programs, and on-line video sessions posted on our website. We will continue to utilize videocasts as a major component of our training program in FY2010, in light of the convenience for the staff to attend, and the cost savings in travel expenses. In general, we will continue to conduct about two videocasts each month. These include:

- *Inside the Rules Series* - featuring Division staff discussing new rules or specific issues on current rules;
- *Fraud Detection Series* - featuring examiners, other securities regulators, and industry fraud experts discussing fraud in the marketplace;
- *Industry Series* - featuring prominent industry speakers discussing securities-related topics;
- *Examination Series* - featuring SEC examiners or other securities regulators discussing exam procedures; and
- *Joint Exams/Cross Training Series* - featuring SEC examiners jointly discussing BD and IA/IC exam issues.

A more detailed list of training initiatives for FY 2010 is attached (*Attachment B*).

We will continue to develop additional sessions for our new examiner on-line video training series, which is designed for new exam staff in their first weeks on the job. For instance, we are planning to add a session on “*Overview of Securities Fraud*” in FY 2010. Finally, we are partnering with SECU to offer a special promotion for examiners to pursue the *Chartered Financial Analyst* certification, similar to our efforts promoting the *Certified Fraud Examiner* certification in FY 2009.

Attachment A
**Significant Findings in Investment Adviser, Investment Company and Broker-Dealer
Examinations in the First Three Quarters of FY 2009**

Sig. Finding Ranking*	RADAR Ranking	Risk Assessment Category	Number of Findings**	Average Risk Score***
1	3	Compliance, Supervision & Risk Management	225	4.42
2	1	Unregistered Firms & Offerings	78	4.26
3	10	Books & Records Issues	70	4.12
4	2	Fraud, Abuse, Misappropriation & Manipulation	62	4.20
5	8	Disclosure	63	3.92
6	14	Marketing & Performance Advertising	54	3.85
7	9	Financial Solvency / Net Capital Issues	44	4.60
8	4	Suitability	43	5.10
9	19	Order Handling & Execution	52	3.80
10	5	Custody/Customer Protection	52	3.80
11	23	Insider Trading & Info Leakage	19	4.49
12	16	Branch Offices & Remote Activities	15	5.43
13	7	Portfolio Management	23	3.81
14	17	Undisclosed Remuneration	34	3.43
15	22	AML/OFAC Compliance	16	3.69
16	25	Fund Distribution	11	3.60
17	12	Valuation & Pricing	9	4.07
18	24	Privacy & Info Safeguards	11	3.24
19	13	Fund Governance	10	2.80
20	15	SROs	3	4.00
21	26	Business Continuity Planning	7	3.37
22	21	Margin & Leverage	5	3.20
23	6	Outsourcing & Service Providers	3	2.67

* Each category was ranked based on the number of findings included in the category and then separately ranked based on the average risk score for each category. The overall rank was determined by combining the two rankings, with a 75% emphasis applied to the ranking based on the number of findings and a 25% emphasis applied to the ranking based on the average risk score. Not included in these rankings are findings involving markets, clearing agencies or transfer agents.

** There were 688 total significant findings, some of which were placed in multiple categories.

*** The average risk score was calculated by multiplying the probability that the finding was occurring (*i.e.*, whether it was an isolated instance or widespread) and the impact of the finding on investors, markets or registrants (on a scale of 1-minor to 5-catastrophic).

Attachment B
OCIE FY 2010 EXAMINER TRAINING PROGRAM
SCHEDULE & RESOURCES

Core Programs

Title	Location
Experienced Examiner Training: BD Phase II	DC
New Examiner Training: IA/IC Phase I	DC
New Examiner Training: BD Phase I	DC
New Examiner 4 Part On-line Training Series	OCIE Training Intranet ¹⁰

Special "In-Person" Programs and Conferences

Title	Location
Annual Senior Examiners (Managers) Conference	TBD
FINRA District Office Oversight	DC
Joint IA/BD Exam Specialists	DC
Clearing Agency Examiners Conference	PLRO, NYRO, or CHRO
Annual Joint Regulatory Examination Training w/ SROs & States	TBD
IA/IC Specialty (Focus/Topic TBD)	DC

Videoconference Series and Programs

Title	Location
<i>Inside the Rules Series</i>	Various
New (Proposed) Custody Rule (When Final)	DC
New (Proposed) Pay-to-Play Rules (When Final)	DC
Private Equity/Pooled Investments	DC
<i>Fraud Detection Series</i>	Various
Churning Fraud	ARO or DC
Series: Lessons Learned from Madoff	DC
Securities Fraud Basics for Newer Examiners	DC
Update on Cyber Fraud in the Securities Markets	DC
<i>Industry Series</i>	Various
CDOs and CDSs	DC
Complex Investment Strategies & Algorithmic Trading	NYRO or DC
Practicalities of Derivatives & Options in the Marketplace	DC
<i>Examination Issues and Policies Series</i>	Various
Proprietary Trading & Information Leakage	DC
Securities Lending	DC
Valuation & Difficult to Value Securities	CHRO, SFRO, or DC
Best Execution Update	DC
E-mail Review Policy & Concordance Basics	DC
Hedge Fund Update	NYRO or DC

¹⁰ See OCIE Training Branch Website, <http://portal.sec.gov/sites/ocie/training/default.aspx>

MSRB Databases	PLRO or DC
Direct Market Access/Sponsored Trading	DC
Joint Exams/Cross Training Series (Multiple)	DC
New Financial Products	DC
Online Series (recordings of past trainings)	OCIE Intranet
Others – TBD	DC

Regional Office Workshops

Title	Location
Interviewing Techniques or Lifecycle of a Trade (1-12)	All Exam Offices

OCIE Professional Development Sessions

Title	Location
Options	DC
Others – TBD	DC

Other Resources

OCIE Training Branch Intranet Site

- Training Schedules
- New Examiner On-line Video Series
- On-line Examiner Training - Videos of Past Trainings
- Materials From Past Trainings
- Search Function
- Links to outside training vendors (i.e., ALI-ABA, Securities Operations Forum)

SEC University: Staff may apply through the SEC University to receive payment for training/conferences, classes or materials associated with pursuing professional certifications, or tuition assistance and materials for university classes. In order to obtain reimbursement, examiners must complete the "Request for Training Form" (SEC-182), obtain supervisory approval, and provide the form to the designated administrative contact who will submit the form to SECU. Note that SECU will approve reimbursement only if SECU approval of the Form 182 has been obtained before examiners register for conferences/training or before study materials are bought. Examiners will then need to complete Form 1164 to receive reimbursement for study materials purchased. Periodically, OHR is offered free slots for various non-SEC training conferences. These slots are then offered by OHR to the administrative contacts in each office.

SECU also offers various classroom & videoconference training programs, which are available at the SECU Training Calendar. SECU also provides access to over 2000 classes online at its e-learning intranet site. Examiners should send a request for an account to the Training Registrations mailbox at trainingregistrations@sec.gov.

OIT Training: OIT offers a variety of training programs for SEC staff. Please contact OIT at oit_infocenter@sec.gov for more information. A course calendar and previous training programs are available at OIT Education.