

Securities and Exchange Commission Historical Society

Fireside Chat

SEC Office of Compliance Inspections and Examinations

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THERESA GABALDON: Good afternoon and welcome to today's broadcast of the Fireside Chats, presented by the Securities and Exchange Commission Historical Society and broadcast on www.sechistorical.org. I am Theresa Gabaldon, Lyle T. Alverson Professor of Law at The George Washington University School of Law and moderator of the Fireside Chats.

The SEC Historical Society preserves and shares the history of securities regulation through its virtual museum and archive at www.sechistorical.org. The museum is free and accessible worldwide at all times and is on track to welcome 100,000 visitors this year. The virtual museum and archive as well as the Society are separate from and independent of the U.S. Securities and Exchange Commission and receive no government funding. We thank Pfizer Inc., for its sponsorship of the 2008 Fireside Chat season. Its support, along with gifts and grants from many other institutions and individuals, make possible the growth and outreach of the virtual museum and archive.

Today's program is one in a series of Fireside Chats looking at the distinctive history and work of many of the major SEC divisions and offices. This series is a part of the Society's commemoration of the 75th anniversary of the SEC in 2009. During this year, the Fireside Chats have looked at the work of the SEC Office of the General Counsel, the Office of International Affairs, the Regional Offices and the Division of Enforcement. The Society's Annual Meeting looked at the Division of Investment Management. All of these programs can be accessed again in the Online Programs section of the museum. At the end of today's chat, I will give you a preview of the Fireside Chats scheduled for next winter and spring.

Today's Fireside Chat looks at the SEC Office of Compliance, Inspections and Examinations, popularly known as OCIE. I am delighted to welcome John Walsh, OCIE's Chief Counsel. John assisted some of the museum's earliest programs on the Special Study of Securities Markets and on Enforcement. It's good to have him participate in making history today as well as recording it. John's remarks today are solely his own and are not representative of the opinions of the Society. He cannot give legal or investment advice. John, welcome.

JOHN WALSH: Thank you. It's a pleasure to be here.

THERESA GABALDON: I was hoping that you might be able to start us off today with a description of what it is that OCIE does?

JOHN WALSH: I would be happy to do that, though of course before I do, I need to give my own standard disclaimer that not only do I not necessarily represent the opinions of the Society, I do not necessarily represent the views of the Commission, the Commissioners or my colleagues on the Commission staff.

What does OCIE do? It is first and fundamentally a law enforcement program. The Commission has divided law enforcement into two parts, to some of the popular terminology of the day. I think with the Division of Enforcement it has a program that looks to the outcomes to the results of what people do. With OCIE, it looks to more preventive to get in before people have violated the law and hopefully to help prevent them from violating the law. To do this, we do examinations of broker dealers, investment advisors, investment companies, transfer agents, self regulatory organizations, exchanges, clearing agencies - the list goes on. More recently we have added PCAOB and rating agencies and if I have forgotten any types of registrants I apologize. In doing these examinations we are a field office, we go out, we deal directly with the firms, we gather evidence and we look for problems or potential problems. That's our fundamental mission.

THERESA GABALDON: I have had several questions from students over the years about just how it is that OCIE differs from the Division of Trading and Markets and the Division of Investment Management. Could you help us out with that?

JOHN WALSH: In fact until 1995, when OCIE was created, the examination function was in Trading and Markets or at that point known as Market Regulation and the Division of Investment Management. The major difference between us is as a field organization we are out visiting the registered firms. We are going to their offices, we are looking at their books and records, we are interviewing their staff and then we are making observations or as we call them findings, not the findings of the Commission but we typically call them findings. That we will then put into a report and put into a deficiency letter to the firm. So we are working directly with that firm. The Division of Trading and Markets and Investment Management - they are more on the regulatory side. They are drafting rules, they are issuing opinions and interpretive guidance. They are more on the regulatory side while we are on the field side. But I can tell you, we cooperate with them very carefully. We have a number of different programs in place to make sure that we are completely in sync as to what we are doing and what they would want us to do. They are involved in our planning memos as we decide what we are going to do. They are involved in our examination modules as to how we will look at particular issues. When we have a new initiative they will review the plans that we have for those initiatives and actually because of electronic records they have a level of review today that I don't think anyone had in the past because we can actually give them access to our electronic exam reports. So people in Trading and Markets and Investment Management today can use Boolean Logic searches to see exactly what the exam program is doing and has been doing. I think we are very tightly coordinated with, but the dividing line is we are out in the field and they are running regulatory programs in headquarters.

THERESA GABALDON: I think it might or might not be helpful, if you could tell us a bit about what the difference is between a Division and an Office? And does that have anything to do with your relationship with the Division of Trading and Markets or the Division of Investment Management?

JOHN WALSH: I think the short answer to the last question is no. And the difference between an Office and a Division I think has no operational significance at all or at least if it does in all the years I have been with the agency I have never noticed it. As a technical matter, I believe, generally the Divisions are seen to be more covering a number of different areas and the Offices tend to be focused in on a particular issue, for example the Office of General Counsel, a very important Office, does a lot of different

things but because they are the in-house lawyers for the Commission they are in Office rather than a Division as I understand it. It's the same thing for OCIE but because we are focused on examinations we are in office. I have to admit it, if you were to go around and take a poll of SEC staff you probably will get different answers from all of them, I am not really sure but the difference is someone somewhere may know exactly what the difference is but I do not.

THERESA GABALDON: I had always wondered and had not remembered to ask until just now.

JOHN WALSH: Well, when we first started back in the mid '90s I asked the same question about what's the difference an examination and an inspection and I talked with people and ultimately at the end of the day I realized there really is no difference, they are all examinations but over time simply as a matter of usage some of them are now called inspections. But technically if you look at the statutes they are all actually examinations.

THERESA GABALDON: I had sort of fancied that perhaps examinations or what happened was people brought information to you, and inspections when you went to them.

JOHN WALSH: I like that, that's actually a good explanation ... very creative, but unfortunately that's not it.

THERESA GABALDON: You mentioned that OCIE was founded in 1990s. Could you tell us a little bit about the motives for splitting it out then?

JOHN WALSH: This was when Chairman Levitt was Chairman of the Commission and the agency encountered some difficult issues in relation to market makers. These were the issues that resulted in the 21(a) report that the Commission issued. Chairman Levitt decided that he wanted the examination program to have more management focus, more people focusing exclusively on exams for their own sake and thinking what can we do to make sure that exams are functioning well and performing as they should. He also wanted an examination program that, as I recall his words, quote, "Didn't pull any punches... don't pull any punches." I think these two goals, management focus and being hard hitting, not pulling any punches are really what has animated the examination program ever since. Now in terms of taking these strategic goals and playing them out into how we actually run the office, I think there are a couple of different things. One is programmatic effectiveness, examinations are different; they are not investigations, they are not regulatory work of issuing a no action Letter or something like that, they occupy their own space and so having an office that was concerned just with that made a lot of sense just as having an office just concerned with enforcement investigations made a lot of sense. We put a lot of time and effort over the years into doing that, training, planning, getting examiners together to talk about shared experiences and so on and other goals, managerial efficiency between 20 and 25% of the agencies in the examination program and it made sense to pull that all together into one place so it could be managed effectively. We have opened up some new program areas like risk assessment, technology and so on that is more efficient and works across the entire program because we have that economy of scale. I think one of the key visions that Chairman Levitt had in that we continue to work towards is that the securities industry is growing together. In the old days when a broker was in his box over here and did just

broker things and an advisor was in a advisor box over there and just did advisor things, those days are gone and to really understand the industry we need to look across all of these different types of registrants and that's something else we have been doing.

And finally I think to make sure that people understand what we do to have more outreach to the industry and to be more transparent so people understand who we are. Most of our work is non-public, examinations are non-public, so in the absence of affirmative outreach the only contact you would have with the program is what we do when we come in to see you and we are trying to broaden that more so people understand better what we are up to. But the bottom line I think that Chairman Levitt really animated this decision was the management focus in that they don't pull any punches.

THERESA GABALDON: A relative new baby for the Commission. Was OCIE tenderly nurtured and given lots of resources to do the things that it was expected to do?

JOHN WALSH: I think that the most important thing it's gotten and I think it's gotten this consistently through the years, it's gotten the support of the Chairman, it's gotten the support of the Commissioners. The reality is and we recognize this, nobody likes to be examined. Sometimes registrants are very nice and at the end an examination they will say, "Thank you very much, we appreciate your comments." But the reality is, nobody really likes somebody coming in, digging around through their firm looking for risks or looking for problems. I am aware of Chairmen and Commissioners who have said, "You know we didn't get complaints from time to time about all these pesky questions, we would wonder whether you were doing your job." But at the end of the day they have given us that support and I think that's really the important issue. They said, "Look, we understand what you are doing, we understand why you are doing it and we support it." Each of the Chairmen has added to what we are doing and I think that's over the history of the office, its been interesting to see how each new Chairman has added something. For example Chairman Levitt was really focused on looking for compliance violations, making sure we are really hard hitting and looking for those issues. Chairman Pitt talked about real time enforcement, real time regulation; we changed the program in a number of ways such as always having exit interviews to get the information back to the registrant immediately so they could immediately begin to act on it when he was Chairman. Chairman Donaldson focused on risk and we began the whole process of revamping our program to look at risk and to consider risk in what we did. Chairman Cox has really emphasized the outreach program, outreach to CCOs, outreach to the compliance community. So in their own ways each of the Chairmen I think has given us tremendous support and had a key role in shaping the program and directing it and making what it is today.

THERESA GABALDON: Would you say there was much industry resistance either to its formation or to the expansion of its mandate?

JOHN WALSH: I would say that it all depends what you are asking because I think one of the most important successes of OCIE over the years has been its relationship with the compliance community and I think standing now in 2008 and looking back at what's happened with the compliance community over the last few years I think it's made dramatic changes, improvement, evolution. I think our relationship with the compliance community has always been really good, very positive. I think like any good positive relationship, it has its down moments but nonetheless its been very good and very

affirmative for both of us, both for us as regulators and for them as compliance personnel. I think there have been other portions of the regulated community that perhaps have not felt quite as positively about OCIE depending on the situation and as I said, no one likes to have someone come in and look over your shoulder and say, "Here's what you are doing wrong." So we would expect to hear some of that.

THERESA GABALDON: I think you indicated that OCIE accounted for roughly 20 to 28%, is that right ...?

JOHN WALSH: Somewhere between a fifth and a quarter. Right now we have total OCIE in headquarters and then examiners in the regional offices, 800 plus total and I believe its somewhere between 820 to 840 right now but as you know in the federal government it all depends whether its full time equivalence or headcounts but if you think 800 plus, that's a good round number.

THERESA GABALDON: And generally you describe the organization in terms of there being a home office and being field examiners?

JOHN WALSH: That's correct. Actually as a technical matter OCIE is only in headquarters and then the examiners in the regional offices are within the regional office structure and OCIE has program management over them, just as the Division of Enforcement has program management over them. I think probably one of the more important organizational changes that's taken place since OCIE was created in addition to the enhancement to the risk assessment, the new technology office and issues like that is the fact that today the programs in the regional offices report both to Enforcement and to OCIE depending on which program. For a period of time the programs reported as line managers up to Enforcement and now it's more the regional office being a direct report to the Chairman and the programs reporting separately to the program offices.

THERESA GABALDON: Does that mean that the same personnel might be engaging both in inspection activity and in enforcement activity or?

JOHN WALSH: It could, it could. It doesn't happen everyday but it's not uncommon that examiners will, during an examination, find an important issue, they will find something that they think warrants Enforcement's scrutiny. They will refer it to Enforcement and the Enforcement staff in their office will say, "You know, you have been spending a lot of time looking at this, we are going to put you on the formal order so you can help us with this investigation." And that does happen. I think that's a way that we support Enforcement. I always like to say, Enforcement is our second most important customer behind the Commission itself. And so we provide a lot of assistance to Enforcement along those lines.

THERESA GABALDON: My next question was going to be, whether you have any thoughts you would be willing to share about the interactions of OCIE with the divisions and other offices and you have started down the road, can you tell us more?

JOHN WALSH: I actually think that we are both a customer of other offices, for example the OIEA, the Office of Investor Education and Advocacy, they receive complaints from investors and others and then that is critically important to us because they will then share them with us and we can use them to target examinations to do cause reviews, to when we are doing our homework before we go into the field to get a sense on how a

firm is doing judging by the complaint traffic that it receives. I think we have a great relationship with them. On the other hand looking from us as almost in a vendor relationship to somebody else being our customer. I think that's true with both the regulatory offices and with Enforcement where we will do sweep reviews at the request of one of the regulatory offices where someone say an associate director will say, "You know, we are thing about this rule making, could you go out and take a look at this area for us and see what's actually happening today and we could go out and do a coordinated review, do a report, give it to them and then they can say, "Well, you know, this is great, we can think about this in terms of the recommendations we make to the Commission with regards to whether we need a new rule or not." Something like that. And with Enforcement, in a relatively small percentage of our examinations and it only ranges from about 5% to about 15% more or less depending on the type of firm and we will hand it over to the Division of Enforcement for further investigation, relatively small percentage but nonetheless that oftentimes is the most serious... those are the most serious issues that we find, so a very important relationship there. I think our relations with the other offices are very good. I think we have worked very hard on both sides, both our side and the offices' side to make it a success and I think it has been.

THERESA GABALDON: As long as we are on the topic of relationships, what sort of a relationship does OCIE have with state regulators?

JOHN WALSH: Again I think very good, we have done a number of coordinated reviews with them, for example the senior activity that's going on right now looking at senior investors and the special compliance risks that they entail, I think we have done a lot of really good work with states in that area and other areas as well I think, so it's a good relationship. I think that again we work really hard to make it a success and the state regulators do as well and, they will call on the phone and ask what are you doing in this area and do you have any thoughts on this? And also they will call on the phone and say, we have an issue here that seems to involve an SEC registrant, you might be interested in and we will do the same, so it's a good relationship.

THERESA GABALDON: So you do cross reference and share information?

JOHN WALSH: Yes, absolutely. In fact we have MOUs with many of the states to facilitate the sharing of information and to make it work very well, absolutely.

THERESA GABALDON: How about foreign regulators?

JOHN WALSH: That really depends on the foreign regulator. I think that's an involving issue; for some regulators it's great. In some cases we have formal MOUs with them, we will do joint exams, we will regularly share information. With others, it's developing but I think the trend has been very positive across the board. I think probably with all foreign regulators the tend is toward more sharing and better coordination. I can't as I sit here right now think of anywhere the trend is moving in the other direction.

THERESA GABALDON: It sounds like you are generally describing a picture of all progress and enthusiasm for the enterprise?

JOHN WALSH: I have to tell you really I am enthusiastic. I think one of the things that I enjoy most going in to the office in the morning is I think there really is a lot of enthusiasm. There is a clear sense of mission, we know what we do, we know how we

do it and I think people are really enthusiastic about that and maybe some of that's coming across here.

THERESA GABALDON: And deserve it. Well, can you translate some of that into specifics of some of what you consider the OCIE's most important initiatives have been? You mentioned a couple of things that I am interested in more detail about the kinds of things it's done in the last 13 years?

JOHN WALSH: I would actually divide that into two categories. I think there are some things that I would call the tangible successes, things where actually you can point to a specific thing and say, here was a success. I think for example right out of the box after we were created we did sales practice reviews that I think were very successful. Some people called them 'the road broker reviews'. We also put out a few years ago a report on soft dollar practices that I think was very helpful. We did a number of reviews relating to payments for shelf space that looked at both the fund side that was making the payment and the broker side that was receiving the payment. I think the variable annuity sales report we did with the NASD a few years ago was very important. New York Stock Exchange specialists again, very critical findings in a critical area and CCO outreach which is an initiative we are doing right now and its very important and I think it has helped our relations with compliance professionals. The intangible successes, it's a little harder to sort of pin down to a particular thing but I think one of the things that I am proud of is we have kept up with the industry. And if you look over the last 13 years...

THERESA GABALDON: No mean feat.

JOHN WALSH: It's grown a lot, it's become more complex. There's a lot going on and if you look at where we are now and where we were back in 1995, just keeping up I think is quite a victory. I think a second thing is, we have really developed an internal infrastructure that allows us to share internally, that allows us to stay in touch with each other to track examinations, to set up a system where any examiner for the SEC, anywhere in the country can see everybody else's work product, can actually read the reports written by another office, use Boolean logic to search those reports to find things of interest to them and we are working on an initiative that someday soon we hope will not only able to read each other's reports but look at each other's work papers as well in the same way and I think that's an important step for enhancing the overall success of the program. But personally the thing I think I would point to is as a success is our ongoing relationship with the compliance community. I think we have developed a tremendous relationship with compliance professionals and regulators, it's really changing the nature of the relationship between regulator and regulate and I think that's an intangible achievement but I think a very important one.

THERESA GABALDON: Is there a dark side of the moon as well?

JOHN WALSH: I guess there always is, isn't there? I assume you would like to hear what I think our failures are. Well, it pains me to say it but it's true, we missed illegal market timing. I could sit here and tell you all the reasons why we missed it. There's a lot of legal market timing and on and on. But the fact of the matter is we missed it. And that became a very big deal when it was discovered. I certainly wish we had found it. But I think when you look at what happened after illegal market timing was discovered, I think that actually says a lot about the program that we have and what we tried to do. And one of our key goals with this management focus, this whole idea of continuous

improvement to make sure that we always learnt from our mistakes, we continuously working to make the program better. And when market timing came to light, we sat down and said, "How did this happen? And how do we make sure it doesn't happen again?" We dramatically enhanced our risk assessment tools. We started reviewing e-mails much more carefully. We realized that e-mail reviews were a critical part of our oversight and we actually changed the program a lot. It was the dark side. There were a lot of dark days there, no question about it, but I think we've learned from it and the program is a much better program because of it. Not that I'm inviting anything like that again, you understand.

THERESA GABALDON: I would fancy that the work load of OCIE would be pretty substantially tackled a bit about the number of feet on the ground. You had to deal with it, but what kind of a work load are we talking about?

JOHN WALSH: Generally we do more than 2,500 examinations in a year. And some years, it's a bit higher than that. But I would say, 2,500 is a good round number and sort of that will give you a sense on what our work load is.

THERESA GABALDON: And how many entities/individuals/SROs are out there to be dealt with?

JOHN WALSH: WI must warn you, whenever I start stringing numbers off the top of my head there's a high probability of error. So, let me put an asterisk next to it here. I think it's now about 11,000 advisors. About 5,000 broker-dealers who do business with the public. There's some others who on floors, but the 5,000 number I think is probably pretty good. Let's see, I believe we have about 400 transfer agents. How many SROs? Well, let's just quit there. Investment company complexes, I think we're down to about 900, something like that.

THERESA GABALDON: Still it's an eye-popping number.

JOHN WALSH: Yes, the numbers are pretty big. When you get to the exchanges and the SROs, the number is smaller. I could probably count them right here, but it's in the tens rather than in the thousands. Don't forget the clearing agencies, the PCAOB, rating agencies which are brand new for us, but others as well.

THERESA GABALDON: There is a huge amount of work to be done in short.

JOHN WALSH: There is and this is where I think the risk assessment is so important because until just a few years ago we had an approach that said, we're going to try and get out to everybody within a particular community, within a certain periodicity or within a certain number of years. I have no objection to that. I think it was a good way to do it given what we had at the time, but I think that one of the advantages we have now with the infrastructure we've been able to develop which is far more sophisticated in terms of its risk assessment, where we can actually take a look at firms and say, "Well, how risky are they really?" Or take a look at activities and say, "How risky are they?" And then target what we're doing much more carefully. I think that's probably one of the most important changes between 1995 and now is what the firms never see. It's all back in OCIE, but that sort of algorithmic crunching, looking at risks, sorting them, ranking them and saying "yes" at the end of the day, let's go look at that firm for that purpose.

THERESA GABALDON: Do the firms know why they're being inspected at any particular time?

JOHN WALSH: As a general matter we don't say to the firm when we show up, we don't give them a particular reason, we don't say, "We're here because you scored at high risk." But I think the reality is that a compliance professional who knows what they're doing, they'll figure it out pretty quickly. There's no question.

THERESA GABALDON: I read in a document that was produced in 1995, shortly after the office was formed, that the inspection cycle for investment advisors was then once every 20 years and the reports seem to be complimentary in that that was down from every 22 years?

JOHN WALSH: It was pretty amazing. There is no question in fact I think that thought different categories, of course that there were the advisors that had custody and those that did not. But one of the things that makes our current approach so exciting for everyone, us included is it's now impossible really to say how often we are going to come and see somebody. Because with the risk based approach, we really don't do it that way and let me tell you some of the ways we do it. For example with investment advisors in particular because you raise them, there is a risk scoring process where there is a special group in the investment advisor, investment company office that will score the risks that they see in the registration materials of investment advisors, do a distribution and then take the top at least riskier appearing advisors and we will make sure we get out to see them at least once every three years. Now we can trump that by what we see on the ground if we go in and we say you know we thought this firm was high risk, it's not high risk and they can then move to the low risk category, or we can go to a low risk advisor and say whatever the algorithm says, this should be high risk and we can do it that way too. We look at higher risk activities, we have a whole risk management process, we have some full time risk managers. They have a thing called radar which is the risk assessment tool that everybody, every examiner puts in their risks, they score them, you know, how likely is it that it will happen, how bad is it if it happens, what can we do about it. And at the end of that process we say, well you know we should go look at this risk here and that risk there. So, we may be picking them for that reason. We do statistical reviews, and this is where it becomes totally impossible to say why we are going to a firm, because we may not even know. Our friends in the Office of Economic Analysis will do a random selection process of low risk advisors, create a sample of low risk advisors who have been selected that way and then we go and do reviews of them and that actually does a number of things that it tests and validates the risk assessment process we think they are low risk, are they really low risk and I am glad to say that those reviews have generally been, have substantiated the low risk advisors that we picked our low risk, helps show the flag in areas where we might not otherwise have the opportunity to go and visit and it helps us look for things we don't expect. How do you look for the unexpected? Well, one way is just to look and see what you see and that does it.

And then finally there are cause exams and that's a very traditional kind of exam where there is a particular issue, a complaint or a newspaper article or something that we go and look. So, if you are at the firm and you are wondering why are these people here and you could say well, is it in my high risk, maybe. Is it a risk activity? Maybe. Is it purely random? Maybe. A high risk cause, maybe. So that for the firms though I think the way they figure out is what we are asking for. And if we come in, and we want to know

all about the personal trading, a portfolio manager acts, and that's all we are asking for, I think they can figure out pretty quickly that's a cause exam or there's something going on with Mr. X that they interested in. If we come in and we are doing a broad based review and we are asking about a lot of different issues and things like that well then I am sure a qualified compliance person would say, well it sounds to me like this is a regular review. A very long answer and I know in the old days you could say five years or 20 years and instead I had to say all of that. But that will give you a sense of really where we are trying to hit. We are trying to be much more sophisticated that we are not simply saying, okay we have been here, we will see you in 20 years. We will try to say well where are the risks and how do we find them and how do we uncover them?

THERESA GABALDON: Now, you may have suggested in that answer that there are sometimes mutating hot spots that their particular kind of practice will come to earth and they turn out to be more wide spread in one type of regulated player rather than another, is that accurate?

JOHN WALSH: I think that's right. I mean just to give you an example of evaluation I think over the last year or so, evaluation has been a hot spot across the program. Broker dealers, investment advisors, funds, I think evaluation has become hot spot and we have been putting resources into it again across the program. So that happens. But we also try to make sure that no one is forgotten, that no one is neglected and ignored, so we care very much whether it's a transfer agent or broker dealer and investment advisor and make sure that all of that included in the planning process and what we are going to go and do for particularly. I think on the one hand it seeks to make sure that we are taking a holistic view across all of the entities and that they are getting the attention that each of them require, but absolutely there are hot spots that come up that we want to focus on. One of the advantages of having the consolidated management of course is if there is a hot spot, we can say well how does this particular issue relate to this type of firm and that type of firm and think about it that way as well instead of coming out in different places and in different areas.

THERESA GABALDON: You mentioned the possibility of complaints. You have any idea what the average number of complaints filed that come to or sees attention during a year might be?

JOHN WALSH: I know that OIEA receives tens of thousands of complaints every year and for some reason the number 70,000 pops into my head that may have been a recent number. I mean they handle tens of thousands every year. So, for them a major part of the process is getting the complaints sorted by classification and available for use by examiners. The complaints that come directly to us, some do simply because people know examiners. I actually get some myself. We have a hot line and the SEC exam hotline is available to anybody who has a comment or a concern or a complaint about an examination and we set it up because we think it's very important that anybody who is in the exam system can reach into the senior levels of OCIE and say, hey I have got a question here, I have got a concern here. We put it in our brochure, we hand out the brochure to every firm at the beginning of every exam, so every registrant that's being examined has that kind of access to OCIE's front office. But to classify what we get, you know it's all kinds of things. A lot of it to be honest, most of them are what I would call facilitation calls, they have a question that has nothing to do with the exam hotline, but that's the number they have. So they call and they say here's my question. I say, well

that's not really a hotline question. They said, yeah. But I see this number right here in the brochure and I say well, we will figure out who you need to talk to.

THERESA GABALDON: Assume we were to call that number, it wouldn't actually ring your desk, would it?

JOHN WALSH: Yes, it would actually ring on my desk and the desk of a handful of senior attorneys who sit around me. And every once in a while, I will get a call and whoever is there will pick it up and it's a special button and everything. Whoever gets to the phone first and sometimes I will answer the phone and somebody I have known and say, "John, I was just curious; you really do answer it."

THERESA GABALDON: I was going to go home and dial that number.

JOHN WALSH: Actually most of the hotline type things I hear to be honest with you, either come on my personal line or people take me aside and person to the conference or something like that. And they say, I was thinking of calling the hotline. I have a hotline type issue and let me ask you before I call it. I say, well it doesn't matter, because if you call the hotline you are going to get me anyway. So you might as well tell me now.

THERESA GABALDON: You must have a great time at conferences.

JOHN WALSH: It's very important that we take this outreach very seriously and it really is a two way street. It's very important for us, both to talk to people about what we are saying and what are our concerns are, but also for people to share with us what they are concerned about. It can be very valuable both in terms of finding out what risks are, that we may not be thinking about. Or that we have thought about, but perhaps where we need to ratchet it up and say, oh, maybe this is more serious than we thought or even just people expressing generalized concerns. Sort of what's the mood, the temperature.

THERESA GABALDON: I would like to turn to a little more in depth consideration of the inspection methods that you use. What can you tell us about what happens in an inspection? You said something about e-mail. I will go ahead and ask this specific question now because this was that was e-mailed to us from Mr. Daniel O'Connor of Ropes and Gray LLP, who e-mailed us to ask, what can you tell us about what registrants that is broker dealers and investment advisors should expect in terms of requests by the exam staff for e-mail productions in routine exams. For instance what number of people and what time periods might be covered?

JOHN WALSH: The e-mail reviews are very important and I would just even broaden that. It's like communication reviews are very important in examinations as they are in compliance and supervisory management of a firm. So what we are doing here I think is similar to what hopefully the supervisors and the compliance professionals at a firm are doing, and looking at these electronic communications and saying well how can we actually approach this in a way that makes sense to see what's happening in that firm or at that trading desk or whatever. We went through a period of time immediately after market timing broke where we used e-mail reviews as what I would call a sort of a reality check. During market timing there were problems at firms and from people that were quite surprising. And we said, what is happening here? How did that happen? And so we did very large e-mail reviews and we made no secret of what we were doing, we told everyone and we said, we were looking at this in an effort to understand what the real

culture of compliance is at this firm? Now what you are telling us, now what you are telling the world, but what's really happening in the front office. Or else weren't in doing in those days, we would make requests for large numbers of e-mails to and from a large number of people over a large period of time. More recently and I think by the way that was a valid sort of crisis tool, a valid thing to do in that time period, but there is no question that was very difficult for the firm's producing them. It was very difficult for us reviewing them. Now we are in a mode where we are trying to be much more targeted in what we do. We may come in and say please give us the e-mails to and from the trading desk, through this period, this particular period of time. Please give us the e-mails to and from the advertising department and those who review and approve the advertising for this particular period of time. So the gentleman who sent in the e-mail request, I would say more likely than not. It will be a targeted review rather than an all encompassing review, but we still from time to time will use those requests going to individuals through a period of time if we feel that our pursuit of the evidence or our pursuit of what we need to finish our exam leads us to that point.

THERESA GABALDON: What other kinds of things would you do in a typical investigation, pick your player, let's say and a broker dealer, what other things should you be looking at other than e-mail?

JOHN WALSH: We would generally give the firm a request list and that would talk about the documents we wanted to see. It could be client accounts. I think you mentioned broker dealer, it could be accounts statements, it could be their compliance controls, it could be downloads of trading data. I think one of the things that has revolutionized what we do and what has revolutionized what compliance people do as the electronic records make it possible to download and conduct screening, conduct assessments, who's paying what commissions, where are the trades going? You can get a level of oversight that just a few years ago would have been impossible. One examiner, one compliance professional sitting in front of a laptop today, that in the paper and pencil era would have required warehouses full of people at desks and the problem will still could not have done as good a job. And that's a key part of our program. We will then interview people, we will want to have a conversation with them and say we have been looking at what is happening here and at the trading desk or wherever. We would like to talk with you about it and get your explanation or we see these recommendations you are making, we would like to get your explanation for them. And then finally when the review is over, we will typically give them what we call a deficiency letter and that letter goes through the problems we found and ask them to fix them.

THERESA GABALDON: It does obviously sound as though the process has gotten much more automated or makes much more use of electronics and I assume software?

JOHN WALSH: Well, actually we do have some pretty good analytical software now for trading and portfolios and for doing various e-mail reviews and things like that. In fact, again going back to managerial focus, one of the things we have done recently is creating a technology office within OCIE, which is led at the assistant director level and has a staff of very experienced and highly qualified technology experts who can help in these areas and both in terms of electronic record productions and things like that but also in pushing forward the, our initiatives to enhance our ability to use technology. So, we actually are pushing that along.

THERESA GABALDON: I was imagining people reading all the e-mails and then making next leap to the software that some people put on their home computers to monitor what their children are doing that's screened for particular words or word patterns. Do you have anything that involved?

JOHN WALSH: Good compliance shops should be doing that and actually that started a few years ago, very basic searches for words. I think now they have gotten much more sophisticated than that in terms of word searches and patterns and issues like that. But that's an important part I think of any kind of compliance process.

THERESA GABALDON: You mentioned that the end result of an inspection might very well be a deficiency letter. What percentage of inspections turn up to the sort of problem that would be commemorated in a deficiency letter?

JOHN WALSH: It varies from year to year and from type of firm to type of firm, but I would say typically anywhere from say 60 to 80 or maybe even 90% in a given year. There are actually three possible outcomes. One would be the deficiency letter, which is by far and away the most common. Another is a close out letter in which we give the firm a letter and basically say we came, we saw, we have no comment, thank you very much. The third possible outcome is an enforcement referral. Now a particular statistic that I think is very interesting to watch is we have what we call significant deficiencies and the significant deficiencies are those that we believe are significant enough because it stopped an on going problem, it identified a new risk. It went to say the firm capital position and there are a number of those in the definition, and we track those from year to year and we actually publish those. Those are part of our annual report and usually anywhere from about 35 up to close to 50% of our exams depending on the year and the program area will generate significant deficiencies. You can actually go to our annual report on the Commission's website and see a table that shows what we did last year and in the previous year. I think that's a good level of public accountability. What we are finding, measuring not just the inputs but the outputs significant findings and tracking it from year to year.

THERESA GABALDON: If a part of that individual or entity receives a deficiency letter, is there typically a time frame for cleaning up the act?

JOHN WALSH: We want a response generally pretty quickly. Though you know that's something where if the firm says, look can you give me a few more weeks or something like that, more often or not the examined income works something out with them. But we would expect them to move reasonably quickly to fix any problems that were identified and we asked them and their response to tell us either that they have fixed them or what they are doing to fix them. The difficulty is and the most dangerous situation is when a firm promises that it will fix it and it does not. I think that's something that is very dangerous for a firm and when we come into do an exam, if we look at the old deficiency letter and we look at what they are doing and they have promised us they will fix it and they haven't, then we will take that very seriously. The Commission has actually brought some enforcement cases recently where the Commission authorized an enforcement action against a firm and in the order pointed to the firm's failure to respond to prior deficiency letters as part of the Commission's reasoning in bringing that action.

THERESA GABALDON: What types of deficiencies are the most common in, rather than picking broker dealers, I will pick investment advisors?

JOHN WALSH: I would say just to give you a few examples of disclosure, what's in their Form ADB, what are they telling customers about themselves. Performance advertising, very, very important area. Directed to your prospective customers and also your own customers that what kind of advisory you are. Very common. Evaluation is an issue for advisors that underlies a lot of different things ranging from the fees you collect to your clients satisfaction with you and how you are doing or not telling as the case maybe. I think those kinds of issues are very common.

THERESA GABALDON: Would say that there is much possibility that anything much would be missed during the course of an inspection?

JOHN WALSH: This is where it's really important that we are very disappointed. I really want to emphasize that, that I think part of being an examination program as opposed to just talking with people on the phone or just getting briefed by people is that we try and take a very disciplined approach to what we are doing. We will have a scope and we will say this is what we are looking at. And of course if we decide not to look at an area we can't say anything about that area. We would hope that the risk management process would be very rigorous in terms of why we are looking at those areas that we think those are the highest risk areas, the other areas don't warrant that kind of review. But once we get into that particular area, what records did we look at? Why did we decide it's an issue, why did we decide it's not an issue? Do we have documentation in our work papers substantiating every statement we make in our report or in our deficiency letter? So, I think the bottom line is that if it's within the scope of the review and we have chosen this as a high risk area that warrants review, I would hope we are not going to miss a lot. I would hope that we are going to be able to pick out those areas that need follow up. If we decided not to look there because we think that's a lower risk area, well if we are not looking, we are not saying and there it falls back on the risk assessment which I think as I have said is much more sophisticated today than it used to be.

THERESA GABALDON: You mentioned earlier that occasionally you might go out and conduct a sweep at the behest of one of the other, one of the divisions and presumably to collect a pool of information, what sorts of information do you feel is fair game in that circumstance?

JOHN WALSH: An exam is an exam is an exam. We do sweeps because someone has identified a risk and we will go to the Commission and say we think we should do a sweep in this area, here's a risk that we think is really serious, let's, how do you feel about as pursuing us through a sweep process. We may get the request from another division. But once we go and do it, it's really important to know that an examination is a mandatory regulatory exercise. And so when we come in, we will make record requests that we believe are relevant to the enquiry that we have been directed to make. We try really hard to make sure that we only ask for the records we need. Sometimes, it's really essential that we ask for a lot of records and some of our requests I think we have to admit, they can involve a lot of documentation. We have done some reviews looking say at institutional order flow for example. In other areas that have involved huge volumes of trading data. But what we really try and make sure that we don't do is we don't duplicate requests. So sometimes we have to ask for a lot which I think is what you are getting at that but the problem is if we ask for the same thing two or three times. And I think we have really done a good job in recent years of managing the program to make sure that

that does not happen. But if it does, call me on the hotline. If you are aware of that happening, I would want to hear about it.

THERESA GABALDON: I suppose what I was getting into was the idea that a risk might be identified that or someone might be interested in trying to figure out whether a particular risk should become a target of regulation that it's not illegal per se yet or it's not a matter of having violated the law. But we are thinking about whether it would be a good thing about which to have regulation. Can you collect information for that purpose?

JOHN WALSH: For broker dealers and investment advisors, we have authority to look at all of their records. And that's in the statute that if it's a brokerage record, if it's an advisory record, we have authority to look at it. I think if it's a risk area and we are examining that risk area, someone has said, say another division that a Commissioner or whatever has said, that we feel that's a risk area that we think your program should look into, we can do that. And the result of that review could very well be that it's a risk area, but as we look at the regulatory system right now, in fact we are not clear as to whether it's a violation perhaps, the regulatory office, perhaps the Commission should consider that. I would say a valid outcome for a sweep type review or any type of review to say we are bumping into an issue here and Commissioners, Chairman and regulatory offices, we want to bring this to your attention.

THERESA GABALDON: As I have indicated before I basically think that the work load of OCIE is extraordinarily great, do you think that do you really have enough funds to do what it is you need to do?

JOHN WALSH: That's a tricky question. That's a tough one. We could always use more help. Absolutely. But again I think, one of the things we have really tried to do and I would emphasize this is to take the tools we are given and to make them work as best we can and I think we have really done that, but perhaps you have more staff. If you would offer them to me, I won't turn them down.

THERESA GABALDON: Are you expecting any changes in funding or mandate in the foreseeable future?

JOHN WALSH: Certainly I think in mandate, I am not expecting anything. I think there have been a number of new rules that the Commission has adopted, as soon as they adopt a rule of course, we immediately try and work it into our program, but for funding I will have to differ on that. If you are offering it I will take it but again I think we take a great deal of pride in saying what are the tools we are given and let's make it work and I think we have.

THERESA GABALDON: When you talk about new things as you have been given, you have just been given the rating agencies and that puts me in mind too of the SROs. What kinds of things would you look for in the inspection of an SRO or an inspection of a rating agency?

JOHN WALSH: Let's put rating agencies to the side. If you go to the Commission's website, you can see a recent report that was issued relating to rating agencies and I think that would perhaps answer that question. But looking at SROs, we typically look at them from a programmatic perspective. We want to take a look surveillance or **FINOP** or the actual programs they are running and then we inspect them on that basis. It's sort of

a top down type approach, what is the SRO itself doing to regulate its members to run in the cases where they actually have a trading facility to actually run their trading market? We also have a bottoms up approach which is we will do a thing called an oversight examination and there we go to a broker dealer that has been recently examined by the SRO and do our own independent review of that broker dealer which shows us how the SRO is interacting with it's members. We will both do a forensic review of the SROs review and our own independent review to come to our own conclusion. So, it's sort of top down with programs and then bottoms up with oversight exams.

THERESA GABALDON: I wanted to make sure that I got to this question, which has to do with the people of OCIE. Aren't there any folks in OCIE's history, short as it relatively is, that you particularly would like to single out as memorable or as having made special contributions?

JOHN WALSH: I think first of all of course is my boss Lori Richards who has been our Director since it was created. I think Lori has made a tremendous impact on the program, has really shaped it in many ways and a lot of the things we have talked about here today, the risk assessment, they are trying to look across the entire securities industry and not getting blocked into like little boxes here and there but saying how do these different pieces are related. I think a lot of that has been driven by Lori and Lori has really made it happen. And another person that I would like to mention is Carrie Dwyer. Carrie Dwyer was Chairman Levitt's Counsel at the time OCIE was created and Carrie really played a tremendous role working with Chairman Levitt and saying we needed an OCIE, we needed an office that does what OCIE does and I don't really think her contribution to OCIE has been recognized as much as it should. What **Gene Gohlke** knows is an institution, he has been examining funds and advisors for a long time. He is just a tremendous resource to the program and I think he should be noted. I should note as a group the line staff, we are incredibly lucky we have a lot of really fine people who do examinations, very qualified, very skilled. And then finally, if I were to mention a last category that might seem a little unusual are critics. We have been very lucky that over the years a number of people have been willing to share their ideas with us. To step forward and say here is what you are doing, here is what we think you could do better, and a lot of that feedback has really helped to improve the program. We have taken it very seriously and we have worked with it very carefully. Not that I am inviting more criticism.

THERESA GABALDON: That's the hotline.

JOHN WALSH: It's called a hotline, but it's been very helpful and I think that we really do appreciate the feedback we have gotten, that people care enough and they are willing to do it.

THERESA GABALDON: A very gracious response. John, thank you for sharing your invaluable insights into the work of OCIE. Thank you too for being part of the museum's history today, because we have just concluded the 50th online program in the virtual museum and archive. All of these programs including today's can be accessed at any time in the Online Programs section of the museum in MP3 audio and transcript format. I would like to thank Pfizer Inc., for its generous sponsorship of the Fireside Chats from 2005 throughout this season.

Our 2008 online program season is now concluded. But I will be back on www.sechistorical.org on Tuesday February 24th for a Fireside Chat on the work of the SEC Division of Corporation Finance. I will also be moderating Fireside Chats on the SEC Office of the Chief Accountant on April 21st and the SEC Office of the Chairman on May 12th. And I will be hosting the museum's first live broadcast from London, when I moderate an online program on international securities regulation on March 12th. I will look forward to joining you again in 2009. Thank you for being with us today.