



U.S. Securities and Exchange Commission  
Office of Inspector General  
Office of Audits

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Office of Compliance Inspections and  
Examinations' Management of Investment  
Adviser Examination Coverage Goals





OFFICE OF  
INSPECTOR GENERAL

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

**M E M O R A N D U M**

March 10, 2016

**TO:** Marc Wyatt, Director, Office of Compliance Inspections and Examinations

**FROM:** Carl W. Hoecker, Inspector General 

**SUBJECT:** *Office of Compliance Inspections and Examinations' Management of Investment Adviser Examination Coverage Goals, Report No. 533*

Attached is the Office of Inspector General's (OIG) final report detailing the results of our evaluation of the Office of Compliance Inspections and Examinations' (OCIE) management of investment adviser examination coverage goals. The report contains two recommendations for corrective action that, if fully implemented, should help OCIE progress toward meeting strategic objectives and long-term investment adviser examination coverage goals.

On February 16, 2016, we provided management with a draft of our report for review and comment. In its March 4, 2016, response, management concurred with our recommendations. We have included management's response as Appendix II in the final report.

Within the next 45 days, please provide the OIG with a written corrective action plan that addresses the recommendations. The corrective action plan should include information such as the responsible official/point of contact, timeframe for completing required actions, and milestones identifying how your office will address the recommendations.

We appreciate the courtesies and cooperation extended to us during the evaluation. If you have questions, please contact me or Rebecca L. Sharek, Deputy Inspector General for Audits, Evaluations, and Special Projects.

Attachment

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# Executive Summary

## OCIE's Management of Investment Adviser Examination Coverage Goals Report No. 533 March 10, 2016

### Why We Did This Evaluation

The U.S. Securities and Exchange Commission's (SEC or agency) Office of Compliance Inspections and Examinations (OCIE) coordinates the national examination program for more than 27,000 market participants over which the SEC has regulatory authority. OCIE's largest program area is the Office of Investment Adviser/Investment Company (IA/IC) Examinations. In April 2014, the SEC Chair stated in Congressional testimony that the SEC was "...in a position to only examine 9% of registered investment advisers in fiscal year 2013...More coverage is plainly needed..." We initiated this evaluation to assess OCIE's efficiency and effectiveness in managing its human resources to meet its long-term goals, particularly for IA examinations.

### What We Recommended

We recommended that OCIE provide us the results of its consultant's efficiency study when the study is complete. We also recommended that OCIE consider the results of the efficiency study and the recommendations of its Risk and Exam Process Steering Committee to improve its planning and staffing processes. Finally, we recommended that OCIE consider fully implementing GAO's risk-management framework. Management concurred with the recommendations, which will be closed upon completion and verification of corrective actions.

### What We Found

OCIE's risk-based examinations of registered entities, including IAs, is central to the SEC's strategic goal of fostering compliance with Federal securities laws. The Government Accountability Office (GAO) has established *Standards for Internal Control in the Federal Government* for ensuring that Federal agencies, including the SEC, achieve stated objectives and allocate resources efficiently and effectively to meet those objectives. Additionally, GAO has established a risk-management framework to help managers make decisions about allocating finite resources and take action under conditions of uncertainty.

We found that OCIE has worked to increase its examination coverage of IAs, including creating an Office of Risk Analysis and Surveillance and enhancing its use of advanced quantitative techniques, and continues to seek new ways to increase its efficiency. In fact, the almost 2,000 formal examinations OCIE conducted in fiscal year 2015 was an increase over each of the previous four fiscal years. However, improvements are needed to assess OCIE's progress toward meeting strategic objectives and long-term IA examination coverage goals. Specifically, we found that:

- (1) OCIE's performance measure – percentage of IAs examined each year – may not provide meaningful information due to variations in exam types, examination candidates, and regional office processes; and
- (2) the IA/IC program may benefit from adopting the GAO risk-management framework.

OCIE's management of IA examination goals and performance metrics can be more consistent with Federal internal control and risk management standards. Doing so will help ensure that examinations conducted support OCIE's examination priorities, as well as OCIE's long-term goal and the SEC's strategic plan. In addition, management should ensure that OCIE's performance metrics allow management to assess performance and ensure efficient and effective use of OCIE's limited resources across regional offices.

In September 2015, OCIE hired a consultant to help identify ways it can more efficiently use its resources. Management expects the consultant will report its findings and recommendations, if any, by September 2016.

For additional information, contact the Office of Inspector General at (202) 551-6061 or [http://www.sec.gov/about/offices/inspector\\_general.shtml](http://www.sec.gov/about/offices/inspector_general.shtml).

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## ABBREVIATIONS

Dodd-Frank	Dodd-Frank Wall Street Reform and Consumer Protection Act
FINRA	Financial Industry Regulatory Authority
FY	fiscal year
GAO	Government Accountability Office
GPRAMA	GPRA Modernization Act of 2010
IA	investment adviser
IC	investment company
NEP	National Examination Program
OCIE	Office of Compliance Inspections and Examinations
OFM	Office of Financial Management
OIG	Office of Inspector General
OMB	Office of Management and Budget
ORAS	Office of Risk Analysis and Surveillance
SEC or agency	U.S. Securities and Exchange Commission
TCR	tips, complaints, and referrals

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## Background and Objectives

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### Background

The U.S. Securities and Exchange Commission's (SEC or agency) Office of Compliance Inspections and Examinations (OCIE) plays a critical role in protecting investors. OCIE administers the SEC's National Examination Program (NEP) and conducts examinations and oversight of the nation's approximately 27,000 registered entities (registrants). These include about 11,900 investment advisers (IAs), about 10,500 mutual funds and exchange-traded funds, nearly 4,300 broker-dealers, 425 transfer agents, 18 securities exchanges, and self-regulatory organizations such as the Financial Industry Regulatory Authority (FINRA). OCIE examinations of these entities improve industry compliance with Federal securities laws, detect and prevent fraud, inform policy, and identify risks.

OCIE is composed of various program areas and operational and administrative offices.<sup>1</sup> The four main program areas are: (1) Office of Investment Adviser/Investment Company (IA/IC) Examinations; (2) Office of Broker-Dealer Examinations; (3) Office of Clearance and Settlement; and (4) Office of Market Oversight. Additionally, OCIE has a Technology Controls Program responsible for technology control program inspections of registered entities, including clearing agencies and exchanges. Each program area is headed by an Associate Director responsible for setting directives and ensuring consistency across the NEP with respect to the Associate Director's program.<sup>2</sup>

As of October 2015, OCIE had over 900 total staff employed at the SEC's Headquarters and its 11 regional offices. As Table 1 shows, in fiscal year (FY) 2015, OCIE conducted almost 2,000 formal examinations of registrants. More than 51 percent of OCIE's FY 2015 examination resources (467 examiners) were allocated to the IA/IC program, accounting for about 69 percent (or 1,358) of the exams conducted.

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<sup>1</sup> OCIE's operational and administrative offices include the offices of the Director, Managing Executive, and Chief Counsel.

<sup>2</sup> OCIE is led by a Director, who is responsible for overseeing and managing the performance of the NEP, including its strategy, structure, people, processes, and technology. The Director introduces new program initiatives and identifies opportunities to enhance and improve the NEP. The Associate Directors report to the Director.

**Table 1. Summary of OCIE Programs, Number of Employees, and FY 2015 Examinations**

Office of IA/IC Examinations	Office of Broker-Dealer Examinations	Office of Clearance and Settlement	Office of Market Oversight
<ul style="list-style-type: none"> <li>• 11,900 IAs</li> <li>• 10,500 mutual funds and exchange-traded funds</li> <li>• \$66 trillion in assets under management</li> </ul>	<ul style="list-style-type: none"> <li>• 4,300 broker-dealers</li> <li>• 160,000 branch offices</li> <li>• 1,000 municipal advisors</li> <li>• New responsibilities pending for certain derivatives markets and crowd funding portals</li> </ul>	<ul style="list-style-type: none"> <li>• 8 active clearing agencies, of which 4 are designated as systemically important</li> <li>• 425 transfer agents</li> <li>• New responsibilities pending for security-based swap data repositories</li> </ul>	<ul style="list-style-type: none"> <li>• 18 national securities exchanges</li> <li>• FINRA, PCAOB, MSRB, FASB, and SIPC</li> <li>• New responsibilities pending for security-based swap execution facilities</li> </ul>
Staff and Examinations within These Program Areas			
	Staff Exams	Staff Exams	Staff Exams
<b>TOTAL</b>	<b>467 1,358</b>	<b>TOTAL 287 534</b>	<b>TOTAL 21 60</b>
<b>Total Number of Program Staff: 808</b>		<b>Total Number of Exams Conducted: 1,975</b>	

Source: Office of Inspector General (OIG)-generated based on information provided by OCIE and obtained from OCIE’s Exam Metrics and Activities tool.

To determine the most appropriate candidates for examination, OCIE staff considers sources of risk information in conjunction with both the NEP’s annual examination priorities and regional office knowledge of registered entities. According to the NEP’s *National Examination Program Manual* (NEP Manual), dated March 30, 2015, the risk assessment process includes the review and consideration of, among other things:

- objective risk-related information;
- examination program insights;
- risks identified by other SEC divisions and offices;
- tips, complaints, and referrals (TCRs); and
- other sources that may raise significant investor or financial risk.

During inspections and examinations, OCIE examiners visit the offices of regulated entities, interview management, review documents, and analyze the entity’s compliance programs and certain operations. When examiners determine that a regulated entity has not complied with securities laws, in most cases, the examiners issue a deficiency letter requiring the registrant to correct the deficiencies. If the deficiencies are serious, examiners may refer the matter to the SEC’s Division of Enforcement to determine whether an investigation and possible enforcement action are appropriate.

**Requirements for Strategic Planning and Resource Allocation.** The GPRA Modernization Act of 2010<sup>3</sup> (GPRAMA) and Government-wide guidance such as Office of Management and Budget (OMB) Circular A-11, *Preparation, Submission, and Execution of the Budget*, provide requirements and strategies for Federal agencies to establish goals and objectives and align and manage resources to meet those goals and objectives. GPRAMA helps Federal agencies focus on their highest priorities and create a culture where data and empirical evidence play a greater role in policy, budget, management decisions, and agency performance assessments. GPRAMA requires agencies to make public a strategic plan that contains, among other things:

1. a comprehensive mission statement covering the agency's major functions and operations;
2. general goals and objectives, including outcome-oriented goals, for the major functions and operations of the agency; and
3. a description of how the goals and objectives are to be achieved, including a description of the processes, skills and technology, and resources required to achieve those goals and objectives.

Moreover, OMB Memorandum M 10-24<sup>4</sup> states that:

An agency's strategic plan is a valuable tool for communicating to agency managers, employees, delivery partners, suppliers, Congress, and the public a common vision for the future. It should inform agency decision-making about the need for major new acquisitions, updated information technologies, hiring, skill development, and evaluations. . . . Above all, an agency's strategic plan should be used to align resources and guide decision-making to accomplish priorities and improve outcomes.

GPRAMA states that the strategic plan "shall cover a period of not less than 4 years following the fiscal year in which the plan is submitted." As needed, the head of the agency may make adjustments to the strategic plan to reflect significant changes in the environment in which the agency is operating, with appropriate notification of Congress.

In accordance with GPRAMA, the SEC developed a strategic plan for FY 2014-2018. To meet its mission of protecting investors; maintaining fair, orderly, and efficient markets; and facilitating capital formation, the SEC established the following four strategic goals:

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<sup>3</sup> Pub.L. 111-352, 124 Stat. 3866 (2011).

<sup>4</sup> OMB M 10-24, *Performance Improvement Guidance: Management Responsibilities and Government Performance and Results Act Documents*; June 25, 2010.

## SEC Strategic Goals

Strategic Goal 1. Establish and maintain an effective regulatory environment.

Strategic Goal 2. Foster and enforce compliance with Federal securities laws.

Strategic Goal 3. Facilitate access to the information investors need to make informed investment decisions.

Strategic Goal 4. Enhance the Commission's performance through effective alignment and management of human, information, and financial capital.

For each goal listed above, the SEC also developed strategic objectives. For example, Strategic Goal 2 has the following three corresponding strategic objectives: (1) the SEC fosters compliance with Federal securities laws; (2) the SEC promptly detects and deters violations of the Federal securities laws; (3) the SEC prosecutes violations of Federal securities laws and holds violators accountable through appropriate sanctions and remedies. To gauge its progress in achieving these strategic objectives, the SEC uses various performance goals. According to the SEC's FY 2014 Agency Financial Report, OCIE is responsible for two of the SEC's three annual performance goals related to the agency's Strategic Goal 2: (1) number of industry outreach and education programs targeted to areas identified as raising particular compliance risks; and (2) percentage of IAs, ICs, and broker-dealers examined during the year.

GPRAMA also requires agencies to make public each year an annual performance plan that is consistent with the agency's strategic plan and describes the agency's planned level of performance during the current and next FYs. Agency annual performance plans should establish a balanced set of performance indicators to be used in measuring or assessing progress toward each performance goal, and provide a basis for comparing actual program results with established performance goals. OMB Circular A-11 states that performance information from the annual performance plan should inform agency budget decisions and complement other factors in the budget process. Performance information includes goals, indicators of past performance, and other evidence such as evaluations.

**OCIE Policies and Procedures for Establishing Priorities and Risks.** To accomplish its goals and foster compliance with Federal securities laws, in part, each year, OCIE issues publicly a document that identifies its calendar year examination priorities. The priorities reflect certain practices and products that OCIE identifies as potentially heightened risk to investors and the integrity of the capital markets. OCIE develops its examination priorities based on a range of factors, including ongoing monitoring of the markets; industry trends; SEC-wide priorities; and input from senior officers, regional staff, other SEC divisions, and other Federal, state, and local

regulators.<sup>5</sup> Although OCIE expects to allocate significant resources to these priorities, as previously discussed, its staff also conducts examinations focused on risks, issues, and policy matters that arise from market developments and new information learned from examinations or other resources, including TCRs.

In addition, OCIE's NEP Manual provides guidance to NEP staff on various aspects of the NEP. As stated in the NEP Manual, many factors need to be considered when assessing risk and determining whether, to what extent, and what kind of examination is warranted. The NEP Manual lists various examples of categories of information staff should consider, including TCRs, news or media concerns, outside business activities of the entity or its personnel, supervisory concerns, financial stress, and the length of time since registration or last examination. To further support NEP staff, OCIE's Office of Risk Analysis and Surveillance (ORAS) informs and facilitates the NEP's risk-based strategies to refine firm risk profiles and better identify potential examination candidates. ORAS does this by: (1) publishing internal reports on certain risks and activities; (2) monitoring registration and filing data, media reports, court filings, and public records; (3) generating internal examination referrals; and (4) providing entity specific data and information to staff.<sup>6</sup>

**Examination Coverage of IAs.** The almost 2,000 formal examinations OCIE conducted in FY 2015 was an increase over each of the previous four FYs. However, as stated in testimony before the U.S. House of Representatives Committee on Financial Services, the SEC Chair has reported:

While the SEC makes increasingly effective and efficient use of its limited resources, we nevertheless were in a position to only examine 9% of registered investment advisers in fiscal year 2013. In 2004, the SEC had 19 examiners per trillion dollars in investment adviser assets under management. Today, we have only 8. More coverage is plainly needed, as the industry itself has acknowledged.<sup>7</sup>

Section 914 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)<sup>8</sup> required the SEC to review and analyze the need for enhanced examination and enforcement resources for IAs. It expressly required that the agency examine its number and frequency of examinations of IAs over the 5 years preceding

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<sup>5</sup> For each initiative, the Associate Director for the IA/IC program sends out initiation memorandums or e-mails to examiners that include information about the initiative as well as guidance for conducting examinations. We obtained the initiation memorandums that OCIE issued as of July 2015 and found that OCIE generally established targets for its priorities and initiatives, including the number of examinations to conduct and a timeframe by which to conduct them.

<sup>6</sup> ORAS has 14 employees whose mission is to drive OCIE's risk-focused examination strategy and the efficient and effective use of resources.

<sup>7</sup> Testimony on "Oversight of the SEC's Agenda, Operations, and FY 2015 Budget Request." SEC Chair Mary Jo White before the Committee on Financial Services, United States House of Representatives; April 29, 2014.

<sup>8</sup> P.L. 111-203, 124 Stat. 1376 (2010).

the date of the legislation. The resulting report – *Study on Enhancing Investment Adviser Examinations* (January 2011)<sup>9</sup> – stated that the number of resources and the amount of time required to conduct an examination depends on: (1) the size and complexity of an IA’s operations; (2) the level of cooperation provided to the examiners; and (3) the scope, method, and efficiency of examinations conducted by OCIE.<sup>10</sup>

Moreover, the study stated that although the SEC’s resources and number of OCIE staff may increase in the next several years, the number of OCIE staff is unlikely to keep pace with the growth of registered IAs. As a result, the SEC likely will not have sufficient capacity in the near or long term to conduct effective examinations of registered IAs with adequate frequency. According to the study, Congress should consider the following three options to strengthen the SEC’s IA program:

1. imposing user fees on SEC-registered IAs to fund their examinations by OCIE;
2. authorizing one or more self-regulatory organizations to examine, subject to SEC oversight, all SEC-registered IAs; and
3. authorizing FINRA to examine dual registrants for compliance with the Investment Advisers Act of 1940.

The SEC Office of the Investor Advocate’s first two reports also identified the IA coverage level to be inadequate. Specifically, the *Report on Activities for FY 2014* states, “...the SEC examined approximately 10 percent of investment advisers, which equates to an examination cycle of once every 10 years. This level of coverage is simply inadequate to protect investors from fraudulent or abusive practices like excessive or undisclosed fees, unauthorized trading, or outright theft.”<sup>11</sup> Furthermore, the *Report on Objectives for FY 2015* states: “The increasing size, sophistication, and complexity of investment advisers make SEC examinations more challenging and time-consuming. Yet, SEC resources devoted to examinations have not reflected the magnitude of the changes in the industry.”<sup>12</sup>

On November 24, 2014, the House Subcommittee on Capital Markets and Government Sponsored Enterprises sent the SEC Chair a letter asking how the SEC plans to reallocate existing resources to increase registered IA examinations. On December 16,

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<sup>9</sup> The Division of Investment Management, with assistance from other divisions and offices, conducted the study.

<sup>10</sup> OCIE generally conducts three types of IA/IC examinations: (1) examinations of higher-risk IAs, (2) cause examinations resulting from TCRs, and (3) special purpose reviews such as risk-targeted examination sweeps and risk assessment reviews. The number of examiners conducting an individual examination varies based on the type of examination and the particular characteristics of the IA being examined. Although a limited examination (one that seeks to achieve a limited purpose) may be completed in only a few days, more comprehensive examinations may take several weeks or months to complete.

<sup>11</sup> Office of the Investor Advocate *Report on Activities for FY 2014* (filed December 23, 2014).

<sup>12</sup> Office of Investor Advocate *Report on Objectives for FY 2015* (filed June 30, 2015).

2014, the SEC Chair responded by stating that the SEC will strive to increase coverage of IAs without sacrificing quality or coverage in other areas. To achieve that goal, the Chair cited the creation of ORAS within OCIE and also noted that the SEC has enhanced its use of advanced quantitative techniques and has launched an examination initiative directed at nonprivate fund IAs that have never been examined.

In October 2015, the SEC Director of the Division of Investment Management testified before the House Subcommittee on Capital Markets and Government Sponsored Enterprises and stated that SEC staff is developing a recommendation for the SEC's consideration that, if proposed and adopted, would establish a program of third-party compliance reviews for registered IAs. The reviews would not replace examinations conducted by OCIE but would supplement them to improve compliance by registered IAs.<sup>13</sup>

Because of (1) the increased scrutiny of the SEC's examination coverage of IAs and the management challenge it presents, and (2) the size of the IA/IC program compared to other OCIE program areas, our evaluation focused primarily on the IA/IC program.

## Objectives

Our objective was to assess OCIE's efficiency and effectiveness in managing its human resources to address mission priorities and long-term goals, particularly for IA examinations. Specifically, we sought to determine:

- the methodology and evidence supporting OCIE's budget requests and the allocation of personnel to OCIE programs, including examinations of IAs and ICs;
- how OCIE identifies and monitors examination targets (number and types) by program area; and
- how OCIE adjusted its examination targets or resource allocations based on the SEC FY 2015 budget approved by Congress.

We conducted our fieldwork primarily at the SEC's Headquarters but also coordinated with regional personnel. We interviewed OCIE's current and former Directors; the Associate Directors for each of its main programs; the SEC Chief Financial Officer to gain an understanding of the SEC budgeting processes and the agency's annual performance plans; and the former SEC Deputy Chief of Staff to gain an understanding of the agency's 2014-2018 Strategic Plan. We obtained and reviewed SEC policies and procedures; documents encompassing OCIE's budget requests for FY 2013, FY 2014, and FY 2015; and internal OCIE documents related to its examination plans. We also

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<sup>13</sup> Testimony on "Oversight of the SEC's Division of Investment Management." David W. Grim, Director of the Division of Investment Management, before the Subcommittee on Capital Markets and Government Sponsored Enterprises, United States House of Representatives; October 23, 2015.

obtained access to OCIE's examination tracking system, TRENDS, and generated reports for examinations conducted during the period under review.

Although our efforts focused on OCIE's program-level management to address strategic goals and objectives, we anticipate performing future reviews of OCIE's detailed operations to further assess its efficiency and effectiveness.

Appendix I includes additional information on our scope and methodology, our review of internal controls, prior audit coverage, applicable Federal laws and guidance, and SEC policies and procedures.

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## Results

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### Improvements Are Needed in OCIE's Management of the IA/IC Program

The Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government*<sup>14</sup> states that an entity determines its mission, sets a strategic plan, establishes objectives, and formulates plans to achieve its objectives. These standards outline the overall framework for establishing and maintaining an effective internal control system that provides reasonable assurance that the objectives of an entity will be achieved. Additionally, GAO has established a risk-management framework to help managers make decisions about allocating finite resources and take action under conditions of uncertainty.<sup>15</sup>

According to the SEC's FY 2014 Congressional Budget Justification, the agency's goal is to examine roughly the same proportion of IAs as FINRA achieves in its examination of broker-dealers, which is about half.<sup>16</sup> OCIE personnel referred to the goal of examining 50 percent of registered IAs each year as an "aspirational goal" primarily because obtaining the required human resources to achieve that goal may not be feasible within the current budget environment. For example, in FY 2015, the SEC requested 316 additional positions for OCIE in its Congressional Budget Justification but OCIE received only 91 positions. In FYs 2013 and 2014, OCIE received just 43 positions out of the 547 positions the SEC requested for OCIE. Due to these resource constraints, OCIE manages the IA/IC program not based on a long-term goal of examining 50 percent of IAs but rather based on the annual goals for each of its performance metrics.<sup>17</sup> In FY 2015, OCIE met its annual goal of examining 10 percent of registered IAs. In FY 2016, OCIE estimates that it will examine 12 percent of registered IAs.

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<sup>14</sup> U.S. Government Accountability Office, *Standards for Internal Control in the Federal Government* (GAO/AIMD-00-21.3.1, November 1999). In September 2014, GAO revised the *Standards for Internal Control in the Federal Government* (GAO-14-704G, September 2014). The revised standards were not effective until FY 2016, although agency management could have adopted them earlier.

<sup>15</sup> GAO developed the risk-management framework based on criteria that include GAO best practices, OMB circulars, *Standards for Internal Control in the Federal Government*, and the Government Performance and Results Act of 1993.

<sup>16</sup> In February 2013, OCIE's Deputy Director e-mailed two OCIE staff members, informing them that the SEC Chair wanted to make it a priority within the FY 2014 budget request to ask for resources necessary to start a multi-year effort to "dramatically increase" examination coverage of IAs.

<sup>17</sup> In its FY 2016 Annual Performance Plan, the SEC identified OCIE's Director as the Goal Leader for the following performance goals: (1) number of industry outreach and education programs targeted to areas identified as raising particular compliance risks; (2) percentage of firms receiving deficiency letters that take corrective action in response to all exam findings; (3) percentage of IAs, ICs, and broker-dealers examined during the year; (4) percentage of compliance exams that are timely concluded in accordance with OCIE's statutory deadline; and (5) number of joint exams, information sharing agreements, and formal meetings with other regulators.

We recognize that there are factors outside of OCIE's control that affect the number of registered IAs that OCIE can examine, including the number of new positions OCIE receives and the total number of registered IAs. We commend OCIE for seeking new ways to increase its efficiency and IA examination coverage. In the last few years, OCIE has developed a risk-based examination strategy and made significant enhancements in data analytics and technology. For example:

- in FY 2014, OCIE's Quantitative Analytics Unit developed the National Exam Analytics Tool. According to the SEC's FY 2014 Agency Financial Report, this tool "enables examiners to review years of trading data and millions of transactions in minutes." And,
- in 2012, OCIE implemented an electronic examination platform called the Tracking Reporting Examination National Documentation System (TRENDS). OCIE uses TRENDS to track and report NEP examination data and manage electronic documents for all examinations.

The FY 2015 Agency Financial Report explains that, because OCIE's examination programs are risk-based, such enhanced capabilities "have enabled each program to better allocate its limited resources to high-risk firms and practices." However, we did not identify a link between OCIE's annual operational goals and the SEC's long-term goal of examining 50 percent of registered IAs. Specifically:

- OCIE's performance measure – the percentage of IAs examined – may not provide meaningful information; and
- the IA/IC program has not fully adopted the GAO risk-management framework.

### **OCIE's Performance Measure – Percentage of IAs Examined Each Year – May Not Provide Meaningful Information Due To Variations in Exam Types, Examination Candidates, and Regional Office Processes**

GAO's *Standards for Internal Control in the Federal Government* states that management should design control activities to achieve objectives. The document further states that performance measures and indicators are a common category of control activities and may include "comparisons and assessments relating different sets of data to one another so that analyses of the relationships can be made and appropriate actions taken."

**Variations in Exam Types.** OCIE conducts on-site examinations of IAs with teams of specialized examiners and other staff. The number of examiners conducting an individual exam varies based on several factors, including the type of exam being conducted. A limited exam (that is, one that seeks to achieve a limited purpose) may be completed in only a few days with few examiners. More comprehensive exams may take several weeks or months to complete with a larger examination team. However,

for the purposes of measuring and reporting on its performance, OCIE counts each exam equally. Given the variation in scope and intended purpose of the different types of exams, counting each exam equally as part of the OCIE-wide metric may not provide OCIE management with meaningful information to assess the efficiency and effectiveness of the IA/IC program, particularly in meeting stated goals.

**Variations in Examination Candidates.** The number of SEC-registered IAs has increased about 31 percent over the last decade and the number of assets under management by these advisers has increased more than two-fold. As of 2016, there are more than 11,900 registered IAs with \$66 trillion in total assets under management and a variety of often complex operations. Among IAs, business activity can also vary, as follows:

- 462 IAs (or about 4 percent) are also broker-dealers, and about 82 percent are registered with FINRA;
- 4,041 IAs (or about 34 percent) conduct investment advisory business out of multiple office locations, including offices that are not in the U.S.;
- 1,449 IAs (or about 12 percent) advise wrap-fee programs;<sup>18</sup>
- 5,154 IAs (or about 43 percent) have custody (including through a related person) of about \$22 trillion in assets under management; and
- 4,489 IAs (or about 38 percent) report 29,400 private funds with gross assets of \$10.4 trillion.

As noted above, the number of examiners assigned to an exam depends on several factors, including the make-up and characteristics of the IA. OCIE may assign only two examiners to conduct an examination of a small adviser with limited operations managing portfolios of equity securities for clients. More examiners, including those with special expertise, are required to conduct an examination of a large adviser. In addition, examinations of higher-risk advisers may require additional time and staffing because OCIE staff may need to conduct more inquiry into the operations relevant to the risks associated with such advisers.

**Variations in Regional Office Processes.** OCIE's regional offices vary in available examination resources, the number of registered IAs overseen, the amount of assets under management, and the number of exams completed each year. According to OCIE management, these differences, in part, result in differences in many regional office processes, including how each office selects candidates for exam. Table 2 shows the range (from low to high) across the regional offices of the number of

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<sup>18</sup> A wrap-fee program is any advisory program under which an IA provides investment advisory services (which may include portfolio management or advice concerning the selection of other IAs) and executes client transactions and charges a specified fee or fees not based directly upon transactions in a client's account.

registered IAs, the amount of assets under management, and the number of OCIE employees assigned to the IA/IC program in FY 2016, and IA examinations completed in FY 2013, FY 2014, and FY 2015.

**Table 2. Registered IAs, Assets Under Management, and Examinations Conducted<sup>19</sup>**

Range	Number of Registered I/As in FY 2016	Amount of Assets Under Management in FY 2016	Number of IA/IC Employees in FY 2016	Examinations Completed		
				FY 2013	FY 2014	FY 2015
Low	552	\$733 Billion	16	35	44	47
High	2,800	\$17.8 Trillion	98	203	237	227
Overall Total	11,956	\$66.7 Trillion	467	965	1,150	1,221

Source: OIG-generated based on OCIE Executive Reports dated October 15, 2013, October 14, 2014, and October 19, 2015.

OCIE senior managers told us that they give regional offices and program areas some autonomy to select examination candidates and address factors such as variations in populations, staffing, local initiatives, and market conditions. According to OCIE management, this autonomy is paramount to executing a risk-based examination program because localized knowledge often plays a critical role.

Notwithstanding the value of localized knowledge, in 2014, an OCIE Risk and Exam Process Steering Committee reviewed each regional office's process for selecting examination candidates to determine whether additional guidance was needed to enhance and promote consistency across OCIE. In November 2014, the Committee issued to OCIE senior management an internal memorandum stating that, among other things, "...the significant differences among the exam candidate selection processes is an area of exposure for the NEP." The Committee recommended that OCIE management consider defining the minimal steps that each regional office's examination candidate selection process should include.<sup>20</sup>

We sought to follow-up on the recommendations of the Risk and Exam Process Steering Committee. OCIE management told us that the internal memorandum produced by the Committee was only a draft document and that the Committee was in the process of updating the document. Therefore, we contacted all 11 regional offices to inquire about their processes for selecting examination candidates. Based on the responses we received, we reached conclusions similar to those of the Committee. For example, we found differences among the regional offices with regard to the number and level of persons tasked with examination candidate selection and their use of registrant data. Specifically, we received varying responses regarding who was the primary individual(s) tasked with executing the examination candidate selection

<sup>19</sup> The figures under each range do not necessarily correspond to a single office, but rather are intended to show either the lowest or highest figure amongst all regional offices for each category.

<sup>20</sup> As of the date of this report, OCIE management was reviewing this issue.

process and whether a formal plan is prepared and submitted to SEC Headquarters. We found that the larger regional offices tend to have a more robust process for selecting examination candidates whereas the smaller offices typically rely on regional management. Some of the more significant differences are as follows:

- In one office, examiners are working with OCIE's Quantitative Analytics Unit and others to develop more comprehensive and current management information systems that will aggregate both qualitative and quantitative registrant information. For example, the office is testing a vendor-supplied program that seeks to identify outliers based on publicly available data. Furthermore, the program has undertaken an initiative to acquire other tools that will allow for the mapping and visualization of registrant data, making it easier to spot trends and target the deployment of staff resources.
- In another office, a Risk Management Strategist is primarily responsible for managing the examination candidate selection process. The Risk Management Strategist assigns "due diligence" reviews to examiners based on her assessment of risk using an algorithm this office developed.<sup>21</sup> Examiners typically perform two to three due diligence reviews each year for this office to maintain a pool of examination candidates ready for scheduling at all times.
- Three offices expressed the challenge of having fewer resources. Two of the three offices stated that their management teams are primarily responsible for selecting examination candidates and that, although there are advantages to management's involvement, leading the selection process while also managing examinations and meeting administrative responsibilities can be challenging.

In addition to differences in the registrant populations and how regional offices plan examinations, regional offices may also be conducting examinations differently. For example, according to OCIE:

- while all regional offices rotate lead examiners, some offices do not rotate new examiners until they have sufficient experience;
- 10 of the 12 offices have examiners work on more than one exam at a time; and
- 9 of the 12 offices have staff return to the office while waiting for information from the registrant under examination.

GAO's *Standards for Internal Control in the Federal Government* states that if substantially different controls, such as examination policies and procedures, were used at different times during the period under evaluation, management should evaluate operating effectiveness separately for each unique control system (that is, regional office).

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<sup>21</sup> Due diligence reviews are limited scope, information-gathering assessments used to determine whether an examination is warranted.

The variation in how examinations are staffed and performed may affect OCIE management’s ability to identify inefficiencies and compare office performance. As shown in Table 3, there is a wide range between the office with the lowest average number of examinations-per-examiner each year and the office with the highest average number of examinations-per-examiner each year.

**Table 3. Average Number of IA/IC Examinations-per-Examiner<sup>22</sup> for FY 2013, FY 2014, and FY 2015**

Range	Exam/Staff		
	FY 2013	FY 2014	FY 2015
Low	1.70	1.77	2.36
High	4.48	5.13	4.63
Overall Average	2.64	3.14	3.26

Source: OIG-generated based on exam figures obtained from TRENDS and staffing data obtained from OCIE.

In September 2015, OCIE hired a consultant to identify areas for possible improvement and study OCIE’s processes for assigning staff to examinations, including:

- OCIE’s organizational structure, using an open architecture model for staffing examinations, workload distribution among managers, and supervisory review of examination processes;
- processes and methods used to identify and staff examinations, use of staff with subject matter expertise, and use of specialized units or teams;
- processes for scheduling, scoping, and conducting examinations;
- processes for managing human resources and measuring productivity; and
- examination coverage of entities regulated by the SEC and potential alternatives for increasing coverage while maintaining or improving examination quality and effectiveness.

According to management, this study will help OCIE identify ways it can more efficiently use its resources, increasing the number of examinations its staff can conduct. Management expects the consultant will report its findings and recommendations, if any, by September 2016.

<sup>22</sup> Includes examiners, accountants, attorney examiners, exam managers, and Assistant Directors.

## The IA/IC Program Has Not Fully Adopted the GAO Risk-Management Framework

As required by Dodd-Frank, GAO regularly reviews the SEC’s oversight of FINRA.<sup>23</sup> Most recently, GAO assessed documents, procedures, and guidance from OCIE’s Office of Market Oversight, which is responsible for FINRA oversight. GAO also compared Market Oversight’s FINRA risk-assessment process with (1) similar processes used by the Board of Governors of the Federal Reserve System and the Federal Housing Finance Authority, and (2) GAO’s risk-management framework.

GAO has reported on the benefits of risk management and identified elements of a risk-management framework for Federal agency oversight efforts.<sup>24</sup> According to GAO, risk management is a strategy for helping make decisions about assessing risks, allocating resources, and taking actions under conditions of uncertainty. GAO has stated that, “The ability to anticipate future happenings and to choose among alternatives lies at the heart of risk management and provides us with a guide, based on good management practices and supported by established internal controls, that can enhance decision making.” GAO’s risk-management framework provides that management decisions should be made in the context of a strategic plan, with clearly articulated goals and objectives that flow from the plan. As Table 4 shows, GAO’s risk-management framework has five phases.

**Table 4. GAO Risk-Management Framework**

Phase	Definition
1. Strategic Goals, Objectives, and Constraints Identification	Identifying the strategic goals that an agency is trying to achieve and the steps needed to attain those goals, including determining limitations or constraints that can affect the desired outcomes.
2. Risk Assessment	Identifying the key aspects of potential risks.
3. Alternatives Evaluation	Considering measures to reduce the identified risks.
4. Management Selection	Management selecting where resources and investments will be made based on selecting the appropriate alternatives for reducing risks.
5. Implementation and Monitoring	Applying and monitoring the selected alternatives for reducing risk to help ensure ongoing effectiveness, including the implementation of new policies, procedures, and controls and how these procedures are documented and maintained.

Source: U.S. Government Accountability Office, *SEC Can Further Enhance Its Oversight Program of FINRA* (GAO-15-376, April 2015).

<sup>23</sup> Section 964 of the Dodd-Frank Act.

<sup>24</sup> U.S. Government Accountability Office, *Further Refinements Needed to Assess Risks and Prioritize Protective Measures at Ports and Other Critical Infrastructure* (GAO-06-91, December 2005).

U.S. Government Accountability Office, *SEC Can Further Enhance Its Oversight Program of FINRA* (GAO-15-376, April 2015).

The risk management framework could aid in assessing risks, allocating resources, and enhancing decision making for the IA/IC program. OCIE's examinations of IAs could better support the SEC's strategic goal of fostering compliance with Federal securities laws if OCIE management established a long-term IA/IC goal with a realistic plan to achieve that goal and performance indicators that track progress toward meeting that goal. Management should ensure that OCIE's performance metrics allow management to assess performance and ensure efficient and effective use of resources across regional offices.

In its April 2015 report, GAO reported that, although OCIE's Office of Market Oversight had taken some steps to assess its oversight of FINRA, it lacked performance goals or measures specific to assessing whether it had met its stated goal of enhancing oversight of FINRA. Specifically, GAO stated:

. . . Performance measures must be clear, concise, and measurable and can be used to measure progress toward these goals. Furthermore, leading practices in federal performance management that [GAO] previously identified state that performance measures should have appropriate targets. Internal control standards in the federal government call for agencies to develop control activities to help ensure that management's directives are carried out, for example, by establishing performance measures that align with their mission and compare performance against targets.

GAO recommended that the SEC establish specific performance goals and performance measures as well as related targets to assess the program's progress in meeting those goals. The SEC concurred with GAO's recommendation and the Office of Market Oversight has begun adopting the GAO risk management framework to: (1) develop specific performance goals and measures, with corresponding targets to monitor its progress toward the goal of enhancing FINRA oversight; (2) formalize procedures for documenting its oversight determinations, such as selecting FINRA areas for inspections and any changes made to planned oversight activities; and (3) perform an assessment of internal risks, such as staff availability and competing priorities, to successfully meeting FINRA oversight program goals and objectives.<sup>25</sup>

## Conclusion

OCIE has worked to increase its examination coverage of IAs, including creating ORAS and enhancing its use of advanced quantitative techniques and technology, and continues to seek new ways to increase its efficiency and IA examination coverage given its limited resources. However, we found that OCIE's management of IA examination goals and performance metrics can be more consistent with Federal internal control and risk management standards. Doing so will help ensure that

<sup>25</sup> GAO did not review the IA/IC program and its review was limited to OCIE's Office of Market Oversight. Therefore, the findings and corresponding recommendations included in GAO's report did not pertain to the IA/IC program.

examinations support OCIE's examination priorities, as well as the SEC's long-term goal. In addition, management should ensure that OCIE's performance metrics allow management to assess performance and ensure efficient and effective use of OCIE's limited resources across regional offices.

## **Recommendations, Management's Response, and Evaluation of Management's Response**

To improve the efficiency and effectiveness of OCIE's human resource management to meet OCIE's long-term goals, including those for IA examinations, we recommend the following:

**Recommendation 1:** The Office of Compliance Inspections and Examinations should (a) provide to the Office of Inspector General the results of its consultant's efficiency study when the study is complete, and (b) consider the results of the study and its Risk and Exam Process Steering Committee's recommendations to improve investment adviser/investment company program planning and staffing processes.

**Management's Response.** The Office of Compliance Inspections and Examinations concurred with the recommendation and will provide the results of the consultant's study to the Office of the Inspector General once the study is complete. The Office of Compliance Inspections and Examinations will also review the recommendations of the consultants, as well as any recommendations from the Exam Process Steering Committee, once both are complete.

**OIG's Evaluation of Management's Response.** Management's proposed actions are responsive; therefore, the recommendation is resolved and will be closed upon verification of the action taken.

**Recommendation 2:** The Office of Compliance Inspections and Examinations should consider fully implementing the Government Accountability Office's risk-management framework in the investment adviser/investment company program. The framework includes five components: (a) identifying strategic goals, objectives, and constraints; (b) identifying key aspects of potential risk; (c) considering measures to reduce identified risks; (d) selecting where resources and investments will be made based on selecting the appropriate alternatives for reducing risks; and (e) implementation and monitoring.

**Management's Response.** The Office of Compliance Inspections and Examinations concurred with the recommendation and will further consider the Government Accountability Office's risk-management framework and how it may implement additional aspects of the framework within the IA/IC examination program.

**OIG's Evaluation of Management's Response.** Management's proposed actions are responsive; therefore, the recommendation is resolved and will be closed upon verification of the action taken.

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## Other Matters of Interest

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During the course of our evaluation, we identified other matters of interest that did not warrant recommendations. We discussed these matters with OCIE management.

**OCIE Did Not Maintain Evidence of Staffing Requests in a Central Location.** For FYs 2013 through 2015, OCIE submitted to the Office of Financial Management (OFM) its staffing requests for the purpose of building the SEC's Authorization Request to Congress. OCIE officials provided us e-mails from senior OCIE and OFM officials that highlighted the methodology and rationale for OCIE's budget requests. However, we found that OCIE's budget requests were based primarily on informal discussions and analysis documented within these e-mails. Without maintaining formal evidence in a centralized location, OCIE cannot readily confirm its budget requests are meeting the minimum requirements set forth by OFM from year to year. OCIE management should consider formalizing the process for developing OCIE's budget requests.

**OCIE Allocated FY 2015 Resources Based on its Congressional Budget Justification.** As part of our evaluation objectives, we reviewed how OCIE adjusted its examination targets or resource allocations based on the SEC's FY 2015 budget approved by Congress. We determined that OCIE's planned examinations are based on risk analysis in conjunction with the NEP's examination priorities and not on the number of positions allocated. With regard to resource allocation, we found that OCIE allocated the 91 OCIE positions approved for FY 2015 based on the percentages in the FY 2015 Congressional Budget Justification. Therefore, we have no findings or recommendations related to this evaluation objective.

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## Appendix I. Scope and Methodology

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We conducted this evaluation from January 2015 through March 2016 in accordance with the Council of the Inspectors General *Quality Standards for Inspection and Evaluation* (2012). Those standards require that we plan and perform the evaluation to obtain evidence sufficient to provide reasonable basis to support our findings and recommendations. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our evaluation objectives.

**Scope.** The evaluation covered the period of January 2011 to December 2015.<sup>26</sup> Our objective was to evaluate OCIE's efficiency and effectiveness in managing its human resources to meet its long-term goals. Specifically, we sought to determine:

- the methodology and evidence supporting OCIE's budget requests and the allocation of personnel to OCIE programs, including examinations of IAs and ICs;
- how OCIE identifies and monitors examination targets (number and types) for each OCIE program; and
- how OCIE adjusted its examination targets or resource allocations based on the SEC's FY 2015 budget approved by Congress.

We conducted fieldwork at the SEC's Headquarters in Washington, DC and coordinated with regional personnel. Although our focus was on OCIE, we also considered OFM (SEC budget process) and the Office of the Chair (SEC 2014-2018 Strategic Plan) and how these offices assisted in determining OCIE's resource needs.

**Methodology.** To gain an understanding of OCIE's policies and procedures for the development of budget requests and the allocation of personnel, we first met with personnel from the SEC's OFM, including the Chief Financial Officer. We gained an understanding of the agency's annual performance plans and how those plans relate to the SEC's strategic plan and requests for additional resources in the last few years. We reviewed OFM's reference guide for the budget formulation process (OFM Reference Guide, *Chapter 04-02 Budget Formulation and Execution: Budget Formulation Process*; December 8, 2010), and confirmed with OFM the key dates in the SEC's FY 2013, FY 2014, and FY 2015 budget formulation processes. We obtained and reviewed OCIE's budget requests for FY 2013 through FY 2015, along with documents supporting the justification for those requests. We also met with personnel from the Office of the SEC Chair, OCIE's current and former Director, Associate Directors for each of OCIE's major programs, and the SEC Investor Advocate. Additionally, we reviewed Federal laws that address the budget process and compared those laws to SEC policies and procedures.

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<sup>26</sup> We focused on OCIE's budget requests for FY 2013, FY 2014, and FY 2015. However, because the SEC's budget cycle commences about 20 months prior to the fiscal year in question, our period of review was adjusted accordingly to begin in January 2011.

To evaluate how OCIE identifies and monitors examination targets for its IA/IC program, we met with the IA/IC program Associate Director and discussed with the Associate Director OCIE's NEP priorities for the last few years. We reviewed OCIE's 2013, 2014, and 2015 NEP priorities and discussed with the Associate Director how OCIE ensures examinations meet those priorities. We obtained and reviewed available initiation memos for OCIE initiatives to identify the registrant populations, number of required examinations by regional office, and expected completion date for each initiative. Additionally, we surveyed senior management from all 11 regional offices to gain an understanding of how senior management conducts the examination candidate selection process. Specifically, we sought to determine the personnel at each regional office responsible for overseeing the process, the data or information used to select examination candidates, and the nature of the examination plan prepared to document the selections made. We contacted an OCIE committee that had assessed the regional offices' examination candidate selection processes. Moreover, we obtained the Statement of Work the SEC prepared to solicit a consultant to study the efficiency of OCIE's staffing processes. We also obtained access to a recently implemented tool called Exam Metrics and Activities to determine how OCIE senior management tracks the number of examinations performed by each of the regional offices.

The Federal laws and guidance, as well as the SEC administrative regulations, policies, and procedures we reviewed included:

**Federal Laws and Guidance:**

- *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1, Government Accountability Office (November 1999) and updated *Standards for Internal Control in the Federal Government*, GAO-14-704G, Government Accountability Office (September 2014).
- GPRA Modernization Act of 2010 (Pub.L. 111-352, 124 Stat. 3866 (2011)).
- OMB Circular A-11, *Preparation, Submission, and Execution of the Budget*, July 2014.
- Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203, 124 Stat. 1376 (2010)).
- Investment Advisers Act of 1940 (As Amended through Pub. L. 112-90, approved January 3, 2012).
- Investment Company Act of 1940 (As Amended through Pub. L. 112-90, approved January 3, 2012).
- Securities Exchange Act of 1934 (As Amended through Pub. L. 112-158, approved August 10, 2012).

**SEC Administrative Regulations, Policies, and Procedures:**

- OCIE Examination Procedures, *National Examination Program Manual*; March 30, 2015.
- OFM Reference Guide, *Chapter 04-02 Budget Formulation and Execution: Budget Formulation Process*; December 8, 2010.
- SEC Administrative Regulation, *Administrative Control Funds (SEC 12-1)*; May 28, 2014.

**Internal Controls.** We obtained an understanding of OCIE's oversight of the budget and examination candidate selection process and identified key internal controls. To gain an understanding of the SEC's management assurance process, we met with personnel from the Office of the Chief Operating Officer, which oversees the process. We obtained a copy of OCIE's FY 2014 management assurance statement and noted that management found no material weaknesses in internal controls related to OCIE. Although management identified areas for improvement, management noted that OCIE is actively working to address those areas and that those areas do not create the risk of a material weakness.

We also noted that under Section 961 of Dodd-Frank, the SEC is required to assess and report annually on internal supervisory controls for staff performing examinations. We obtained the SEC's Certifications of Internal Supervisory Controls for FY 2011 through FY 2014 and noted that management did not identify any deficiencies in internal supervisory controls.

Based on our review of the documents above, we determined that OCIE has established an effective internal control system. However, as discussed in the report, we found that improvements are needed in the IA/IC program to ensure OCIE efficiently and effectively manages its human resources to meet its long-term goals. Our recommendations, if implemented, should correct the weaknesses we identified.

**Computer-processed Data.** GAO's *Assessing the Reliability of Computer-Processed Data* (GAO-09-680G, July 2009) states that "data reliability refers to the accuracy and completeness of computer-processed data, given the uses they are intended for. Computer-processed data may be data (1) entered into a computer system or (2) resulting from computer processing." During our evaluation, the only computer-processed data that had a material impact on the evaluation's findings, conclusions, or recommendations were examination data from TRENDS.

We conducted interviews with OCIE personnel to understand how examiners document their examinations in TRENDS. We obtained access to TRENDS and conducted a walkthrough with OCIE personnel to learn about the system's reporting capabilities. To perform limited testing of the data in TRENDS, we used TRENDS to generate reports on the number of examinations conducted during the period under review. We compared that data to examination data we obtained from OCIE personnel (data

external to TRENDS). Although the comparison did not yield a perfect match, we considered the differences in data to be immaterial. Therefore, we determined that TRENDS data was sufficiently reliable for the purposes of the evaluation.

**Prior Coverage.** During the last 7 years, the SEC OIG and GAO issued two reports of particular relevance to this evaluation. Unrestricted reports can be accessed over the Internet at [http://www.sec.gov/about/offices/oig/inspector\\_general\\_audits\\_reports.shtml](http://www.sec.gov/about/offices/oig/inspector_general_audits_reports.shtml) (SEC OIG) and <http://www.gao.gov> (GAO).

SEC OIG:

- *Review of the Commission's Processes for Selecting Investment Advisers and Investment Companies for Examination* (Report No. 470, November 19, 2009).

GAO:

- *SEC Can Further Enhance Its Oversight Program of FINRA* (GAO-15-376, April 2015).

## Appendix II. Management Comments

### MEMORANDUM

TO: Rebecca L. Sharek  
Deputy Inspector General for Audits, Evaluations, and Special Projects  
Office of the Inspector General

FROM: Marc Wyatt *mw*  
Director, Office of Compliance Inspections and Examinations

RE: Office of Compliance Inspections and Examinations' Response to the Office of Inspector General's Report, *Office of Compliance Inspections and Examinations' Management of Investment Adviser Examination Coverage Goals*

DATE: March 4, 2016

The Office of Compliance Inspections and Examinations ("OCIE") submits this memorandum in response to the Office of Inspector General's ("OIG") draft report number 533 entitled *Office of Compliance Inspections and Examinations' Management of Investment Adviser Examination Coverage Goals* ("Report").

Over the past several years, OCIE has made significant improvements designed to streamline the examination process while incorporating prior OIG recommendations and building an effective system of internal control based on the elements and principles addressed in GAO's Standards for Internal Control in the Federal Government. We appreciate that the OIG acknowledged that OCIE has developed a risk-based examination strategy and made significant enhancements in data analytics and technology. We also appreciate the acknowledgment of OCIE's internal efforts to assess and improve its efficiency.

We welcome the OIG's recommendations to improve the efficiency and effectiveness of the management of our examination program. Our response to the recommendations is below.

***Recommendation 1:*** *The Office of Compliance Inspections and Examinations should (a) provide to the Office of Inspector General the results of its consultant's efficiency study when the study is complete, and (b) consider the results of the study and its Risk and Exam Process Steering Committee's recommendations to improve investment adviser/investment company program planning and staffing processes.*

OCIE concurs with this recommendation. As noted in the report, OCIE's leadership team retained a consulting firm to study OCIE's existing processes to understand ways it can improve as an organization to meet the responsibilities involved in overseeing a growing portfolio of registrants. The goal of the study is to articulate in a report realistic recommendations for improvement that will assist OCIE as it continues to meet the increasing challenges of tomorrow in the most efficient and effective manner possible. OCIE will provide the results of this study to the Office of Inspector General once the study is complete. OCIE will review the recommendations of the consultants conducting this study, as well as any recommendations from the Exam Process Steering Committee relating to each regional office's process for selecting examination candidates, once both are complete. We believe it is reasonable to

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anticipate that the recommendations made will take time to digest and will require a thoughtful, careful consideration of alternative approaches to meeting our program objectives, a consideration of budgetary constraints, consultation with multiple stakeholders, and a review of the effect, if any, implementing such recommendations may have on our existing internal controls, policy, and procedures.

***Recommendation 2:** The Office of Compliance Inspections and Examinations should consider fully implementing the Government Accountability Office's risk-management framework in the investment adviser/investment company program. The framework includes five components: (a) identifying strategic goals, objectives, and constraints; (b) identifying key aspects of potential risk; (c) considering measures to reduce identified risks; (d) selecting where resources and investments will be made based on selecting the appropriate alternatives for reducing risks; and (e) implementation and monitoring.*

OCIE concurs with this recommendation. OCIE will consider further the GAO risk-management framework and how it may implement additional aspects of this framework within its investment adviser and investment company ("IA/IC") examination program.

We believe that OCIE has made great strides over the past several years to improve its risk-based examination process and has taken steps to incorporate aspects of the GAO's risk-management framework into the IA/IC examination program. Some of these steps include establishing and publishing strategic priorities, developing a risk-based approach to assessing and selecting firms for examination, and implementing alternative measures to address risks through outreach activities.

Finally, we are pleased that the OIG found that OCIE has worked to increase its coverage of IA examinations and has increased its coverage of IAs during the previous four fiscal years. As the OIG notes in footnote 22, the staff numbers used to create Table 3 include managers, many of whom oversee multiple examinations. Once managers are excluded from these numbers, the ratio of exams-per-staff for FY 2015 increases to 4.31 (up from 3.26) and the range of the regional office ratios for FY 2015 also change by removing managers from the equation to 3.09-6.29 (instead of 2.36-4.63).<sup>1</sup> The exam by examiner metric does not adequately capture other work that impacts our examination coverage, such as desk reviews, training, and enforcement assistance. As such, this metric is one of several metrics OCIE uses to evaluate productivity.

As the report notes, there are many factors that impact the staffing and complexity of examinations, which in turn impact the number of investment advisers examined each year. These factors include, most significantly, the type and scope of examinations conducted, the size and complexity of firms examined, market events, and staffing levels. Also, as the OIG noted in its report, examinations are not conducted by a single examiner but by teams of examiners. The teams range in size, but they generally consist of 2-3 examiners. In a single year, the average examiner works on between 6 and 9 exams.

We appreciate the opportunity to review and comment on the draft report. Please contact Jane Jarcho, Deputy Director, if you have any questions.

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<sup>1</sup> The ratio of exams-per-staff for FY 2014 increased to 4.24 (up from 3.14) and the ratio of exams-per-staff for FY 2013 increased to 3.50 (up from 2.64). The range of regional office ratios for FY 2014 are 2.42-6.83 (instead of 1.77-5.13) and the range of regional office ratios for FY 2013 are 2.29-5.89 (instead of 1.70-4.48).

## Major Contributors to the Report

Carrie Fleming, Audit Manager

Juan Figueroa, Lead Auditor

John Dettinger, Auditor

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## Comments and Suggestions

If you wish to comment on the quality or usefulness of this report or suggest ideas for future audits, please contact Rebecca Sharek, Deputy Inspector General for Audits, Evaluations, and Special Projects at [sharekr@sec.gov](mailto:sharekr@sec.gov) or call (202) 551-6061. Comments, suggestions, and requests can also be mailed to the attention of the Deputy Inspector General for Audits, Evaluations, and Special Projects at the address listed above.