



July 2018

# SECURITIES REGULATION

## SEC Inspections of Financial Industry Regulatory Authority's Governance Were Consistent with Internal Guidance

# GAO Highlights

Highlights of [GAO-18-522](#), a report to congressional committees

## Why GAO Did This Study

The securities industry is generally regulated by a combination of federal and industry oversight. FINRA, a self-regulatory organization, is responsible for regulating securities firms doing business with the public in the United States. SEC oversees FINRA's operations and programs.

Section 964 of the Dodd-Frank Act includes a provision for GAO, following an initial report, to triennially review and report on aspects of SEC's oversight of FINRA. GAO issued its first report in May 2012 ([GAO-12-625](#)) and its second report in April 2015 ([GAO-15-376](#)).

This report (1) determines if SEC's oversight of FINRA included the 10 areas specified in Section 964 of the Dodd-Frank Act and (2) evaluates the extent to which selected SEC internal guidance for examinations of FINRA follows generally accepted government auditing standards and the extent to which SEC's examinations of FINRA's governance practices followed SEC internal guidance. GAO reviewed all SEC examinations relating to a Section 964 area completed since fiscal year 2015 (including five that were governance-related), reviewed certain SEC procedures used to examine self-regulatory organizations against *Government Auditing Standards*, and compared completed inspections against SEC guidance. GAO also interviewed SEC and FINRA staff.

## What GAO Recommends

GAO is not making any recommendations. SEC agreed with GAO's findings.

View [GAO-18-522](#). For more information, contact Michael Clements at (202) 512-8678 or [clementsm@gao.gov](mailto:clementsm@gao.gov).

July 2018

## SECURITIES REGULATION

# SEC Inspections of Financial Industry Regulatory Authority's Governance Were Consistent with Internal Guidance

## What GAO Found

Since fiscal year 2015, Securities and Exchange Commission (SEC) examinations of the Financial Industry Regulatory Authority, Inc. (FINRA) covered each of the 10 areas specified in Section 964 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), such as governance, funding, and transparency. The most commonly covered area was FINRA examinations of its members.

Selected SEC guidance used to examine FINRA, including requirements for planning, prefieldwork scoping, and communicating findings, was consistent with generally accepted government auditing standards, and SEC inspections of FINRA were consistent with SEC's guidance. The five governance-related inspections of FINRA that GAO reviewed were consistent with SEC guidance for planning examinations and communicating findings (see fig.). Not all the requirements were applicable (because in certain instances completion of one requirement eliminated the need to satisfy others).

**Figure: Extent to Which SEC Followed Its Requirements for Five Governance-Related Inspections It Performed of FINRA, Fiscal Years 2015–2017**

Selected areas	Inspection 1	Inspection 2	Inspection 3	Inspection 4	Inspection 5	
<b>Examination preparation</b>						
Did examiners hold the required prefieldwork examination team meeting?	●	●	●	●	●	
Did examiners document the scope of the examination?	●	●	●	●	●	
Did the Examination Manager or Assistant Director approve the examination scope?	●	●	●	●	●	
<b>Communication of examination findings</b>						
Did examiners complete the examination within the 180-day deadline?	●	●	●	●	●	
Did examiners hold the exit conference call?	●	●	—	●	—	
Did examiners issue a disposition letter and, if applicable, was voluntary corrective action taken? <sup>a</sup>	●	●	●	●	●	
Did examiners obtain requests by FINRA for an extension of time to respond to a disposition letter in writing, and were such requests approved by the Examination Manager?	●	—	—	●	—	
Did examiners read and analyze FINRA's response to the disposition letter to determine adequacy as necessary?	●	●	—	●	—	
	Yes ●	8	7	5	8	5
	Not applicable —	0	1	3	0	3

FINRA = Financial Industry Regulatory Authority, Inc.  
SEC = Securities and Exchange Commission

Source: GAO analysis of Securities and Exchange Commission documentation. | GAO-18-522

Note: The inspections evaluated the following FINRA areas: code of conduct, executive and employee compensation practices, investment portfolio, compliance resource provider, and funding for regulatory service agreements. Certain selected areas are not applicable because completion of one requirement eliminated the need to satisfy others. For instance, one inspection did not have material findings and therefore examiners did not need to hold an exit conference call.

<sup>a</sup>A disposition letter represents a deficiency, no-further-action, unresolved issue, or close-out letter.

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## Abbreviations

Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
Exchange Act	Securities Exchange Act of 1934
FINRA	Financial Industry Regulatory Authority, Inc.
FSIO	FINRA and Securities Industry Oversight
GAGAS	Generally Accepted Government Auditing Standards
NEP	National Examination Program
NFA	National Futures Association
OCIE	Office of Compliance Inspections and Examinations
SEC	Securities and Exchange Commission
SRO	self-regulatory organization

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July 18, 2018

The Honorable Michael Crapo  
Chairman  
The Honorable Sherrod Brown  
Ranking Member  
Committee on Banking, Housing, and Urban Affairs  
United States Senate

The Honorable Jeb Hensarling  
Chairman  
The Honorable Maxine Waters  
Ranking Member  
Committee on Financial Services  
House of Representatives

The securities industry is generally regulated by direct Securities and Exchange Commission (SEC) regulation and industry self-regulation with SEC oversight. Self-regulatory organizations (SRO), such as national securities exchanges and associations, perform much of the day-to-day oversight of the securities markets. SROs are primarily responsible for establishing standards under which members conduct business; monitoring the conduct of business; and bringing disciplinary actions against members for violating applicable federal statutes, SEC rules, and SRO rules. SEC oversees SROs to ensure that they carry out their regulatory responsibilities.

The Financial Industry Regulatory Authority, Inc. (FINRA) is an SRO registered with SEC as a national securities association. All securities broker-dealers doing business with the public in the United States—approximately 3,700 firms with 630,000 brokers—must be registered with FINRA.<sup>1</sup> Among other activities, FINRA writes rules to govern these firms and their representatives, examines for and enforces broker-dealer

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<sup>1</sup>The Securities Exchange Act of 1934 (Exchange Act) defines a broker as any person engaged in the business of effecting transactions in securities for the account of others, and a dealer as any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise. 15 U.S.C. § 78c(a)(4)(A) and 15 U.S.C. § 78c(a)(5)(A). A broker or dealer doing business with the public must be registered with a national securities association. As FINRA is the only national securities association for the securities industry, all brokers or dealers doing a public business must be a FINRA member.

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compliance with FINRA rules and federal securities laws, and conducts surveillance of the over-the-counter securities market. FINRA also provides regulatory services to other SROs—specifically, U.S. equities and options exchanges. Through its relationships with exchanges, FINRA conducts market surveillance on more than 99 percent of U.S.-listed equities and 50 percent of U.S.-listed options. Given the scope of FINRA’s regulatory responsibilities, ensuring that it carries out these responsibilities is critical to SEC’s mission to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.

Section 964 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) includes a provision for GAO to evaluate SEC’s oversight of national securities associations registered under Section 15A of the Securities Exchange Act of 1934 (Exchange Act), a provision that currently applies to FINRA.<sup>2</sup> Specifically, Section 964 identifies 10 aspects of SEC’s oversight of FINRA for our review:<sup>3</sup>

1. Governance of FINRA, including the identification and management of conflicts of interest.
2. Examinations performed by FINRA, including the expertise of examiners.
3. Executive compensation practices of FINRA.
4. Arbitration services provided by FINRA.
5. Reviews performed by FINRA of advertising by its members.
6. Cooperation with and assistance to state securities regulators by FINRA.

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<sup>2</sup>Pub. L. No. 111-203, § 964(a), 124 Stat. 1376, 1910 (2010). The National Futures Association (NFA) is also registered as a national securities association, as specified in Section 15A(k) of the Exchange Act, but only for the limited purpose of regulating the activities of NFA members registered as brokers or dealers in security futures products under Section 15(b)(11) of the Exchange Act. Because the Commodity Futures Trading Commission is NFA’s primary regulator (SEC has limited direct oversight of NFA), GAO does not consider NFA to fall under the provision to evaluate SEC oversight of national securities associations in Section 964.

<sup>3</sup>Section 964 also states that we may include any other issues that have an impact, as determined by the Comptroller General, on the effectiveness of such national securities associations in performing their mission and in dealing fairly with investors and members.

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7. Use of funding to support FINRA's mission, including the methods and sufficiency of funding, how FINRA invests funds pending use, and the impact of these aspects on FINRA's regulatory enforcement.
  8. Policies on the employment of former employees of FINRA by regulated entities.
  9. Effectiveness of FINRA's rules.
  10. Transparency of FINRA's governance and activities.

Section 964 also specified that GAO was to conduct an initial review no later than 2 years after the enactment of the Dodd-Frank Act and every 3 years thereafter. We issued our first report in 2012 and the second in 2015.<sup>4</sup> The first report examined how SEC conducted oversight of FINRA and planned to enhance such oversight and the second report included an examination of SEC's implementation of a risk-based framework for overseeing FINRA.

This report generally focuses on SEC oversight of FINRA's governance. Specifically, this report (1) determines if SEC oversight of FINRA operations and programs since fiscal year 2015 included the 10 areas specified in Section 964 of the Dodd-Frank Act, (2) evaluates the extent to which selected SEC internal guidance on conducting examinations of FINRA follows generally accepted government auditing standards, and (3) evaluates the extent to which SEC examinations of FINRA's governance practices followed SEC's internal guidelines.<sup>5</sup>

To assess SEC oversight of FINRA since fiscal year 2015 as it relates to Section 964 areas, we requested and reviewed materials for SEC examinations (a term we use to include program inspections, examinations, and oversight activities stemming from tips and referrals) that addressed those areas. To determine the extent to which selected SEC internal guidance for FINRA examinations followed generally accepted government auditing standards, we compared the current version of SEC's internal guidance (examination manual) to an earlier

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<sup>4</sup>GAO, *Securities Regulation: Opportunities Exist to Improve SEC's Oversight of the Financial Industry Regulatory Authority*, [GAO-12-625](#) (Washington, D.C.: May 30, 2012), and *Securities Regulation: SEC Can Further Enhance Its Oversight of FINRA*, [GAO-15-376](#) (Washington, D.C.: Apr. 30, 2015).

<sup>5</sup>It is implied but not required that SEC review the 10 areas specified in Section 964 of the Dodd-Frank Act.

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version that we previously determined had done so.<sup>6</sup> Any differences or additions were then assessed for compliance with government auditing standards. To determine the extent to which SEC's program inspections of FINRA's governance (in fiscal years 2015–2017) followed SEC's internal guidance, we compared SEC internal guidance (examination manual) with examination documents that included scope memorandums, letters to FINRA describing any deficiencies found, and closing letters to the file explaining disposition of examinations.<sup>7</sup> We only reviewed the extent to which examinations followed specified guidelines and did not evaluate the analysis, findings, or disposition of the examinations. We also interviewed SEC staff about the examination process and documentation requirements.<sup>8</sup>

We conducted this performance audit from November 2017 to July 2018 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Background

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### SEC Examinations of FINRA

The Office of Compliance Inspections and Examinations (OCIE) administers SEC's nationwide examination and inspection program for registered SROs, broker-dealers, transfer agents, clearing agencies, investment companies, and investment advisers. OCIE conducts examinations and inspections to improve compliance, prevent fraud, monitor risk, and inform policy. Individual groups in OCIE have oversight responsibility for the various registered entities. The FINRA and Securities Industry Oversight (FSIO) program within OCIE performs

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<sup>6</sup>For the auditing standards, see GAO, *Government Auditing Standards*, [GAO-12-331G](#) (Washington, D.C.: Dec. 1, 2011). We also reviewed draft changes to the current version of the examination manual that had not yet been approved by SEC officials but were in use by SEC examiners.

<sup>7</sup>SEC conducted five program inspections that met our review criteria from fiscal years 2015–2017.

<sup>8</sup>For more information about our scope and methodology, see appendix I.



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examinations of FINRA and the Municipal Securities Rulemaking Board, an SRO that regulates the municipal bond market.<sup>9</sup>

As part of its FINRA oversight activities, FSIO conducts four types of reviews that may involve Section 964 areas.

- Program inspections are reviews of FINRA operations and program areas (for example, FINRA's review of applications by broker-dealers seeking to become members).
- Oversight examinations are single, stand-alone examinations of specific examinations that FINRA conducts of its member firms. FSIO initiates an oversight examination when its examinations of a broker-dealer find deficiencies FSIO believes should have been identified by FINRA in its own examination of the broker-dealer.
- Thematic oversight examinations are a series of oversight examinations that evaluate FINRA's review of a particular regulatory area across a number of its member firms.
- Tips, complaints, and referrals are allegations or statements of concern about possible violations of securities laws or risky conduct received by SEC. FSIO reviews FINRA-related tips, complaints, and referrals by evaluating facts and circumstances and conducting background research. The reviews may result in FINRA-related inspections or examinations or may be used for inspection planning purposes.

To help identify the FINRA programs and topics that it will review, FSIO uses a risk-based approach that includes an annual assessment of high-

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<sup>9</sup>FSIO was formed in 2016. Previously, the Market Oversight group within OCIE performed inspections of FINRA, while a separate group conducted FINRA oversight examinations. For the purposes of this report, we generally refer to FSIO as the group responsible for FINRA oversight during the period we reviewed.

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risk areas and consideration of the areas specified in Section 964.<sup>10</sup> According to SEC staff, FSIO also conducts ongoing monitoring of FINRA's activities through reviews of information provided by FINRA and meetings with FINRA officials.

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## Standards Useful for Assessing Examination Policies and Procedures

Generally accepted government auditing standards define performance audits as those that provide findings or conclusions based on an evaluation of sufficient, appropriate evidence against criteria.<sup>11</sup> Performance audit objectives can include assessments of program effectiveness, economy, and efficiency; internal control; compliance; and prospective analyses.<sup>12</sup>

SEC's examinations of SROs share many of the attributes of performance audits, including their objectives. For example, examinations (including inspections) of FINRA enable FSIO staff to evaluate compliance with applicable laws and regulations; FINRA rules, regulations, or by-laws; or both. Although SEC is not required to follow the auditing standards when examining SROs, these standards and guidance provide a framework for conducting high-quality reviews that can serve as useful criteria in evaluating a regulatory agency's examination or inspection programs.

Areas of generally accepted government auditing standards relevant to SRO examinations include independence, competence, quality control and assurance, planning, supervision, evidence, documentation, and reporting:

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<sup>10</sup>Our prior reviews of SEC's oversight of FINRA assessed the development and implementation of OCIE's risk-assessment framework. See [GAO-12-625](#) and [GAO-15-376](#). These reports included three recommendations for SEC to improve its oversight of FINRA by (1) encouraging FINRA to conduct retrospective reviews of its rules and establishing a process to examine the reviews; (2) following all elements of a risk-management framework in developing an enhanced risk-based approach to FINRA oversight; and (3) incorporating additional risk-management practices, including establishing specific performance goals and measures, formalizing documentation of procedures, and requiring an assessment of internal risks to successfully meeting the program's goals and objectives. In 2014, FINRA implemented a retrospective rule review program and SEC established a process for examining FINRA's reviews. Consequently, we determined that SEC had implemented the first recommendation. Although it has taken some steps, SEC needs to take additional actions to fully implement the remaining recommendations.

<sup>11</sup>See [GAO-12-331G](#), 2.10, chapter 2.

<sup>12</sup>[GAO-12-331G](#), 2.11, chapter 2.

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- Independence refers to the audit organization and individual auditor's need to be independent and include documentation proving independence.
  - Competence refers to the extent to which audit staff collectively should possess adequate professional competence and technical knowledge, skills, and expertise.
  - Quality control and assurance refers to a system of quality control that an organization should establish that is designed to provide the organization with reasonable assurance that its personnel comply with professional standards and legal requirements.
  - Planning includes creating a written audit plan for each audit.
  - Supervision requirements include sufficient guidance and direction to the staff assigned to the audit to address the audit objectives and follow applicable requirements, while staying informed about significant problems encountered, reviewing the work performed, and providing effective on-the-job training.
  - Evidence refers to sufficient, appropriate evidence to provide a reasonable basis for the auditor's findings and conclusions.
  - Audit documentation requirements state that auditors must prepare documentation related to planning, conducting, and reporting for each audit.
  - Finally, communication of the results entails auditors issuing audit reports.

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## SEC's FINRA Oversight Activities Covered Key Areas Identified in the Dodd- Frank Act

Since fiscal year 2015, SEC examinations related to FINRA included reviews of all areas identified in Section 964. We determined that FSIO completed at least one examination covering each of the Section 964 areas since fiscal year 2015 (see table 1). In total, FSIO began or completed 61 examinations (program inspections, oversight examinations, and thematic oversight examinations) related to FINRA programs and operations in that period. Some examinations evaluated other aspects of FINRA's programs and operations (those not specifically identified in Section 964), such as market surveillance and restitution for harmed investors.

**Table 1: SEC Oversight of FINRA by Areas Identified in Section 964 of the Dodd-Frank Act, October 2014–April 2018**

	Program inspections <sup>a</sup>		Oversight examinations <sup>b</sup>		Total
	Open	Closed	Open	Closed	
<b>Total<sup>c</sup></b>	<b>8</b>	<b>19</b>	<b>17</b>	<b>17</b>	<b>61</b>
<b>By Section 964 area</b>					
Governance	–	5	–	–	<b>5</b>
Examinations performed by FINRA	3	5	17	16	<b>41</b>
Executive compensation	–	1	–	–	<b>1</b>
Arbitration services	–	2	–	–	<b>2</b>
Review of member advertising	–	–	–	2	<b>2</b>
Cooperation with state securities regulators	–	2	–	–	<b>2</b>
Funding	–	4	–	–	<b>4</b>
Policies on former employees	–	1	–	–	<b>1</b>
Effectiveness of FINRA's rules	–	1	–	–	<b>1</b>
Transparency of governance and activities	1	2	–	–	<b>3</b>
Other <sup>d</sup>	6	9	–	1	<b>16</b>

Legend: FINRA = Financial Industry Regulatory Authority, Inc.; SEC = Securities and Exchange Commission; Dodd-Frank Act = Dodd-Frank Wall Street Reform and Consumer Protection Act; OCIE = Office of Compliance Inspections and Examinations; FSIO = Financial Industry Regulatory Authority, Inc. and Securities Industry Oversight Examination Program

Source: GAO analysis of Securities and Exchange Commission documentation. | GAO-18-522

<sup>a</sup>Program inspections are reviews of FINRA operations and program areas.

<sup>b</sup>These include single, stand-alone reviews of specific examinations that FINRA conducts of its member firms as well as thematic oversight examinations that evaluate FINRA's review of a particular regulatory area across a number of its member firms. The figures in this table do not include individual oversight examinations that together comprise a thematic oversight examination. According to SEC staff, OCIE includes the underlying oversight examinations in its public reporting of examination statistics. The table also does not include any single oversight examinations that OCIE may have conducted prior to the formation of FSIO in 2016.

<sup>c</sup>This row represents the total number of discrete inspections and examinations. Some inspections and examinations covered multiple Section 964 areas. As a result, column totals for the Section 964 areas do not sum to the total.

<sup>d</sup>These reviews examined FINRA programs and operations in areas other than those specified in Section 964 of the Dodd-Frank Act. Seven inspections and one examination covered only areas not identified in Section 964. Eight inspections also covered at least one Section 964 area.

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FSIO examinations either focused on a single Section 964 area or considered multiple areas.<sup>13</sup>

- Some examinations focused specifically on a single Section 964 area. For example, in 2017 FSIO reviewed FINRA’s arbitration program, which provides retail investors a venue for resolving disputes with their brokers.
- Other examinations considered one or more of the areas as part of a broader scope. For instance, a program inspection completed in 2016 touched on FINRA’s arbitration services, cooperation with state securities regulators, transparency, and other topics. Another program inspection involved governance, policies on former employees, and other topics.
- FSIO examinations most frequently covered FINRA examinations (41 of 61). Nearly all of the oversight examinations reviewed at least some aspect of FINRA examinations. In two cases, the oversight examinations also covered another area—review of advertising by FINRA members.

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<sup>13</sup>From 2011 through 2013, OCIE completed program inspections specific to each of the Section 964 areas. According to staff, OCIE conducted the inspections to establish a baseline understanding of FINRA’s practices in the areas. Since the initial reviews, SEC has not conducted comprehensive reviews of each Section 964 area but instead has incorporated oversight of certain areas into inspections of FINRA programs—or conducted inspections of individual review areas—based on its risk-assessment framework. Also see [GAO-15-376](#).

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## Selected Guidance Used for FINRA Governance Inspections Generally Was Consistent with Relevant Auditing Standards

We found that OCIE policies and procedures used for examining FINRA since fiscal year 2015 generally were consistent with the requirements of generally accepted government auditing standards. SEC uses an examination manual to conduct its SRO examinations.<sup>14</sup> We previously found that OCIE policies and procedures (including the prior version of the manual) generally were consistent with the requirements of the auditing standards that we determined were most relevant to assessing examination policies and procedures: independence, competence, quality control and assurance, planning, supervision, evidence, documentation, and reporting.<sup>15</sup>

We compared the current and prior versions of the examination manual. More specifically, we selected requirements for planning, prefieldwork scoping, and communicating findings from the current manual and compared those with similar sections in the prior version of the manual.<sup>16</sup> We found that the new version includes the same material as the prior version while also incorporating additional guidance in certain areas. The planning section of the current version includes two additional requirements on the inclusion of non-National Examination Program staff.<sup>17</sup> The communicating findings section of the current version included two additional requirements related to extensions of time to respond to disposition letters. Two of the four additional requirements were generally consistent with government auditing standards, and the remaining two additional requirements were minor adjustments that did not materially change the requirements. Therefore, we deemed the selected sections of the current version of the manual to also be consistent with the auditing standards.

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<sup>14</sup>While the manual establishes the framework of policies pursuant to which examinations are conducted, it indicates that the specific facts and circumstances of individual examinations may require that alternative procedures be used.

<sup>15</sup>[GAO-15-376](#). Generally Accepted Government Auditing Standards, also known as GAGAS, apply to audits and attestation engagements of government entities, programs, activities, and functions when the use of GAGAS is required or voluntarily followed.

<sup>16</sup>For more information on our methodology for selecting requirements, see appendix I.

<sup>17</sup>The National Examination Program's (NEP) mission is to protect investors, ensure market integrity, and support responsible capital formation through risk-focused strategies that: (1) improve compliance; (2) prevent fraud; (3) monitor risk; and (4) inform policy. The results of NEP's examinations are used by SEC to inform rule-making initiatives, identify and monitor risks, improve industry practices, and pursue misconduct.

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## Inspections of FINRA Governance Were Consistent with SEC Internal Guidance

OCIE (and from 2016, FSIO) program inspections of FINRA governance in fiscal years 2015–2017 were consistent with internal examination guidance.<sup>18</sup> OCIE identified five inspections in that period that related to FINRA governance. Each of the inspections focused on one of the following areas: (1) code of conduct, (2) executive and employee compensation practices, (3) investment portfolio, (4) compliance resource provider program, and (5) the funding mechanism for its regulatory services agreement.<sup>19</sup>

- FINRA’s code of conduct imposes restrictions on employees’ investments and requires financial disclosures that are uniquely related to its role as a securities regulator. The code also outlines FINRA’s ethical commitments and expectations and provides guidance on what employees must do to meet them.
- FINRA’s executive and employee compensation practices consist of salary and incentive compensation determined by FINRA’s Management Compensation Committee using operational, strategic, and financial factors, in addition to individual performance.
- FINRA’s investment portfolio is governed by a policy based on the degree of risk appropriate for FINRA assets, as applied by its board to its investment objectives.
- In the compliance resource provider program, FINRA worked with organizations to offer firms compliance-related products and services at a discounted price or with additional features. According to FINRA staff, this program was discontinued in May 2017 and replaced with FINRA’s Compliance Vendor Directory.
- FINRA’s regulatory service agreements are designed to provide market surveillance, financial surveillance, examinations, investigations, and disciplinary services to other entities, including the New York Stock Exchange LLC and the Chicago Board Options Exchange.

For our review, we judgmentally selected the most relevant requirements from the section of the examination manual related to planning inspections and the most relevant requirements from the section of the

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<sup>18</sup>We selected governance because it was 1 of the 10 areas in Section 964 of the Dodd-Frank Act that we had not previously examined in depth.

<sup>19</sup>We obtained information on the FINRA inspection areas from FINRA’s website (<http://www.finra.org>), with the exception of the discontinuance of the compliance resource provider program. We obtained that information from FINRA officials.

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manual related to communicating inspection findings to determine if OCIE conducted the inspections in accordance with its guidance.

- The planning section covers planning examinations and prefieldwork scoping and requires the examination team to discuss the results of background research and determine an appropriate scope for the examination as early as possible.
- The communicating findings section requires entities to be provided with timely and concise communications on the results. It also discusses how examination staff should take further actions for those findings that could involve notifications to other regulators.

We reviewed relevant inspection-related documentation (including scope memorandums, disposition letters, emails, and information extracted from an examination database) and compared them against the selected requirements to determine if the guidance was followed. We tallied our results with a scorecard methodology (see fig. 1).<sup>20</sup>

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<sup>20</sup>For more information about our scope and methodology, see appendix I.



**Figure 1: Extent to Which SEC Followed Its Requirements for Five Governance-Related Inspections It Performed of FINRA, Fiscal Years 2015–2017**

Selected areas	Inspection 1	Inspection 2	Inspection 3	Inspection 4	Inspection 5
<b>Examination preparation</b>					
Did examiners hold the required prefieldwork examination team meeting?	●	●	●	●	●
Did examiners document the scope of the examination?	●	●	●	●	●
Did the Examination Manager or Assistant Director approve the examination scope?	●	●	●	●	●
Were modifications to the scope approved by the Examination Manager or Assistant Director?	—	—	—	—	—
If non-National Examination Program staff, including enforcement staff, participated in the examination, were relevant procedures (such as approvals, disclosures, etc.) followed?	—	—	—	—	—
<b>Communication of examination findings</b>					
Did examiners complete the examination within the 180-day deadline?	●	●	●	●	●
Did examiners hold the exit conference call?	●	●	—	●	—
Did examiners issue a disposition letter and, if applicable, was voluntary corrective action taken? <sup>a,b</sup>	●	●	●	●	●
Did examiners obtain requests by FINRA for an extension of time to respond to a disposition letter in writing, and were such requests approved by the Examination Manager?	●	—	—	●	—
Did examiners read and analyze FINRA's response to the disposition letter to determine adequacy as necessary?	●	●	—	●	—
Did examiners escalate any inadequate disposition letter responses as necessary?	—	—	—	—	—
Did examiners decline any questions about how best to respond to a disposition letter as necessary?	—	—	—	—	—
	8	7	5	8	5
	4	5	7	4	7

FINRA = Financial Industry Regulatory Authority, Inc.  
 SEC = Securities and Exchange Commission

Yes ●  
 Not applicable —

Source: GAO analysis of Securities and Exchange Commission documentation. | GAO-18-522

Note: The inspections evaluated the following FINRA areas: code of conduct, executive and employee compensation practices, investment portfolio, compliance resource provider, and funding for regulatory service agreements. Certain selected areas are not applicable because completion of one requirement eliminated the need to satisfy others. For instance, one inspection did not have material findings and therefore examiners did not need to hold an exit conference call.

<sup>a</sup>A disposition letter represents a deficiency, no-further-action, unresolved issue, or close-out letter.

<sup>b</sup>SEC staff told us there was no formal requirement to secure corrective action.

We found that all five inspections we reviewed met all requirements applicable to that particular inspection. For example, across all the inspections, OCIE examiners held prefieldwork meetings and documented and received approval for the scope of the examinations. Additionally, all five inspections met the required 180-day completion deadline and closed the inspection with a disposition letter. In cases in which requirements were not applicable, the reasons generally were that a triggering event had not occurred and no further action was needed. For instance, the scope was not modified in any of the inspections, so the requirement for approval of such modifications did not apply. Furthermore, none of the inspections included non-National Examination

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Program staff (such as personnel from SEC's Enforcement Division), and so requirements surrounding participation by those groups did not apply.

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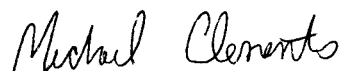
## Agency Comments

We provided a draft of this report to SEC for their review and comment. In its comment letter, which is reprinted in appendix II, SEC concurred with our findings and appreciated our attention to the issues discussed in the report. SEC also provided technical comments on the draft report, which we incorporated as appropriate.

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We are sending copies of this report to the appropriate congressional committees, the Securities and Exchange Commission, the Financial Industry Regulatory Authority, Inc., and other interested parties. In addition, this report is available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or [clementsm@gao.gov](mailto:clementsm@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix III.



Michael Clements  
Director, Financial Markets and Community Investment

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# Appendix I: Objectives, Scope, and Methodology

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This report (1) determines if the Securities and Exchange Commission's (SEC) oversight of the Financial Industry Regulatory Authority, Inc.'s (FINRA) operations and programs since fiscal year 2015 included the 10 areas specified in Section 964 of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), (2) evaluates the extent to which selected SEC internal guidance on conducting examinations of FINRA follows generally accepted government auditing standards, and (3) evaluates the extent to which examinations of FINRA's governance practices followed SEC's internal guidance.

To assess whether oversight of FINRA by SEC's Office of Compliance Inspections and Examinations (OCIE) included the Section 964 areas, we requested and reviewed documentation for all examinations since fiscal year 2015 (from October 2014 through April 2018) that OCIE staff identified as relating to Section 964 areas.<sup>1</sup> We use the term "examination" to include program inspections, two types of oversight examinations, and oversight activities stemming from tips and referrals.<sup>2</sup> The documentation included scope memorandums, deficiency letters, and closing letters to the file for OCIE examinations. We evaluated whether the documentation indicated that an examination's scope and findings covered one or more Section 964 areas or included other areas related to FINRA oversight that were not specified in Section 964.

To determine the extent to which OCIE's internal guidance on conducting examinations of FINRA followed generally accepted government auditing standards, we compared SEC's examination manual against generally

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<sup>1</sup>More specifically, the FINRA and Securities Industry Oversight (FSIO) program within OCIE currently performs examinations of FINRA and the Municipal Securities Rulemaking Board, a self-regulatory organization that regulates the municipal bond market. FSIO was formed in 2016. Previously, the Market Oversight group within OCIE performed inspections of FINRA, while a separate group conducted FINRA oversight examinations.

<sup>2</sup>As part of its FINRA oversight activities, OCIE conducts four types of review activities that may involve Section 964 areas: (1) Program inspections are reviews of FINRA operations and program areas. (2) Oversight examinations are single, stand-alone reviews of examinations that FINRA conducts of its member firms. OCIE initiates an oversight examination when its examination of a broker-dealer finds deficiencies OCIE believes should have been identified by FINRA in its own examination of the broker-dealer. (3) Thematic oversight examinations are a series of examinations that evaluate FINRA's review of a particular regulatory area across a number of its member firms. (4) Reviews of FINRA-related tips, complaints, and referrals are evaluations of the associated facts and circumstances and also involve background research. The reviews may result in FINRA-related inspections or examinations or may be used for inspection planning purposes.

accepted auditing standards.<sup>3</sup> We reviewed selected sections of the current version of the manual and the earlier version. We judgmentally selected the two sections that most directly related to our focus on self-regulatory organization (SRO) inspections, which focused on preparing for examinations and communicating examination findings. Other areas of the examination manual that were not relevant focused on administration and organizational issues. We relied on our work that found that the earlier version of the manual followed the auditing standards and also interviewed pertinent staff within OCIE to discuss the guidance and why it did or did not include certain elements.<sup>4</sup> We analyzed any differences between the versions to determine whether changes or additions in the current version of the manual also followed auditing standards. In addition, we interviewed FINRA staff to gain a general understanding of how OCIE staff work with them to conduct examinations.

To determine the extent to which OCIE's program inspections of FINRA's governance in fiscal years 2015–2017 followed OCIE's internal guidance, we used a scorecard methodology to compare inspections of FINRA's governance with the examination manual and draft updates.<sup>5</sup> We only reviewed the extent to which examinations followed specified guidelines and did not evaluate the analysis, findings, or disposition of the examinations. We created a checklist of relevant elements from the examination manual by judgmentally selecting 6 requirements from the planning inspections section of the manual and 11 requirements from the communicating findings section of the manual that were most applicable to our focus on the actual SRO inspection process. Other requirements that we deemed less relevant include examinations of exempt reporting advisers and the process for approving examination documents.

- The planning section of the manual covers planning examinations and prefieldwork scoping and requires the examination team to discuss

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<sup>3</sup>For the auditing standards, see GAO, *Government Auditing Standards*, [GAO-12-331G](#) (Washington, D.C.: Dec. 1, 2011).

<sup>4</sup>For our prior work on SEC oversight of FINRA and Section 964 areas, see GAO, *Securities Regulation: SEC Can Further Enhance Its Oversight of FINRA*, [GAO-15-376](#) (Washington, D.C.: Apr. 30, 2015).

<sup>5</sup>There were a total of five inspections that met the criteria of both reviewing FINRA governance and concluding during fiscal years 2015–2017. SEC's most recent updates to the examination manual are still in draft status. That is, the updates had not yet been approved by SEC officials but were in use by SEC examiners.

the results of background research and determine an appropriate scope for the examination as early as possible.

- The communication of examination findings section requires entities to be provided with timely and concise communications on the results. It also discusses how examination staff should take further actions for those findings that could involve notifications to other regulators.

We then reviewed different types of inspection-related documentation to determine whether the guidance was followed. For instance, we assessed certain inspection requirements, such as compliance with changing the scope of the inspection, based on formal written documentation such as scope memorandums and disposition letters. We assessed other requirements (such as whether prefieldwork team meetings were held) based on informal documentation, such as email appointments. We also relied on other internal documentation, which included the examination tracking database, which is used to certify compliance with a requirement to complete an inspection within 180 days from the completion of audit work.

Two analysts then independently compared the elements against documentation for the five OCIE inspections to determine the extent to which the inspections documented the requirements outlined in the examination manual. Analysts assigned a rating of “yes” if the element was found in the inspection materials we reviewed, “no” if there was no mention of the element in the inspection materials we reviewed, “partially” if the element was not fully addressed in the inspection materials we reviewed, and “n/a” if the element was not applicable to the inspection. We also interviewed pertinent staff within OCIE to discuss the guidance and why it did or did not include certain elements.

We conducted this performance audit from November 2017 to July 2018 in accordance with generally accepted government auditing standards. These standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

# Appendix II: Comments from the Securities and Exchange Commission



OFFICE OF COMPLIANCE  
INSPECTIONS AND  
EXAMINATIONS

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

June 28, 2018

Michael Clements  
Director  
Financial Markets and Community Investment  
United States Government Accountability Office  
441 G Street NW  
Washington, DC 20548

Dear Mr. Clements:

Thank you for the opportunity to review the U.S. Government Accountability Office's (GAO) draft report entitled Securities Regulation: SEC Inspections of FINRA Governance Were Consistent with Internal Guidance (GAO-18-522). We are pleased that the GAO found the SEC staff complied with internal guidance and is not making any recommendations to the SEC.

We appreciate the GAO's attention to these important issues.

Sincerely,

A handwritten signature in blue ink that reads "Peter Driscoll" followed by a stylized initial "KCS".

Peter B. Driscoll  
Director - OCIE

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# Appendix III: GAO Contact and Staff Acknowledgments

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## GAO Contact

Michael Clements, (202) 512-8678 or [clementsm@gao.gov](mailto:clementsm@gao.gov)

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## Staff Acknowledgments

In addition to the contact named above, Karen Tremba (Assistant Director), Jon D. Menaster (Analyst in Charge), Kevin Averyt, Farrah Graham, Marc Molino, Akiko Ohnuma, Barbara Roesmann, and Jessica Sandler made key contributions to this report.

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