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An Audit Report on

The State Securities Board

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Overall Conclusion

The State Securities Board (Board) effectively carried out its statutory duties in core areas. Specifically, the Board:

- Processed securities registrations in accordance with the Texas Securities Act, the Texas Administrative Code, and internal policies and procedures. In fiscal year 2009, the Board processed 108 new or renewal securities registrations (0.4 percent) and 26,021 new or renewal notice filings (99.6 percent).
- Collected registration fees during the first two quarters of fiscal year 2010 that were substantially correct according to its established fee schedule. The Board collected all but \$1,740 of the \$39.2 million (99.9 percent) of funds that auditors calculated were due to the State.
- Conducted inspections and investigations in accordance with its policies and procedures. The Board's Inspections and Compliance Division investigated complaints against 383 registered firms or individuals and performed 606 inspections of registrants between September 1, 2007, and February 28, 2010. Its Enforcement Division reported that it opened 932 investigations during the same time period.

Background Information

The State Securities Board (Board) conducts several activities to protect Texas investors. These include:

- Registering certain securities (mostly mutual funds) offered or sold in Texas. Federal law greatly limits the Board's review of almost all the securities it registers.
- Registering and overseeing the firms and individuals selling securities or providing investment advice to Texans.
- Detecting and preventing securities fraud, sales of unregistered securities, or sales of securities by unregistered dealers.

While the Board conducted its inspections in a consistent manner, it did not have a policy or goal for how long it should take to resolve inspections. The Board had not resolved 33.0 percent of its fiscal year 2008 and fiscal year 2009 inspections; not resolving inspections may reduce the inspections' effectiveness.

The Board also should increase the effectiveness of its monitoring of investment advisers and brokers by incorporating a formal, risk-based process when selecting entities for inspection. While the Board's inspections provided good geographic coverage of several areas of Texas in which the Board does not have a branch office, the Board used an informal, undocumented risk assessment process to select registrants for inspection. In addition, the Board did not meet its internal goal of inspecting all registrants for which it has primary oversight responsibility within a five-year cycle. Having a formalized risk assessment could help the Board

focus its resources on registrants that present the most risk to investors. The Board could consider other approaches for selecting registrants for inspection that may enable the Board to more effectively select registrants for inspection.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which the Board's analysis indicates will increase the number of investment advisers that the Board is responsible for monitoring. The Dodd-Frank Act increases the threshold for federal registration of investment advisers from \$25 million in assets under management to \$100 million in assets under management. As a result of this change, the Board estimates that the number of investment advisers that it regulates will increase from 1,205 as of July 23, 2010, to approximately 2,450, an increase of 103.3 percent. The Board's legislative appropriations for the 2010-2011 biennium contained a contingency appropriation that may apply if federal regulatory oversight is reduced. If applicable, the Board may receive up to an additional \$934,072 in annual appropriations and 10 full-time equivalent (FTE) positions. The Board must successfully file a finding of fact and support that it will achieve revenue targets in the legislative appropriations request it submits to the Legislative Budget Board and the Governor's Office before those funds can be appropriated.

Although the Board's receipting process has some strong controls, the overall integrity of its receipting process is weakened by deficiencies in controls over its mail distribution, payment tracking and reconciliation, and segregation of duties. These weaknesses expose the Board to the risk of lost revenue through fraud or error. Auditors gained assurance through testing of deposit vouchers that the Board did not lose funds during fiscal year 2009, but the risk of loss remains. The Board could reduce this risk by reducing the amount of checks and cash processed in the mailroom by increasing the use of electronic payments and/or having a third party process payments received through the mail.

Summary of Management's Response

The Board generally agrees with the recommendations in this report. However, the Board does not agree with the recommendation to provide securities filers with a receipt when the Board receives a payment. Instead, Board management stated that it will make the programming changes necessary to post the fee amounts paid by securities filers on the Board's online registration database available to securities filers and the public.

The Board's management responses are presented immediately following each set of recommendations in the Detailed Results section of this report.

Summary of Information Technology Review

Auditors reviewed the Board's automated systems for registrations, receipting, inspections, and enforcement. The Board has documented information resource

policies and procedures and adequate physical security controls over its automated systems. In addition, critical data tested in the Board's Registration System, Money System, and Inspections and Compliance System was accurate.

However, auditors identified significant weaknesses in the Board's controls over data entry and data verification. For example, the Board's Registration System lacks sufficient controls over the approval of registrations. The Board does not review the change of any securities registration's status from "pending" to "approved" in its Registration System.

Summary of Objectives, Scope, and Methodology

The objectives of this audit were to determine whether the Board (1) has controls to provide assurance that securities filings comply with applicable laws and regulations and (2) conducts inspections and investigates complaints in a consistent, risk-based manner.

The scope of this audit included the Board's processes, documentation, and financial information related to securities filings from September 1, 2008, to February 28, 2010; to inspections opened from September 1, 2007 to February 28, 2010; to inspection coverage of registrants from September 1, 2004 to August 31, 2009; and to complaint investigations from September 1, 2008, to February 28, 2010.

The audit methodology included reviewing the Board's internal controls and processes related to receipt handling, securities registration, inspections, and complaint investigations.

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Detailed Results

Chapter 1

The Board Has Controls to Ensure That Securities Filings Are Registered in Compliance with Applicable Laws and Regulations

Types of Securities Filings

The Board processes two major types of securities filings: securities registrations and notice filings.

Most securities registrations are for direct participation programs, such as commodity pools or real estate investment trusts. The Board ensures that these filings comply with certain provisions of the Texas Securities Act, such as making required disclosures in the prospectus.

Notice filings are a limited form of securities filing that does not include a comprehensive merit-based review of the securities. In fiscal year 2009, 83 percent of new or renewal notice filings were for mutual funds.

The Board uses the controls it has in place to ensure that securities filings comply with the Texas Securities Act. The Board should strengthen these controls by independently verifying that securities filers have filed the required documents with the U.S. Securities and Exchange Commission (SEC). In fiscal year 2009, the Board processed 108 new or renewal securities registrations (0.4 percent) and 26,021 new or renewal notice filings (99.6 percent) (see text box for definitions of these securities filings).

The Board processes securities registrations in accordance with the Texas Securities Act, the Texas Administrative Code, and internal policies and procedures.

The Board's securities registration process includes a merit-based, comprehensive review of the securities filing to ensure that the offering terms are fair, just, and equitable and that fraudulent means are not used in the issue or sale of the offering. The internal controls that the Board has implemented related to securities registrations are:

- Written policies and procedures that provide specific guidance on the registration process to Board staff.
- Use of forms to gather information required to determine whether the securities comply with the Texas Securities Act and the Board's rules. Some of these forms were created by the Board. Many of the other forms are maintained by the SEC or the North American Securities Administrators Association (NASAA)¹ on their Web sites and are uniform across states so that registrants can use them to register securities in multiple states.
- Supervisory reviews by both the Deputy Commissioner and the Registration Division Director of summaries of the analysis of each securities registration application as part of the approval process.

¹ The North American Securities Administrators Association (NASAA) is an international association of state and provincial securities regulators from the United States, Canada, and Mexico. It creates regulatory materials, such as modules, that it makes available to its members. The Texas Securities Commissioner is currently this association's president.

Auditors examined 16 securities registrations, which represented 10.3 percent of all the securities registrations filed during fiscal year 2009 and the first half of fiscal year 2010.² All 16 registrations complied with the Board's policies and procedures. Specifically:

- All filers completed all required forms.
- No offering had anticipated marketing expenses that exceeded those allowed by statute.³
- Senior management reviewed all registrations.
- The Board sent deficiency letters or substantive comment letters to securities filers in conjunction with three of the registrations. These letters were sent to the filers within the timeframes specified in the Board's rules.

Most securities filings that the Board processes are notice filings, which are exempt from merit-based reviews.

After the passage of the National Securities Markets Improvement Act of 1996 (Markets Improvement Act), the Board could no longer perform a merit-based review of certain covered securities (see text box). However, the Board could require securities filers who want to sell securities in Texas to submit a notice filing and pay a fee for this filing. The Board's registration process for notice filings consists of Board staff ensuring that the application includes copies of certain documents filed with the SEC and that the filer paid the correct fee.

Board management stated that prior to the passage of the Markets Improvement Act, the Board performed complete securities registration reviews on a significantly larger percent of securities offerings in Texas. For example, management stated that it performed 18,895 registrations, which included merit-based reviews, in fiscal year 1995 compared to 108 registrations in fiscal year 2009.

Auditors reviewed 65 notice filings and independently verified that all filers had filed a Notice of Exempt Offering of Securities with the SEC, which they must do in conjunction with submitting a notice filing with a state regulatory agency. Auditors also verified that the Board had determined the securities' effective dates with the SEC as specified in Board rules, when applicable. SEC effective dates determine when securities registration expires in Texas.

Notice Filings Compared to Merit-based Reviews

The National Securities Markets Improvement Act of 1996 (Market Improvements Act) preempted the Board's merit-based review of most securities offerings. These securities offerings included nationally traded securities, which are federally registered, and securities offered only to certain classes of qualified purchasers.

The Board performed a merit-based review of all securities subject to its regulation prior to passage of the Act. In a merit-based review, Board staff review the registration application and supporting documentation to ensure the securities were "fair, just, and equitable" for the investor in accordance with the criteria established by the Texas Securities Act and Board rules.

States are still allowed to require issuers of these covered securities to submit a notice filing and to collect fees for this filing. Notice filings can include copies of any documents provided to the SEC during the securities' registration.

Sources: Information from the Board and the SEC.

² The Board received 155 securities registrations (excluding amendments) from September 1, 2008, through February 28, 2010.

³ These expenses can total 20 percent of the value of the offering, with the exception of real estate investment trusts and oil and gas programs, which are allowed up to 15 percent for marketing expenses.

The Board collected registration fees during the first two quarters of fiscal year 2010 that were substantially correct according to its established fee schedule.

Auditors tested all registration fees that the Board collected from securities registrations and notice filings for the first two quarters of fiscal year 2010. The Board charged the correct fee amount for 34,167 (99.9 percent) of the 34,197 transactions that it processed during that time. The Board collected all but \$1,740 of the \$39.2 million (99.9 percent) of funds that auditors calculated were due to the State.

The Board's Registration System lacks sufficient controls over the approval of registrations.

The Board does not review the change of any securities registration's status from "pending" to "approved" in its Registration System. The Registration System is designed to allow a single person with the proper system access to change a securities filing's status as part of the filing process for both securities registrations and notice filings. This limits the Board's ability to ensure that securities are approved only after receiving the proper authorization.

Securities' status in the Registration System is available to the public. The Board's public Web site accesses information about registered securities from the automated Registration System, including whether securities have been successfully registered with the Board.

In addition to not reviewing changes in registration status, the Board does not review the data entered into the Registration System for notice filings. The Board performs some review of data entered for securities registrations. The Board also does not independently verify that securities are registered with the SEC, instead accepting the registrant's representations that the securities are registered or copies of screen shots from the SEC's Web site. Auditors tested data for notice filings and securities registrations in the Registration System and found that it accurately reflected the underlying information. Although audit testing showed that registration data was accurate, without selective reviews of data entry there is an increased risk of data inaccuracy.

Recommendations

The Board should:

- Implement automated system approval controls that require two persons to change securities' status to reduce the risk of securities being registered without proper authorization. In addition, a person not entering the notice filing data into the Registration System should verify that key data is accurate.

- Independently verify that all securities are registered with the SEC, including those securities that are notice filed.

Management's Response

Recommendation 1. The Agency agrees with the recommendations to implement automated system approval controls to reduce the risk of securities being registered without proper authorization and to conduct selective reviews for accuracy of key notice filing data manually entered into the Registration System by persons who have not entered the data. The Director of Registration is responsible for these controls. Implementation is expected to be completed during the first quarter of fiscal year 2011.

Recommendation 2. The Agency agrees with the recommendation to implement a procedure for independent verification of SEC registration for securities offerings seeking registration or authorization in Texas. The Director of Registration is responsible for this procedure. Implementation is expected to be completed during the first quarter of fiscal year 2011.

The Board Conducts Inspections in Accordance with Its Policies and Procedures; However, It Has Not Resolved 33 Percent of Its Fiscal Year 2008 and Fiscal Year 2009 Inspections

Definitions of Investment Adviser and Broker Dealer

Investment Adviser - An individual who furnishes investment advice for a fee.

Broker Dealer - An individual who is in the business of buying and selling securities (called trading) on behalf of customers.

Sources: State Securities Board Investor Education Program Web site at www.texasinvestored.org, and *Cutting through the Confusion - Where to Turn for Help with Your Investments*, Coalition on Investor Education.

The Board's Inspections and Compliance Division (Inspections Division) conducts inspections of registered investment advisers and broker dealers (see text box for definitions) consistent with its policies and procedures. The Inspections Division has primary oversight responsibility for Texas registrants that are not inspected by other regulatory entities, and it shares oversight responsibilities for registrants that are subject to inspection by other entities, such as the SEC.

From fiscal years 2005 through 2009, the Inspections Division had primary oversight responsibilities for 1,628 registrants and had shared oversight responsibilities for 3,992 registrants. The Inspections Division reported that it met its fiscal year 2009 performance measure targets by conducting at least 225 inspections and inspecting 20 percent of Texas registrants who are not inspected by any other regulatory entity.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). As a result of the changes in the Dodd-Frank Act, the Board estimates that the number of investment advisers that it regulates will significantly increase.

Also, the Board has not resolved 157 (33.0 percent) of the inspections it conducted during fiscal years 2008 and 2009. Resolution includes sending the registrant an inspection "no action" letter, notifying the registrant of necessary corrective action, receiving a satisfactory response from the registrant indicating corrective action has been implemented, or referring the deficiency for possible legal action. The Board does not have a policy or goal for a resolution timeline.

Chapter 2-A

The Board Had Primary Oversight Responsibility for 1,628 Registrants and Shared Oversight Responsibility for 3,992 Registrants

The Inspections Division has regulatory oversight over five categories of broker dealer registrants and investment advisers (registrants). It has primary oversight responsibility for two categories of registrants and shares concurrent jurisdiction with the SEC and self-regulatory organizations, including the Financial Industry Regulatory Authority (FINRA), for inspecting certain types of registrants. Table 1 on the next page shows the total number of registrants over which the Board had oversight responsibility from fiscal years 2005 through 2009. (See Appendix 2 for additional information about the regulation of the Texas Securities Industry.)

Table 1

Registrants Over Which the Board Had Oversight Responsibility Fiscal Years 2005 to 2009				
Type of Registrant	Was the Board's Oversight Responsibility Primary or Shared?	Number of Registrants That Were Active During All Five Fiscal Years	Number of Registrants That Were Active During a Portion of the Five Fiscal Years	Total Registrants
<u>Texas Investment Advisers</u> - The Inspections Division had exclusive responsibility for inspecting investment advisers that managed less than \$25 million in client assets. Investment advisers managing more than \$25 million in client assets generally registered with the SEC, which had exclusive responsibility to inspect them.	Primary	452	975	1,427
<u>Texas Broker Dealers Registered with the Board But Not with FINRA</u> - The Inspections Division had exclusive responsibility for inspecting any of these broker dealers not registered with the SEC. If a broker dealer was registered with the SEC, the SEC, the Inspections Division, and any self-regulatory organization of which the broker dealer is a member shared inspection responsibility.	Primary/Shared ^a	48	153	201
Total Number of Registrants for which the Board Had Primary Oversight Responsibility		500	1,128	1,628
<u>Investment Advisers Headquartered Outside of Texas</u> - The Inspections Division had primary responsibility for inspecting investment advisers doing business in Texas that managed less than \$25 million in client assets. State regulators in the state in which the investment adviser was headquartered could inspect the investment adviser's operations in that state. The SEC had exclusive responsibility to inspect investment advisers managing more than \$25 million in client assets.	Shared	86	246	332
<u>Texas Broker Dealers Registered with FINRA</u> - These broker dealers could be inspected by the Inspections Division, FINRA, or the SEC.	Shared	210	156	366
<u>Broker Dealers Headquartered Outside Texas</u> - These broker dealers could be inspected by the Inspections Division, any self-regulatory organization of which the broker dealer is a member, or the SEC. State regulators in the state in which the broker dealer was headquartered could inspect the broker dealer's operations in that state.	Shared	1,586	1,708	3,294
Total Number of Registrants for which the Board Had Shared Oversight Responsibility		1,882	2,110	3,992
Total Registrants		2,382	3,238	5,620
^a Inspections Division data does not show which broker dealers are registered with the SEC. Auditors included the Texas broker dealers that are not registered with FINRA in this row, even though some of them may have been registered with the SEC.				

The Board Conducts Inspections in Accordance with Its Policies and Procedures

The Inspections Division conducted 606 inspections of 585 registrants between September 1, 2007, and February 28, 2010.⁴ Board policy expresses a preference for unannounced inspections. Prior to conducting an inspection, examiners perform a pre-examination of the registrant that helps financial examiners identify potential risks, such as informational discrepancies, prior disciplinary history, and violations detected during the last inspection.

Auditors tested a sample of 30 of these inspections, including inspections conducted by all three of the Inspections Division's branch locations, and all inspections were conducted in accordance with the Inspections Division's policies and procedures. Specifically, all inspection files contained:

- Consistent documentation, including the Inspections Division's standard inspection modules, which the NASAA developed and the Inspections Division used for each inspection to achieve consistency.
- Pre-examination checklists, which Inspections Division staff used to document advance planning.
- Evidence that a supervisor appropriately reviewed the examiner's work, including an examination tracking report, which the Inspections Division used to track an inspection's progress.
- Appropriate management approval to close the inspection prior to issuance of the appropriate closing letter.

The Board Has Not Resolved 157 (33.0 Percent) of Its Fiscal Year 2008 and Fiscal Year 2009 Inspections

As of February 28, 2010, the Board had not resolved 157 (33.0 percent) of the 476 inspections the Inspections Division conducted in fiscal years 2008 and 2009 (see Table 2 on the next page). A June 30, 2009, internal audit report also noted this issue and specified that the Inspections Division still had 36 inspections open from fiscal years 2005 and 2006 as of that report's date. The Austin Branch Office—which is responsible for all areas except for the Houston area and the Dallas/Fort Worth metroplex—accounted for most of the unresolved inspections conducted in fiscal years 2008 and 2009. The Board did not have a policy or goal for how long it should take to resolve inspections. Not resolving inspections may reduce the inspections' effectiveness.

⁴ This period covered all of fiscal years 2008 and 2009, as well as the first half of fiscal year 2010.

According to the Board, a resolution can include any of the following actions:

- Sending the registrant an inspection “no action” letter, which indicates no deficiencies were noted during the inspection.
- Notifying the registrant about necessary corrective action through a “caution letter” and receiving a satisfactory response from the registrant indicating that corrective action has been implemented.
- Referring the deficiency to the Inspections Division’s legal section for possible legal action that could include suspending or revoking the registrant’s registration, or assessing an administrative fine.

Table 2

Unresolved Inspections by Branch Office					
As of February 28, 2010					
Inspections		Austin Branch Office	Dallas Branch Office	Houston Branch Office	Totals
Fiscal Year 2008	Total Inspections	97	73	69	239
	Number of Unresolved Inspections	44	2	3	49
	Percent of Total Inspections	45.4%	2.7%	4.3%	20.5%
Fiscal Year 2009	Total Inspections	105	55	77	237
	Unresolved Inspections	80	21	7	108
	Percent of Total Inspections	76.2%	38.2%	9.1%	45.6%
Totals for Fiscal Years 2008 and 2009	Total Inspections	202	128	146	476 ^a
	Unresolved Inspections	124	23	10	157
	Percent of Total Inspections	61.4%	18.0%	6.8%	33.0%

^a The Inspections Division conducted 130 inspections in fiscal year 2010, 102 of which were open as of February 28, 2010.

Source: Data from the Board’s Inspections and Compliance System.

In July 2010, the Inspections Division reviewed the 157 fiscal year 2008 and fiscal year 2009 inspections that were open as of February 2010. Of these inspections, 101 were still open as of July 2010. Of these still open inspections:

- 20 were the subject of an ongoing investigation.
- 37 had a caution letter sent that had not been resolved.

The Inspections and Compliance System does not record detailed information regarding the status of inspections after the end of an inspection's fieldwork stage. The system tracks three dates: the inspection start date, the inspection end date, and the inspection resolution date. Increasing the number of data fields might assist management in monitoring the Inspections Division's progress in resolving inspections. Additional fields that might be helpful include:

- Date on which a no action or caution letter was sent to the registrant.
- Date on which management completed its review of the inspection work.
- Date on which the registrant's response to the Inspections Division's request for information is due.

Chapter 2-D

Registrants Generally Comply with the Requirement to Self-report Corrective Actions Taken as a Result of Inspections

The Inspections Division generally relies on registrants to self-report their implementation of corrective action. Of the 30 sample inspections that auditors tested, registrants reported the following regarding required corrective action:

- 22 (73.3 percent) of the 30 registrants reported that they had implemented corrective actions to address the violations and issues identified during the inspections within the Inspections Division's required 30-day timeframe.
- 7 (23.3 percent) of the 30 registrants reported they implemented corrective actions between 3 and 35 days after the date of the caution letter.
- 1 (3.3 percent) of the 30 registrants did not implement corrective action; it terminated its registration within 6 months of the inspection end date.

The Inspections Division typically does not perform follow-up inspections to ensure that the corrective actions actually have been implemented. Of the 606 inspections it conducted from September 2007 through February 2010, the Inspections Division inspected 16 registrants more than once, but it designated only 5 of the 606 inspections (about 0.8 percent) as a follow-up inspection.

The Board Reported That It Met Its Fiscal Year 2009 Performance Measure Targets Related to Inspections

The Board's performance measures specify targets for (1) the number of inspections the Inspections Division conducts in a year from all categories of registrants and (2) the Board's percentage coverage of Texas registrants (for the two categories for which the Board has primary oversight responsibility).

In fiscal year 2009, the Inspections Division's performance measures (see text box) targets were to conduct at least 225 inspections and to inspect 20 percent of Texas registrants not inspected by any other regulatory entity. The Inspections Division reported that it met both targets by conducting 237 inspections and inspecting 20.1 percent of Texas registrants.⁵

Key Performance Measures

Outcome: Percentage of Texas Dealers and Investment Advisers Inspected - Inspect Texas registered dealers and Texas registered investment advisers that are not inspected by any other regulatory entity.

Output: Number of Inspections Conducted - A count of all inspections of registered dealers and registered investment advisers.

Source: Automated Budget and Evaluation System of Texas.

The Inspections Division's director determines how many inspections each of the Inspections Division's branch offices will conduct each quarter and what type of registrants the branch offices will inspect based on staffing. The assistant director managing each branch office then selects the registrants to be inspected from those under the

branch office's jurisdiction. The assistant director prioritizes registrants for inspection, in part, using an informal, undocumented risk assessment process. The assistant director considers various criteria, such as whether a registrant is subject to inspection by other entities; complaints the Board has received about a registrant; referrals the Board received; and a registrant's geographic location. Management also considers factors, such as staffing limitations and travel coordination, when selecting registrants for inspection.

The Board does not have a formalized risk assessment through which it identifies risk factors and assesses how each factor applies to each registrant. These factors could include data from the registrants' registration forms, such as whether the registrant has custody of its clients' assets. Having a formalized risk assessment could help the Board focus its resources on registrants that present the most risk to investors.

The Inspections Division's inspections provided good geographic coverage of several areas of Texas in which the Board does not have a branch office.

The Inspections Division has branch offices in Dallas, Houston, and Austin. The Dallas office has six financial examiners and covers the Dallas/Fort Worth metroplex. The Houston office has four financial examiners and covers mainly the Houston area. The Austin office has eight financial examiners and has jurisdiction over the rest of the state.

⁵ Auditors verified the accuracy of the Division's reported Number of Inspections Conducted, but not the Division's reported Percentage of Texas Dealers and Investment Advisers Inspected.

The Inspections Division’s three branch offices provide good coverage in areas such as El Paso, Tyler, Lubbock, San Antonio, and Amarillo. However, the Inspections Division could improve its coverage in the Midland/Odessa and McAllen areas (see Table 3).

Table 3

Geographical Coverage of Registrant Inspections Fiscal Years 2005 through 2009						
Metropolitan Area	Registrants Over Which the Board Has Primary Responsibility to Inspect			All Registrants		
	Total Registrants	Number of Registrants Inspected	Percent of Registrants Inspected	Total Registrants	Number of Registrants Inspected	Percent of Registrants Inspected
Amarillo	6	4	66.7%	8	5	62.5%
Austin	55	54	98.2%	71	58	81.7%
Dallas/Fort Worth	165	125	75.8%	267	146	54.7%
El Paso	9	8	88.9%	9	8	88.9%
Houston	151	128	84.8%	214	134	62.6%
Lubbock	4	4	100.0%	7	6	85.7%
McAllen	2	0	0.0%	2	0	0.0%
Midland/Odessa	5	2	40.0%	6	2	33.3%
San Antonio	36	31	86.1%	54	37	68.5%
Tyler	4	4	100.0%	5	4	80.0%
All Other Areas	63	44	69.8%	67	44	65.7%
Totals	500	404	80.8%	710	444	62.5%

Source: Data from the Board’s Inspections System.

Despite meeting annual performance measure targets for inspections, the Board did not meet its internal goal of inspecting all registrants for which it has primary oversight responsibility within a five-year cycle.

The Board has an internal goal of inspecting all registrants for which it has primary oversight responsibility within a five-year cycle (20 percent per year). The number of investment advisers and Texas non-FINRA registered broker dealers fluctuated considerably between fiscal years 2005 and fiscal year 2009. During that period, there were 1,628 registrants, but only 500 were registered during the entire 5-year period. The Inspections Division inspected 80.8 percent (404 of 500) of these registrants. The Board conducted a total of 1,219 inspections during the 5-year period, exceeding its annual output target of 225 inspections each year.⁶ Even so, the number of inspections was only

⁶ The Board’s output target was 225 inspections each year except fiscal year 2005. Its output target was 94 inspections for fiscal year 2005.

74.9 percent of the total number of registrants for which the Board had primary oversight responsibility.

The Board's current inspection cycle coverage of registrants for which it has primary oversight may not be the best approach available for the Board given its available resources. There are other approaches that may enable the Board to more effectively select registrants for inspection. The Board should determine a methodology to adequately cover risk to Texas investors and formally document this methodology. Some of the options available to the Board include:

- Adopting a two-tiered approach in which it inspects high-risk registrants during a cycle and also inspects a selection of medium- and low-risk registrants.
- Increasing the number of pre-examinations to cover more registrants.

Recent changes in federal law will likely increase the number of investment advisers that the Board regulates.

The recently enacted Dodd-Frank Act increases the threshold for federal registration of investment advisers from \$25 million in assets under management to \$100 million in assets under management. As a result, the Board estimates that the number of investment advisers that it regulates will increase from 1,205 as of July 23, 2010, to approximately 2,450, an increase of 103.3 percent. The Board's legislative appropriations for the 2010-2011 biennium contained a contingency appropriation that may apply if federal regulatory oversight is reduced. If applicable, the Board may receive up to an additional \$934,072 in annual appropriations and 10 full-time equivalent (FTE) positions. The Board must successfully file a finding of fact and support that it will achieve revenue targets in the legislative appropriations request it submits to the Legislative Budget Board and the Governor's Office before those funds can be appropriated.

Recommendations

The Board should:

- Implement a policy that establishes a time frame for resolving inspections.
- Review and make necessary adjustments to its allocation of examiners to balance the inspection workload among the three branch offices.
- Modify its Inspections and Compliance System to help it better track the progress of inspections after fieldwork is completed.
- Formalize the risk assessment it uses to select registrants for inspection and increase the factors that it uses to select registrants for inspection.

- Review how it selects registrants for inspection and study whether its current cycle inspection coverage of registrants for which it has primary oversight is the best approach available or whether it should modify its approach. As part of this review, the Board should study ways to cover more registrants and ensure that it includes inspections of registrants for which the Board has shared oversight responsibility.

Management's Response

Recommendation 1. The Agency agrees with the recommendation to establish a time frame for resolving inspections. The Director of the Inspections and Compliance Division is responsible for this procedure. Implementation is expected to be completed during the first quarter of fiscal year 2011.

Recommendation 2. The Agency agrees with the recommendation to review and make necessary adjustments to its allocation of examiners to balance the inspection workload among the three branch offices. The Director of the Inspections and Compliance Division is responsible for this process. Implementation is expected to be completed during the first quarter of fiscal year 2011.

Recommendation 3. The Agency agrees with the recommendation to modify its Inspections and Compliance System to help it better track the progress of inspections after fieldwork is completed. The Director of the Inspections and Compliance Division is responsible for this change. Implementation is expected to be completed during the first quarter of fiscal year 2011.

Recommendation 4. The Agency agrees with the recommendation to formalize the risk assessment it uses to select registrants for inspection and increase the factors that it uses to make inspection selections. The Director of the Inspections and Compliance Division is responsible for this procedure. Implementation is expected to be completed during the first quarter of fiscal year 2011.

Recommendation 5. The Agency agrees with the recommendation to review how it selects registrants for inspection and study whether its current inspection coverage of registrants for which it has primary oversight is the best approach available or if it should modify its approach. As part of this review, the Agency will study ways to cover more registrants and ensure that it includes inspections of registrants for which it has shared oversight responsibility. The Director of the Inspections and Compliance Division is responsible for this review and study. Such actions are expected to be completed during the second quarter of fiscal year 2011.

The Board Investigates Complaints in Compliance with Its Policies and Procedures

The Board has two divisions that investigate complaints: the Inspections Division and the Enforcement Division. The Inspections Division investigates complaints against individuals or firms who are registered with the Board, in addition to conducting inspections (see Chapter 1-B). The Enforcement Division investigates complaints against unregistered firms or persons.

The Inspections Division

The Inspections Division receives complaints by fax, mail, or through the Board's Web site. The Inspections Division has one financial examiner primarily assigned to investigate complaints and nine examiners who divide their time between conducting inspections and conducting investigations.

The Inspections Division investigated complaints against 383 registered firms or individuals between September 1, 2007, and February 28, 2010. As of March 1, 2010, it had resolved 179 of those complaints.⁷ According to Board data, between September 1, 2007, and February 28, 2010, the Division averaged 174 days between the receipt of a complaint and its resolution. The Board took more than a year to resolve 11.7 percent of those complaints. The Board does not have a target number of days for resolving complaints.

Inspections Division records show that, of the 179 resolved complaints:

- 58 (32.4 percent) resulted in a referral to the Inspections Division's legal section for possible imposition of administrative actions or the sending of a caution letter to the subject firm or individual.
- 15 (8.4 percent) were determined to be outside the Inspections Division's authority. Of those 15 cases, the Inspections Division referred 7 to the Enforcement Division.
- 2 (1.1 percent) resulted in the Division issuing the firm or individual a caution letter, which documented deficiencies for which the firm or individual must submit a corrective action plan within 30 days.
- 104 (58.1 percent) did not result in formal action by the Board against the firm or individual. Even without formal action, some firms or individuals voluntarily reimbursed the complainant investor; however, board data limitations did not allow auditors to quantify how many of these cases resulted in the firms or individuals voluntarily reimbursing the investors or allowing investors to liquidate their investments. Auditors could not

⁷ As of March 1, 2010, 204 of these complaints had not been resolved.

determine how many of these complaints resulted in investor reimbursement because the Board does not track this outcome separately.

Auditors tested 30 of the 179 resolved complaints and determined that the Board investigated those complaints in a manner consistent with its processes and procedures. For those 30 complaints, Inspections Division staff:

- Ensured that all formal complaints were submitted in writing as required by law.
- Sent all the quarterly investigation status update letters required by the Texas Securities Act to complainants and complaint subjects, except in two cases. In those two cases, staff sent some but not all of the required letters.
- Referred matters outside the Board's jurisdiction to another authority, such as the Department of Insurance, as appropriate.
- Issued a caution letter to a registrant to resolve one complaint. The Inspections Division received documentation from the registrant that it had implemented corrective action.

Inspections Division data shows that 43 of the 179 resolved complaints were referred to the Inspections Division's legal section. The legal section, which has two full-time attorneys on staff, enables the Inspections Division to develop legal cases against registrants, rather than having to refer the cases to a separate division. This structure differs from the SEC's structure for developing legal cases resulting from complaints and inspections. In fiscal year 2009, as a result of the legal section's work, 27 administrative orders were issued against registrants, which resulted in \$12 million in administrative fines paid to the State.

The Enforcement Division

Auditors could not determine how many complaints the Board's Enforcement Division received because it does not track complaints separately as does the Inspections Division. The Enforcement Division does not have as great a need to track complaints because the Texas Securities Act's complaint documentation requirements apply only to complaints against registrants. The Enforcement Division investigates complaints against non-registrants.

The Board reported that the Enforcement Division opened 932 investigations between September 1, 2007, and February 28, 2010, and that 75 cases resulted in either indictment or conviction of the subjects. The Enforcement Division does not differentiate between investigations initiated as a result of a complaint and investigations initiated as a result of other sources. For example, the Enforcement Division may initiate an investigation if an investigator identifies potential violations of the Texas Securities Act when

searching the Internet or newspaper ads. Referrals from other securities regulators, such as the SEC, or law enforcement agencies may also result in an investigation being initiated.

How the Enforcement Division Processes Complaints

When the Enforcement Division receives a complaint, management determines whether the complaint should be handled as a pre-investigation inquiry or as an investigation. Most investigations are initially handled as pre-investigation inquiries, during which Enforcement Division staff members determine whether the Enforcement Division should commit its resources to a formal investigation.

Because the Enforcement Division does not track complaints separately, auditors tested 30 randomly selected investigation files and 30 randomly selected pre-investigation inquiries (see text box for more information about the enforcement process) and determined that the Enforcement Division managed its investigations against unregistered entities in a manner that is consistent with the Board's policies and procedures. Of the 60 investigations and inquiries tested, 33 (54.1 percent) originated from complaints. For those 60 investigations and inquiries, Enforcement Division staff:

- Referred all matters outside their jurisdiction to the Inspections Division or another authority, such as the U.S. Internal Revenue Service.
- Administered all applicable fines or penalties within any applicable time lines.
- Ensured that 57 (95.0 percent) of the files contained the proper documentation showing that management had approved the investigation's or inquiry's closure.

Recommendations

The Board should:

- Send all required quarterly update letters to complainants and subjects of complaints and ensure that it documents all instances when letters are sent.
- Create and retain the proper documentation of management's authorization to close investigations and inquiries.
- Consider distinguishing complaints that result in investor reimbursement from other complaints that do not result in formal Board action. The Board should also study the benefits of tracking the amount of money investors recover through complaints that result in investor reimbursement.

Management's Response

Recommendation 1. The Agency agrees with the recommendation to ensure that all required quarterly update letters to complainants and subjects of complaints are sent and documented. The Director of the Inspections and

Compliance Division is responsible for this procedure. Implementation is expected to be completed during the first quarter of fiscal year 2011.

Recommendation 2. The Agency agrees with the recommendation to create and retain the proper documentation of management's authorization to close investigations and inquiries. The Director of the Inspections and Compliance Division and Director of the Enforcement Division are responsible for this procedure. This recommendation has been implemented.

Recommendation 3. The Agency agrees with recommendations to consider distinguishing complaints that result in investor reimbursement from other complaints that do not result in formal Board action and to study the benefits of tracking the amount of money investors recover through complaints that result in investor reimbursement. The Director of the Inspections and Compliance Division and Director of the Enforcement Division are responsible for this work. The actions recommended are expected to be taken during the first quarter of fiscal year 2011.

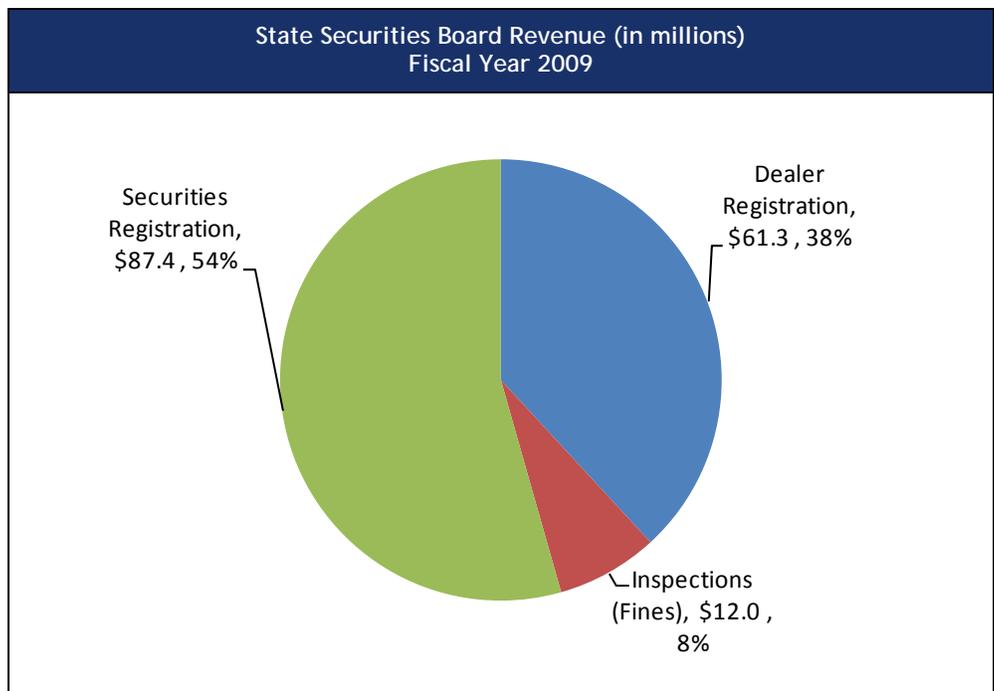
While the Board Has Controls in Place Over Receipts of Payments for Fees and Fines, It Should Improve Its Processes Over the Collection of These Securities Registration Revenues

Although the Board’s receipting process has some strong controls, the overall integrity of this process is weakened by deficiencies in controls over mail distribution, payment tracking and reconciliation, and segregation of duties. These weaknesses expose the Board to the risk of lost revenue through fraud or error. Auditors gained assurance through testing of deposit vouchers that the Board did not lose funds during fiscal year 2009, but the risk of loss remains.

In addition, the Board uses a self-reporting process in its oversight of securities sales. However, it does not ensure that all securities filers submit end-of-year sales reports or final sales reports.

The Board collects revenue from several different sources, including registration fees from investment professionals and securities filings and administrative fines from inspections (see Figure 1). In fiscal year 2009, the Board received \$95.6 million in checks and cash through its mailroom and \$65.1 million through electronic funds transfer.

Figure 1



Source: Data from the Board’s automated receipt tracking system.

Weaknesses in the Board's Receipting Process Expose the Board to the Risk of Lost Revenue

The Board has several policies and procedures in place for the processing of payments received through its mailroom that are designed to prevent the misappropriation of funds and reduce the Board's risk of lost revenue. Auditors observed that these controls were in place as per Board policy and procedure. For example:

- Two employees must be in the mailroom at all times when mail containing payments is opened and processed.
- All checks must be deposited or returned to the sender if they cannot be processed within three business days.
- Checks and applications must be stamped with unique numbers that enable Board staff to match checks with securities filings applications.
- Employees sort checks in batches and calculate batch totals, which are verified by a second employee.
- Checks must be reconciled daily with deposits entered in the Board's automated receipt tracking system (Money System).
- Employees who process receipts must be assigned to a division that is different from the divisions that produce revenues.

These controls provide general assurance that revenue the Board receives through the mail is materially and accurately reflected in the Board's accounting system. However, weaknesses in the Board's controls over mail distribution, payment tracking and reconciliation, and segregation of duties increase the Board's risk of a loss of funds through fraud or error. These weaknesses are described below:

- Mail is not directly delivered to the mailroom, which creates a risk that checks or cash may be lost or stolen before they are delivered to the mailroom.
- The Board does not track payments until they are grouped in batches for entry into the Money System. As a result, the loss of a payment prior to the batching would not be detected.
- The Board does not provide securities filers with written receipts for payments. Instead, the Board relies on filers to check the Board's Web site to determine whether the Board has approved their filings. Requiring staff to provide filers a written receipt can help filers to track their fees.

- The Board does not reconcile the information in its Registration System with the information in its Money System. As a result, securities filings that the Board processed are never reconciled with the fees it reportedly received for those filings. In addition, as discussed in Chapter 1, the Board's Registration System lacks sufficient controls to ensure that changes to securities' status have been approved. The Board's Registration System and Money System do not have comparable data fields, which inhibit the Board's ability to reconcile the application information in the Registration System with the fee information in the Money System.
- The Board did not maintain adequate segregation of duties between its Registration System and its Money System. Auditors identified one employee who is a programmer and database administrator for both the Registration System and the Money System. As a result, this employee can initiate, edit, and delete transactions in those systems. Auditors confirmed that the employee edited transactions on both systems. The programmer also had access to checks and cash received by the Board when the employee served as a back-up mail processor.
- The Board does not ensure that it always sequentially issues the unique numbers it assigns to payments received and their matching applications. Auditors detected 29 gaps in the sequence of the numbers issued in fiscal year 2009 and in the first half of fiscal year 2010. Two of these gaps were due to data entry errors. The other 27 unexplained gaps could indicate an incomplete accounting for funds.
- The Board does not provide written notification when it approves securities filings. While the small number of filers whose registrations undergo merit-based reviews receive a phone call, most filers do not receive any notification.
- Board policies require that it perform initial background checks on all employees. Management stated that it also performs annual background checks on all employees, but the Board does not maintain documentation showing that it had conducted these background checks for each employee, such as a checklist.

Auditors performed tests to gain assurance that the Board did not lose funds during fiscal year 2009. Specifically, auditors:

- Verified that amounts in the Money System accurately reflected the underlying receipts.
- Tested the Board's reconciliations between the Money System and the Uniform Statewide Accounting System and determined that they were accurate.

- Traced a sample of 34 transactions in the Registration System to the Money System. All 34 transactions from the Registration System were present in the Money System.

There are potential alternatives available to the Board for processing its receipts. The Board could have payments received through the mail through a State Treasury lockbox or require that all payments be sent electronically through Texas.gov. These alternatives would route payments through proven processes that are specialized for cash receipts processing. The use of the State Treasury lockbox would not require payment from the Board; use of Texas.gov may require a processing fee.

The Board collected \$65.1 million in fees electronically in fiscal year 2009, and it increased its capability to collect fees electronically in fiscal year 2010.

In addition to payments received through its mailroom, the Board electronically received \$65.1 million in revenue during fiscal year 2009 for registrations of certain investment professionals from the Financial Industry Regulatory Authority.

In November 2009, the Board also implemented processes to allow PNC Global Investment Servicing (PNC) to electronically send securities registrations payments to the Board for mutual funds registered through PNC's proprietary mutual fund compliance system. During the first two quarters of fiscal year 2010, the Board received \$22.0 million in revenue through electronic submissions from PNC.

Chapter 4-B

The Board Collects Revenue from the Oversale of Securities in Accordance with Applicable Laws and Regulations

The Board collected \$1.2 million in revenue from fines for the oversale of securities in fiscal year 2009. The Board uses a self-reporting process through

which it requires securities filers to report the amount of their securities sales to the Board (see text box). If filers sell more securities than the amount for which they have registered or authorized with the Board, they must pay a fine of 0.3 percent of the oversale amount. Securities filers in 39 (97.5 percent) of 40 sales reports for oversold securities tested submitted the correct fine amount. One securities filer overpaid its fine by \$3.15.

The Board does not ensure that all securities filers submit end-of-year sales reports or final sales reports. It relies on securities filers to self-report their sales, and it does not monitor securities filers to ensure that they submit those reports unless the securities filers renew their registrations or authorizations. The Board does not attempt to contact or pursue action against securities filers that have

Securities Filers Must Report Securities Sales to the Board

All registrants must prepare and forward to the securities commissioner annual reports showing the amount of securities that have been sold in Texas and the amount of unsold securities authorized to be sold in Texas. Upon completion of all offerings of securities registered or authorized in Texas, a final sales report must be filed with the securities commissioner showing the total aggregate amount of securities sold by a registrant.

Source: Texas Administrative Code, Title 7, Sections 113.10 and 114.4.

not submitted a final sales report for the year.

During the first half of fiscal year 2010, the Board processed 40 oversale transactions from the 23,793 active registrations and authorizations at that time. A large percentage of securities filers do not renew their registrations or authorizations. For example, the Board granted 4,119 new registrations or authorizations from September 1, 2008, through February 28, 2009. Of those new registrations and authorizations, only 1,438 (34.9 percent) renewed their registration or authorization for the next year.

Recommendations

The Board should:

- Require mail to be delivered directly to the Board's mailroom instead of to the reception area.
- Design and implement the use of a mechanism, such as a form, to track and account for the initial receipt of checks and cash in the mailroom.
- Provide securities filers with a written receipt when the Board receives a payment.
- Modify the Registration System or the Money System so that the systems have common data elements to allow for regular reconciliation between receipts and registration transactions.
- Use sequential numbering of receipts, and periodically review and investigate any gaps in the numbers.
- Ensure that access to information systems, as well as employee duties, are appropriately segregated to reduce the opportunity for loss of revenue due to fraud or error.
- Maintain documentation, such as a checklist, showing that the Board conducted annual criminal background checks on all employees if management chooses to continue this practice. Management should also consider formalizing this practice in policy.
- Provide securities filers written notification when the Board approves their registrations.
- Reduce the amount of checks and cash processed in the mailroom by increasing the use of electronic payments and/or have third parties process payments received through the mail.
- Add functionality to its Registration System to allow it to identify those securities filers that have not submitted the required sales reports.

- Ensure that securities filers provide the Board with all required reports. This should include sending notifications to and following up with securities filers identified as not having submitted the required reports and ensuring that securities filers submit all reports before the Board renews a securities filing.

Management's Response

Recommendation 1. The Agency agrees with the recommendation to require that Agency mail be delivered directly to its mail room if it continues to receive payments through the mail. The Director of the Staff Services Division is responsible for implementation of this procedure. Implementation is expected to be completed during fiscal year 2011.

Recommendation 2. The Agency agrees with the recommendation to design and implement the use of a mechanism, such as a form, to track and account for the initial receipt of checks and cash in the mail room if it continues to receive payments through the mail. The Director of the Staff Services Division is responsible for implementation of this procedure. Implementation is expected to be completed during fiscal year 2011.

Recommendation 3. The Agency will address the risk identified in the audit report pertaining to written receipts by making programming changes necessary to post the fee amounts paid by securities filers on the Agency's online registration database available to securities filers and the public. The Director of the Staff Services Division is responsible for the implementation of this change. Implementation is expected to be completed by the second quarter of fiscal year 2011. The Agency believes that with this change, a separate written receipt is unnecessary. Filers are accustomed to going to the Agency's online registration system to confirm filing information. Filers can also contact the Agency directly to obtain that information by telephone or by email. This is the same process used in other states. The Agency's experience has been that these methods of communication have proven sufficient for securities filers. The Agency also believes that sufficient safeguards have been established to ensure that the amount of payment correctly corresponds to the amount of securities authorized for sale. Payments entered into the Money System by one division of the Agency automatically populate read-only data for amounts of securities authorized in the Registration System which is independently verified by another division of the Agency. Any change in such data must be documented and authorized by the Director of the Registration Division.

Recommendation 4. The Agency agrees with the recommendation that the Registration System and Money System should contain common data elements to allow for regular reconciliation between receipts and registration

transactions. The Director of Staff Services is responsible for implementation of this procedure. This recommendation has been implemented.

Recommendation 5. The Agency agrees with the recommendation to use sequential numbering of receipts and periodically review and investigate any gaps in the numbers if it continues to receive payments through the mail. The Director of the Staff Services Division is responsible for implementation of this procedure. Implementation is expected to be completed during fiscal year 2011.

Recommendation 6. The Agency agrees with the recommendation to ensure that access to information systems, as well as employee duties, are appropriately segregated. The Director of the Staff Services Division and Director of the Registration Division are responsible for implementation of this procedure. Implementation is expected to be completed during the first quarter of fiscal year 2011.

Recommendation 7. The Agency agrees with the recommendations to maintain documentation, such as a checklist, showing that the Agency conducted criminal background checks on employees and formalizing this practice in policy. The Director of the Staff Services Division is responsible for implementation of this procedure. Implementation is expected to be completed during the first quarter of fiscal year 2011.

Recommendation 8. The Agency agrees with the recommendation to provide securities filers written notification when the Board approves their registration. The Director of the Registration Division is responsible for implementation of this procedure. Implementation is expected to be completed during the first quarter of fiscal year 2011.

Recommendation 9. The Agency agrees with the recommendation to reduce the amount of checks and cash processed in the mailroom by increasing the use of electronic payments and/or requiring payments received through the mail to be processed via a third-party. The Director of the Staff Services Division and Director of the Registration Division are responsible for implementation of this process. Implementation is expected to be completed during fiscal year 2011.

Recommendation 10. The Agency agrees with the recommendation to add functionality to its Registration System to allow it to identify those securities filers that have not submitted the required sales reports. The Director of the Registration Division is responsible for implementation of this procedure. Implementation is expected to be completed during the second quarter of fiscal year 2011.

Recommendation 11. The Agency agrees with the recommendation to ensure that securities filers provide the Agency with all required sales reports. The Agency will send notifications to and follow up with securities filers identified

as not having submitted the required sales reports and will ensure that filers submit all sales reports before the Agency renews a securities filing. The Director of the Registration Division is responsible for implementation of this procedure. Implementation is expected to be completed during the second quarter of fiscal year 2011.

Although Critical Data in the Board's Automated Systems Was Accurate, the Board's Controls over Data Entry and Verification Are Not Adequate to Ensure Continued Accuracy

The Board has documented information resources policies and procedures and adequate physical security controls over its automated systems. In addition, critical data tested in the Board's Registration System, Money System, and Inspections and Compliance System (Inspections System) was accurate⁸ (see text box for descriptions of these systems). However, auditors identified significant weaknesses in the Board's controls over data entry and data verification. As a result of those weaknesses, the Board faces an increased risk of lost or misappropriated funds and cannot ensure future data reliability.

The Board's systems are not designed to share data, preventing the Board from sharing or reconciling data among the systems.

The Board's Registration System, Money System, and Inspections System do not have common data elements that would allow for the sharing and reconciling of information across the systems. As discussed in Chapter 4, information about applications in the Board's Registration System cannot be matched with payment information in its Money System. The Board's ability to detect lost or misappropriated funds is reduced if it cannot reconcile registrations with the payments received.

In addition, the data in the Registration System cannot be reconciled with the information in the Inspections System to determine which registrants should be scheduled for inspection. Instead, the Board has a manual process through which the Inspections Division assistant directors manually download a list from the Registration System and reconcile that information to create the inspections schedule. This manual process increases the risk of human error and inspections not being performed on a timely basis.

Although critical data in two of the Board's systems is accurate, the Board should reduce the risk of future errors and unauthorized changes by implementing additional application controls, such as edit checks and audit trails.

Auditors tested data in the Registration and Inspections systems and determined that critical data in both systems was generally accurate. Specifically:

The Board's Automated Systems

The Board uses three automated systems and one database to carry out its daily functions. These are:

- **Registration System:** Contains databases which hold more than 500,000 records, including historical records, for securities registration and broker dealer and investment adviser registration. This system also contains the Board's automated receipt tracking system (a module referred to as the Money System, which is described below).
- **Money System:** Contains information on deposits from securities registration fees, broker dealer fees, and fines.
- **Inspections and Compliance System:** Tracks the broker dealers and investment advisers at which the Board performed inspections or performed pre-inspections. Also tracks the status of complaints against registrants.
- **Enforcement database and related spreadsheet:** Serves as a file index for investigation files. The Enforcement Division uses spreadsheets to track complaints and to prepare data for the Board's performance measures.

⁸ Auditors did not rely on the data in the Enforcement database for analysis or testing.

- 567 (98.6 percent) of 575 data elements tested in the Registration System contained accurate information.
- 267 (98.9 percent) of 270 data elements tested in the Inspections System contained accurate information.

Despite the accuracy of critical data in both systems, auditors identified weaknesses in the application controls that increase the risk of future errors. Specifically:

- The Registration System does not maintain a complete audit history of all changes made to data between the initial entry and the most recent entry. In addition, the field that records the date of the most recent change does not record the time of that change. If unauthorized changes have been made to the data, not having a complete audit history may limit the Board's ability to determine who made the changes and what changes were made.
- The Registration System does not calculate the registration fees. Currently, the Board's financial examiners calculate and manually enter those fees into the systems. Auditors tested the accuracy of fees charged for 34,197 securities registration transactions in fiscal year 2010 and determined the fees were materially accurate.
- The Registration System and Inspections System lack edit checks to prevent certain data entry errors. For example, auditors identified 18 records for which an inspection's end date was before its start date.
- The Money System does not automatically reset between records. As a result, the amount entered for one record is still listed in the Amount Field when a new record is started. This increases the risk that an incorrect fee will be recorded in the database.

The Board allowed a database administrator to enter and edit data directly into the Registration and Money systems' databases.

One of the Board's information technology employees with database administrator access rights entered and edited data directly in the databases for the Registration System and Money System. Allowing systems support personnel, such as database administrators and programmers, to enter and manipulate data increases the risk of unauthorized changes to data that are not detected.

While there may be instances in which a database administrator must change the data, most data changes should be done by the division employees responsible for managing the data in each system. In addition, all changes to the data made by systems support personnel should be (1) approved in writing before the changes are made and (2) fully documented.

The Board did not ensure that only authorized users had access to its Inspections System.

The Board generally has good access controls for the Inspections System but needs to further limit access to only those persons who need access to that system as part of their job duties. For instance, a former employee of the Board still had director level access to the Inspections System.

The Board has documented information security policies and procedures and adequate physical security controls.

The Board has developed and adopted information resource policies and procedures that include procedures for:

- Updating the accounts of individuals who change roles within the Board or removing accounts of individuals whose employment has been terminated.⁹
- Requiring appropriate password composition to ensure password strength.

In addition, the Board's controls over the physical security of its automated systems include securing the server room and providing a fire suppression system and an uninterruptible power supply.

Recommendations

The Board should:

- Modify its automated systems so that they have common data elements to allow for regular sharing and reconciliation of data among the systems.
- Implement complete audit trails of all data entry and data edits in its Registration System to allow Board personnel to determine the source of all data changes and the time and date when those changes were made.
- Modify its Money System so that all fields, including the amount, are cleared before a new record is entered.
- Ensure that only authorized employees have appropriate access to Inspections Division data. Management should review which persons have access to the Inspections Division's systems to ensure that only persons who need access to these systems have access.
- Create a policy stating that systems support personnel should not change or edit data without prior written approval and documentation. In addition,

⁹ Terminations may include voluntary and involuntary separations from an agency, reductions in force, transfer to a different state entity, retirement, and death.

audit history should be complete, used to monitor data integrity, and protected.

Management's Response

Recommendation 1: The Agency agrees with the recommendation to modify its automated systems so that they have common data elements to allow for regular sharing and reconciliation of data among the systems. The Director of the Staff Services Division, Director of the Inspections and Compliance Division, and Director of Registration are responsible for implementation of this process. Implementation is expected to be completed during fiscal year 2012. In view of the large scope of this project, its implementation will be subject to adequate legislative appropriations and personnel.

Recommendation 2. The Agency agrees with the recommendation to implement audit trails of data entry and data edits in its Registration System to allow Agency personnel to determine the source of critical data changes and the time and date when those changes were made. The Director of the Staff Services Division and Director of Registration are responsible for implementation of this process. Implementation is expected to be completed during fiscal year 2011. In view of the large scope of this project, its implementation will be subject to adequate legislative appropriations and personnel.

Recommendation 3. The Agency agrees with the recommendation to modify its Money System so that all fields, including the amount, are cleared before a new record is entered. The Director of the Registration Division and Director of the Staff Services Division are responsible for implementation of this process. Implementation should be completed during the second quarter of fiscal year 2011.

Recommendation 4. The Agency agrees with the recommendation that the Agency ensure that only authorized employees have appropriate access to Inspections and Compliance Division data. The Director of the Inspections and Compliance Division and the Director of the Staff Services Division are responsible for implementation of this process. Implementation is expected to be completed during the first quarter of fiscal year 2011.

Recommendation 5. The Agency agrees with the recommendations that the Agency create a policy stating that support personnel should not change or edit data without prior written approval and documentation and that audit history should be complete, used to monitor data integrity and protected. The Director of the Staff Services Division is responsible for implementation of these recommendations. Implementation is expected to be completed during the first quarter of fiscal year 2011.

Appendices

Appendix 1

Objectives, Scope, and Methodology

Objectives

The objectives of this audit were to determine whether the State Securities Board (Board):

- Has controls to provide assurance that securities filings comply with applicable laws and regulations.
- Conducts inspections and investigates complaints in a consistent, risk-based manner.

Scope

The scope of this audit included the Board's processes, documentation, and financial information related to securities filings from September 1, 2008, to February 28, 2010; to inspections opened from September 1, 2007, to February 28, 2010; to inspection coverage of registrants from September 1, 2004 to August 31, 2009; and to complaint investigations from September 1, 2008, to February 28, 2010. The audit also included a review of automated systems for registrations, receipting, inspections, and enforcement.

Methodology

The audit methodology included reviewing the Board's internal controls and processes related to receipt handling, securities registration, inspections, and complaints investigations.

Information collected and reviewed included the following:

- The Board's policies and procedures.
- Securities registrations data for securities for which the Board approved registration during fiscal year 2009 and the first half of fiscal year 2010.
- Registrant data for broker dealers and investment advisers who were registered from September 2004 through August 2009.
- Money System data for fiscal year 2009 and the first half of fiscal year 2010.
- The Board's revenue codes and schedule of fees.

- Reconciliations between the Board's Money System and Uniform Statewide Accounting System (USAS) for fiscal year 2009.
- Deposit vouchers from September 1, 2008, to February 28, 2010.
- Sales reports that securities filers submitted to the Board from September 2009 through February 2010.
- Inspection and Compliance System data between September 1, 2007, and February 28, 2010.
- Inspection files opened between September 1, 2007, and February 28, 2010.
- List of inspections that the U.S. Securities and Exchange Commission (SEC) and other regulators conducted on the Board's registrants.
- Data for investigations that the Board's Enforcement Division closed from September 1, 2008, to February 28, 2010.
- Enforcement Division investigation and investigation/suspense files for investigations closed between September 2008 and February 2010.
- *Report of the 2009 Special Review Committee on FINRA's Examination Program in Light of the Stanford and Madoff Schemes*, Financial Industry Regulatory Authority (FINRA), September 2009.
- *Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme*, SEC Office of Inspector General, March 31, 2010.
- Access listings for the various information technology systems that the Board uses to regulate securities.
- Traffic statistics for the Board's Web site.

Procedures and tests conducted included the following:

- Interviewed key personnel in the Board's Registration Division, Inspections and Compliance Division, Enforcement Division, and Staff Services Division.
- Reviewed electronic and paper files of securities registrations and notice filings to determine compliance with the Texas Securities Act and the Texas Administrative Code.
- Recalculated fees for securities registrations and notice filings.

- Tested the Board's monthly reconciliations between its Money System and USAS.
- Traced cash receipts to monthly revenue reconciliations.
- Tested Money System data for completeness.
- Reviewed sales reports to determine whether oversale fees were calculated according to the Texas Administrative Code.
- Analyzed inspections that the Board conducted.
- Tested a sample of inspections and investigations for compliance with Inspections and Compliance Division policies, processes, and controls.
- Identified and assessed information technology controls over the Board's automated systems.
- Analyzed edit checks in the Money System and Inspections and Compliance database.
- Reviewed traffic statistics for the Board's Web site.

Criteria used included the following:

- Texas Securities Act.
- Texas Administrative Code, Title 7, Part 7 (Banking and Securities, Part 7 State Securities Board).
- Board policies and procedures.
- Recommendations from the *Report of the 2009 Special Review Committee on FINRA's Examination Program in Light of the Stanford and Madoff Schemes*, FINRA, September 2009.

Project Information

Audit fieldwork was conducted from March 2010 through April 2010. We conducted this performance audit 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.

The following members of the State Auditor's staff performed the audit:

- Gregory Scott Adams, MPA, CGFM, CPA (Project Manager)

- Darrell Edgar, CFE (Assistant Project Manager)
- Michael Boehme, CIA, PHR
- Kendra Shelton, MACy
- Karen Smith, CGAP
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Regulation of the Securities Industry in Texas

The State Securities Board (Board) protects Texas investors through four strategies:

- Securities registration.
- Law enforcement.
- Dealer registration.
- Inspection of records.

In addition to the Board, the U.S. Securities and Exchange Commission (SEC) and industry self-regulating organizations, including the Financial Industry Regulatory Authority (FINRA), also protect Texas investors to varying degrees.

Securities Registration

Most securities filers selling securities in Texas must register with the SEC and notice-file with the Board before selling the securities. Notice filings include copies of any documents provided to the SEC during the securities' registration; the Board collects a fee for this filing.

Intrastate offerings, certain governmental securities, or offerings that are either limited in size or the number of investors are not required to register with the SEC. The Texas Securities Act and Board rules also exempt certain securities from registration with the Board if they are offered to specific, limited groups of investors using limited, specified means to solicit investment

Most of the securities that the Board registered in fiscal year 2009 were direct participation programs, such as commodity pools and real estate investment trusts. The Board's securities registration process includes a merit-based comprehensive review of the securities filing to ensure that the offering terms are fair, just, and equitable and that fraudulent means are not used in the issue or sale of the offering.

Law Enforcement

The Board's Enforcement Division investigates illegal sales of unregistered nonexempt securities, sales of securities by unregistered dealers, and fraud connected with the sale of securities in Texas committed by entities not registered by the Board. The Enforcement Division makes criminal referrals to district attorneys and U.S. attorneys.

The Board's Inspections and Compliance Division investigates complaints against persons and firms registered under the Texas Securities Act; reviews and investigates complaints filed with the Board against registered persons and firms; and pursues administrative, civil, and criminal penalties for violations of the applicable securities laws and regulations.

The SEC investigates and brings enforcement actions against regulated persons and entities, as well as other market participants.

Dealer Registration

Individuals and firms offering or selling securities, or providing investment advice within Texas for compensation, must be registered or notice-filed with the Board unless they meet the criteria for an exemption. The Board's Registration Division reviews and processes the applications for registration and renewal of registration for these individuals and firms.

The SEC requires all broker dealers, except for the following, to be registered with the SEC:

- Individuals who work for a registered broker dealer.
- A broker dealer that conducts all of its business in one state.
- Certain broker dealers that limit their business to excluded and exempted securities.
- Banks and thrifts.

In addition, the SEC requires broker dealers to become members of self-regulating organizations; the SEC oversees these self-regulating organizations. These organizations include FINRA, the Municipal Securities Rulemaking Board, and national securities exchanges. FINRA states that it is the largest independent regulator for all securities firms doing business in the United States, and that it oversees approximately 4,700 brokerage firms, 167,000 branch offices, and 635,000 registered securities representatives.

Registration of investment advisers and their representatives is divided between the SEC and state regulators. The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) increases the threshold for federal registration of investment advisers from \$25 million in assets under management to \$100 million in assets under management. As a result of this change, the Board estimates that the number of investment advisers that it regulates will increase from 1,205 as of July 23, 2010, to approximately 2,450, an increase of 103.3 percent. Investment advisers with \$100 million or more in assets under management will register with the SEC and file a notice filing with the Board.

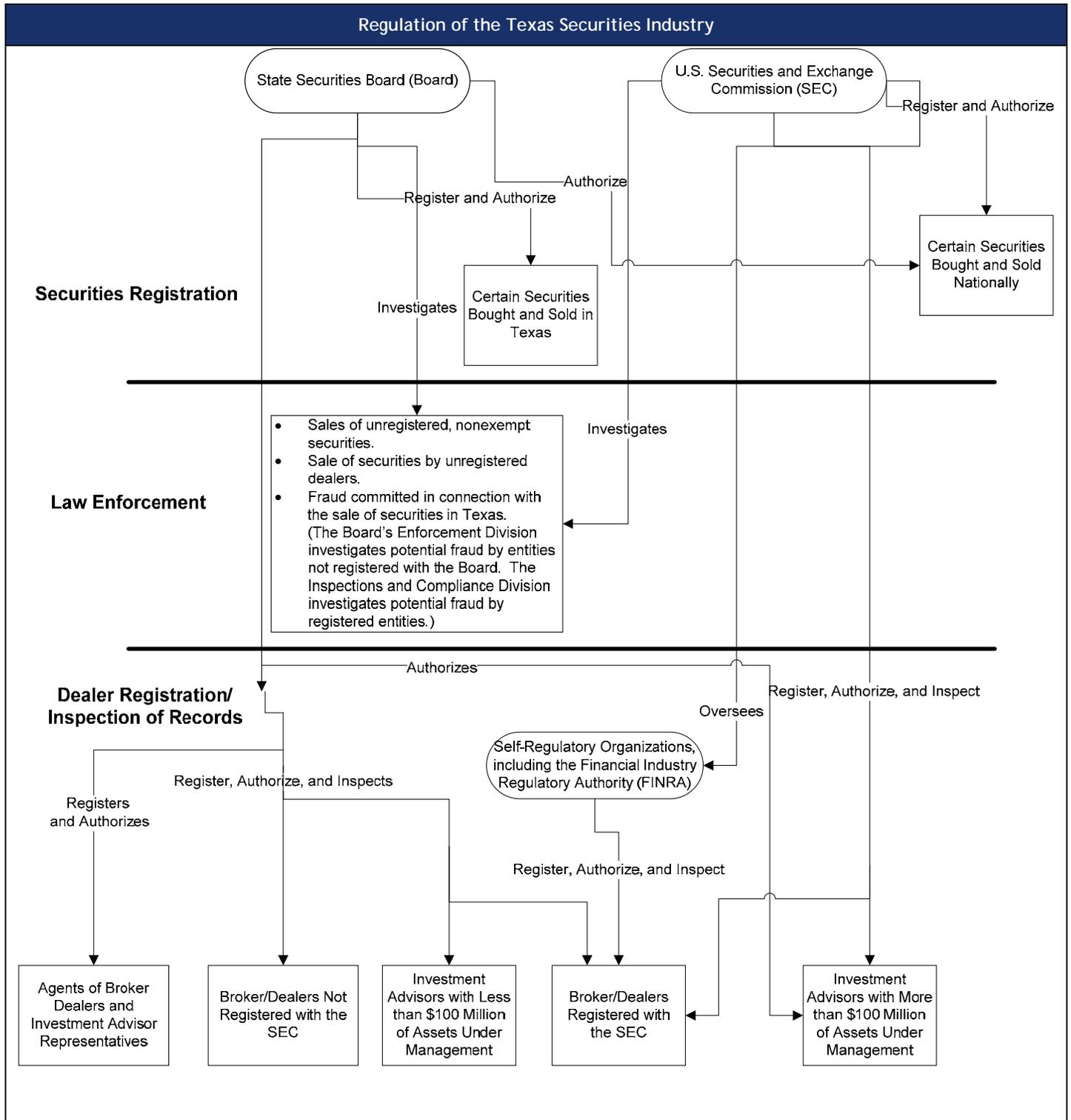
Inspection of Records

The Board's Inspections and Compliance Division periodically inspects the business premises of registered dealers and investment advisers to determine their compliance with all applicable securities laws and regulations. This division also investigates fraud committed by the Board's registrants.

Self-regulating organizations inspect their member broker dealers. The SEC also inspects broker dealers and investment advisers that are registered with it. The SEC reported that in federal fiscal year 2009, it and self-regulating organizations, including FINRA, inspected 54 percent of broker dealers. It also reported that it inspected 10 percent of investment advisers.

Figure 2 on the next page shows the roles of the SEC and the Board in regulating the Texas securities industry.

Figure 2



Source: SEC and the Board.

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