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An Audit Report on  
**The Inspection Processes at the  
State Securities Board**

August 2022  
Report No. 22-037



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## Overall Conclusion

The State Securities Board (Agency) has an inspection process to ensure that securities dealers and investment advisers registered in Texas (registrants) comply with the Texas Securities Act<sup>1</sup> and Texas Administrative Code requirements.

Specifically, the Agency (1) used the appropriate checklists to perform inspections, (2) performed supervisory reviews of the planning prior to inspections, (3) included all deficiencies identified during inspections in the letters sent to registrants, and (4) ensured that supervisors reviewed the registrants' responses to the identified deficiencies as required.

The Agency inspected the majority of its registrants every five years as required by the targeted timelines established in its policies. During its inspection process, the Agency identifies the registrants under its jurisdiction and selects registrants identified for inspection. However, it should document this process to ensure that (1) all registrants in the Agency's jurisdiction are identified and (2) the Agency's regions are consistent in their evaluation processes.

In addition, the Agency generally had automated processes and related controls that help ensure the accuracy and completeness of its data. However, it should strengthen certain information technology controls.

Table 1 on the next page presents a summary of the findings in this report and the related issue ratings. (See Appendix 2 for more information about the issue rating classifications and descriptions.)

### Inspections and Compliance

The State Securities Board (Agency) is responsible for the inspection processes to ensure that registrants comply with the Texas Securities Act and Agency rules. This includes:

- Conducting periodic examinations of the books and records of registered firms, and
- Investigating complaints against persons and firms registered under the Securities Act.

The Agency has three regions responsible for inspections:

- Dallas office, which is responsible for Dallas-Fort Worth area.
- Houston office, which is responsible for greater Houston area.
- Austin office, which is responsible for the remaining areas of Texas and registrants headquartered in another state.

Source: The Agency.

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<sup>1</sup> See Title 12 of the Texas Government Code.

Table 1

Summary of Chapters and Related Issue Ratings		
Chapter	Title	Issue Rating <sup>a</sup>
1	The Agency Has an Inspection Process to Determine Whether Texas Registrants Comply with Requirements	Low
2	The Agency Inspected Registrants at Least Every Five Years as Required; However, It Should Document Its Processes for Identifying and Selecting Registrants for Inspection	Medium
3	The Agency Should Strengthen Certain Information Technology Controls	Medium

<sup>a</sup> A chapter is rated **Priority** if the issues identified present risks or effects that if not addressed could critically affect the audited entity's ability to effectively administer the program(s)/function(s) audited. Immediate action is required to address the noted concern(s) and reduce risks to the audited entity.

A chapter is rated **High** if the issues identified present risks or effects that if not addressed could substantially affect the audited entity's ability to effectively administer the program(s)/function(s) audited. Prompt action is essential to address the noted concern(s) and reduce risks to the audited entity.

A chapter is rated **Medium** if the issues identified present risks or effects that if not addressed could moderately affect the audited entity's ability to effectively administer the program(s)/function(s) audited. Action is needed to address the noted concern(s) and reduce risks to a more desirable level.

A chapter is rated **Low** if the audit identified strengths that support the audited entity's ability to administer the program(s)/function(s) audited or the issues identified do not present significant risks or effects that would negatively affect the audited entity's ability to effectively administer the program(s)/function(s) audited.

## ***Summary of Management's Response***

At the end of each certain chapters in this report, auditors made recommendations to address the issues identified during this audit. The Agency agreed with the recommendations in this report.

## ***Audit Objective and Scope***

The objective of this audit was to determine whether the Agency's inspection processes and related controls help ensure that registered dealers and registered investment advisers (registrants) comply with the Texas Securities Act and other applicable requirements.

The scope of this audit covered (1) the Agency's inspections opened in the National Examination Module (NEMO) system and completed from September 1, 2020, to January 31, 2022; (2) all active registrants that fell under the Agency's jurisdiction as of January 31, 2022; and (3) the risk assessments the Agency performed for calendar years 2021 and 2022. The scope also included a review of significant internal control components related to the Agency's inspection process.

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# Detailed Results

Chapter 1

## The Agency Has an Inspection Process to Determine Whether Texas Registrants Comply with Requirements

Chapter 1  
Rating:

Low<sup>2</sup>

The State Securities Board (Agency) has an inspection process to ensure that securities dealers and investment advisers registered in Texas (registrants) comply with the Texas Securities Act<sup>3</sup> and Texas Administrative Code requirements (see text box for information about types of registrants). For that process, Agency inspectors use electronic checklists that incorporate all related requirements to help determine whether registrants are in compliance. The Agency and the North American Securities Administrators Association (NASAA) created the checklists to be used starting in February 2020.

For all 28 applicable inspections tested, the Agency:

- Used the appropriate checklists.
- Performed supervisory reviews of the planning prior to the inspection.
- Ensured that the letters sent to registrants included all deficiencies identified during the inspection.
- Reviewed the registrants' responses to the identified deficiencies as required.

### Types of Registrants

**Dealer** - A person or company who engages in selling, offering for sale or delivery or soliciting subscriptions to or orders for, or undertaking to dispose of, or to invite offers for, any security or securities and who deals in any other manner in any security or securities within this state.

**Investment Adviser** - A person who, for compensation, (1) engages in the business of advising another, either directly or through publications or writings, about the value of securities or to the advisability of investing in, purchasing, or selling securities, or (2) as part of a regular business, issues or adopts an analyses or a report concerning securities.

**Crowdfunder** - A small business development engaged exclusively in intrastate offers and sales of securities in Texas. Activities are limited to operating a website used to offer and sell securities that are exempt from registration and does not facilitate a secondary market in securities.

**Finder** - An individual who receives compensation solely for introducing an accredited investor to a company issuing securities and/or introducing an issuer to accredited investors.

**Business Broker** - An individual or a company whose securities activities are restricted to acting as a broker between principals for the sale of a majority of the stock or equity securities of a privately held business pursuant to a privately negotiated purchase agreement.

Source: The Agency.

<sup>2</sup> The risk related to the issues discussed in Chapter 1 A is rated as Low because the audit identified strengths that support the audited entity's ability to administer the program(s)/function(s) audited or the issues identified do not present significant risks or effects that would negatively affect the audited entity's ability to effectively administer the program(s)/function(s) audited.

<sup>3</sup> See Title 12 of the Texas Government Code.

## ***The Agency Inspected Registrants at Least Every Five Years as Required; However, It Should Document Its Processes for Identifying and Selecting Registrants for Inspection***

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**Chapter 2**  
**Rating:**  
Medium <sup>4</sup>

As of February 2022, the Agency had inspected 1,155 (96 percent) of its 1,201 registrants at least once within the last five years, as required by the targeted timelines established by its policies. The Agency's oversight includes Texas registrants (1) whose headquarters are located in Texas and who are not registered with the Financial Industry Regulatory Authority (FINRA), (2) registered with FINRA and whose assets under management are less than \$100 million, and (3) headquartered in another state that does not perform inspections.

The Agency uses a risk assessment process to select registrants for inspection. Every quarter, the Agency's three regions identify registrants within their oversight responsibility by creating reports and reviewing:

- Information about the year in which a registrant registered with the Agency and the most recent inspection date and inspection results from the Inspection & Compliance (I&C) database.
- Information about the amounts and types of assets that a registrant manages from FINRA's Central Repository Database.

Each region uses the information to identify the registrants in its jurisdiction, calculate a risk score, and select the registrants for inspection. While this process generally ensured that all registrants were inspected as required, the Agency had not documented this process or the criteria it used. This decreases the Agency's ability to ensure process continuity during staff turnover and increases the risk that not all registrants under its oversight are identified and/or inspected within the five-year timeline.

Documenting its identification and selection processes and criteria is especially important given that each region approaches the identification and selection process differently. For example:

- **Identifying Non-FINRA Registrants.** Two of the three regions are capturing the Non-FINRA registrants in their routine quarterly reports. The third region reviews Non-FINRA registrants only annually, increasing the risk that Non-FINRA registrants may be overlooked during the selection process.

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<sup>4</sup> The risk related to the issues discussed in Chapter 2 is rated as Medium because they present risks or effects that if not addressed could moderately affect the audited entity's ability to effectively administer program(s)/function(s) audited. Action is needed to address the noted concern and reduce risks to a more desirable level.

- **Identifying out-of-state registrants.** For Texas registrants headquartered in another state, the Agency asserted that in most cases, the other states' securities agencies will inspect the Texas registrants. However, if the other state does not perform inspections, the Agency will perform the inspections. The Agency communicates informally with securities agencies in other states to determine oversight and has not documented its process for identifying and contacting the other states. Not documenting this process increases the risk that the Agency will not identify out-of-state registrants under its oversight.

While some flexibility among the regions may be necessary to accommodate staff turnover and experience, documenting processes could help the Agency ensure consistency during staff turnover, as well as help ensure that registrants are inspected within its five-year timeline.

### **Recommendation**

The Agency should develop and implement documented policies and procedures for (1) detailing the reports and criteria needed to identify registrants within its jurisdiction and (2) how to evaluate registrants to be inspected.

### **Management's Response**

*The agency agrees with the recommendations. The agency will enhance policies and procedures in line with the recommendation. The inspections program assistant directors, director, the deputy commissioner, and commissioner will be responsible for oversight of implementation of the recommendation. The implementation measures will be completed no later than end of first quarter fiscal 2023.*

## **The Agency Should Strengthen Certain Information Technology Controls**

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**Chapter 3  
Rating:**  
Medium<sup>5</sup>

The Agency generally has automated processes and related controls that help ensure the accuracy and completeness of its data. However, for changes to the I&C application and database tested, the Agency did not maintain supporting documentation showing that the changes were tested and validated prior to implementation, as required by the National Institute of Standards and Technology (NIST) and the Department of Information Resources (DIR). Establishing a policy related to testing and validating changes to its systems and maintaining documentation showing the changes were tested and validated prior to implementation would help the Agency ensure that changes to the system do not alter data or promote weaknesses that could affect data.

Additionally, the Agency should strengthen its user access controls to ensure that they consistently comply with its information technology policies and procedures. To minimize security risks, auditors communicated details about the identified weaknesses related to access separately to the Agency in writing.

### **Recommendations**

The Agency should strengthen its information technology controls to ensure that:

- Changes to its information technology systems are tested and validated before implementation, in accordance with NIST and DIR requirements.
- User access controls comply with all information technology policies and procedures.

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<sup>5</sup> The risk related to the issues discussed in Chapter 3 is rated as Medium because they present risks or effects that if not addressed could moderately affect the audited entity's ability to effectively administer program(s)/function(s) audited. Action is needed to address the noted concern and reduce risks to a more desirable level.



## **Management's Response**

*The agency agrees with the recommendations. The agency will enhance policies, procedures, and controls in line with the recommendation. The inspections program assistant directors, director, the deputy commissioner, and commissioner will be responsible for oversight of implementation of the recommendation. The implementation measures will be completed no later than end of first quarter fiscal 2023.*

# Appendices

Appendix 1

## **Objective, Scope, and Methodology**

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### **Objective**

The objective of this audit was to determine whether the State Securities Board's (Agency's) inspection processes and related controls help ensure that registered dealers and registered investment advisers (registrants) comply with the Texas Securities Act and other applicable requirements.

### **Scope**

The scope of this audit covered (1) the Agency's inspections opened in the National Examination Module (NEMO) system and completed from September 1, 2020, to January 31, 2022; (2) all active registrants that fell under the Agency's jurisdiction as of January 31, 2022; and (3) the risk assessments the Agency performed for calendar years 2021 and 2022. The scope also included a review of significant internal control components related to the Agency's inspection process (see Appendix 3 for more information about internal control components).

### **Methodology**

The audit methodology included reviewing relevant criteria, the Agency's processes related to inspections, and its internal controls; interviewing Agency staff; and testing and analyzing inspections and quarterly inspection selection reports. In addition, during the audit, matters not required to be reported in accordance with *Government Auditing Standards* were communicated to the Agency's management for consideration.

### **Data Reliability and Completeness**

To test the inspection process, auditors used inspection data from the Agency's NEMO application and the Inspection & Compliance (I&C) system. Additionally, auditors observed Agency staff extract the data, reviewed the query parameters, and compared the data between the two systems. Auditors determined that the data was sufficiently reliable for the purposes of this audit.

To determine the reliability of (1) data related to changes made to the I&C database and its applications and (2) user access data in both NEMO and the I&C system, auditors observed Agency staff extract user access data and role permissions and reviewed and observed change management logs and documentation. Additionally, auditors reviewed user access settings from

NEMO obtained by the third party that manages NEMO. Auditors determined that the data was sufficiently reliable for the purposes of this audit.

#### **Sampling Methodology**

Auditors selected a nonstatistical stratified random sample of 25 out of a total of 270 Texas registrant inspections in both NEMO and the I&C system. Auditors selected an additional three registrant inspections based on risk; those inspections were in one system but not both. This sample design was chosen to ensure that the sample included a cross section of Texas registrants. The sample items were not necessarily representative of the population; therefore, it would not be appropriate to project the test results to the population.

Auditors also selected a nonstatistical sample of 5 out of 43 changes made to the I&C database through random selection. This sample design was chosen so the sample could be evaluated in the context of the population. The test results may be projected to the population, but the accuracy of the projection cannot be measured.

Information collected and reviewed included the following:

- The Agency's policies and procedures.
- Data for active registered dealers, investment advisers, crowdfunder, finders, and business brokers for the I&C system.
- Data from the I&C system for inspections completed between September 1, 2020, and January 31, 2022.
- User access lists for the information technology systems that the Agency uses to perform inspections.
- Log of changes made to the I&C system and corresponding support.
- Completed inspection records in NEMO.
- Registrants for inspection selection and assignment reports.

Procedures and tests conducted included the following:

- Interviewed key personnel in the Agency's I&C Division
- Analyzed active registrants and their last year of inspection as of February 24, 2022.
- Analyzed the Agency's inspection selection process.

- Tested a sample of completed inspections for compliance with Inspections & Compliance Division requirements.
- Tested a sample of changes made to the I&C database and all of the change to the I&C application.
- Tested user access to NEMO and the I&C system.

Criteria used included the following:

- The Texas Securities Act (codified in Title 12 of the Texas Government Code).
- Texas Administrative Code, Title 7, Part 7.
- Agency policies and procedures.
- Department of Information Resources' *Security Controls Standards Catalog*, version 1.3.
- National Institute of Standards and Technology's *Security and Privacy Controls for Information Systems and Organizations*, SP 800-53, Revision 5.

## **Project Information**

Audit fieldwork was conducted from January 2022 through July 2022. 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:

- Jacqueline M. Thompson, CFE (Project Manager)
- Kirstin Adamcik, MBA, CFE (Assistant Project Manager)
- Cheri Jones, MBA
- Alex Lerma, MS
- Austin McCarthy, CPA

- Ann E. Karnes, CPA (Quality Control Reviewer)
- Becky Beachy, CIA, CGAP (Audit Manager)

## Issue Rating Classifications and Descriptions

Auditors used professional judgment and rated the audit findings identified in this report. Those issue ratings are summarized in the report chapters/sub-chapters. The issue ratings were determined based on the degree of risk or effect of the findings in relation to the audit objective(s).

In determining the ratings of audit findings, auditors considered factors such as financial impact; potential failure to meet program/function objectives; noncompliance with state statute(s), rules, regulations, and other requirements or criteria; and the inadequacy of the design and/or operating effectiveness of internal controls. In addition, evidence of potential fraud, waste, or abuse; significant control environment issues; and little to no corrective action for issues previously identified could increase the ratings for audit findings. Auditors also identified and considered other factors when appropriate.

Table 2 provides a description of the issue ratings presented in this report.

Table 2

Summary of Issue Ratings	
Issue Rating	Description of Rating
Low	The audit identified strengths that support the audited entity's ability to administer the program(s)/function(s) audited <u>or</u> the issues identified do not present significant risks or effects that would negatively affect the audited entity's ability to effectively administer the program(s)/function(s) audited.
Medium	Issues identified present risks or effects that if not addressed could <u>moderately affect</u> the audited entity's ability to effectively administer the program(s)/function(s) audited. Action is needed to address the noted concern(s) and reduce risks to a more desirable level.
High	Issues identified present risks or effects that if not addressed could <u>substantially affect</u> the audited entity's ability to effectively administer the program(s)/function(s) audited. Prompt action is essential to address the noted concern(s) and reduce risks to the audited entity.
Priority	Issues identified present risks or effects that if not addressed could <u>critically affect</u> the audited entity's ability to effectively administer the program(s)/function(s) audited. Immediate action is required to address the noted concern(s) and reduce risks to the audited entity.

## Internal Control Components

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Internal control is a process used by management to help an entity achieve its objectives. The U.S. Government Accountability Office's *Government Auditing Standards* require auditors to assess internal control when internal control is significant to the audit objectives. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) established a framework for 5 integrated components of internal control, which are listed in Table 3.

Table 3

Internal Control Components	
Component	Component Description
Control Environment	The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.
Risk Assessment	Risk assessment is the entity's identification and analysis of risks relevant to achievement of its objectives, forming a basis for determining how the risks should be managed.
Control Activities	Control activities are the policies and procedures that help ensure that management's directives are carried out.
Information and Communication	Information and communication are the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.
Monitoring Activities	Monitoring is a process that assesses the quality of internal control performance over time.

Source: Internal Control - Integrated Framework, Committee of Sponsoring Organizations of the Treadway Commission, May 2013.

## **Related State Auditor's Office Reports**

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Table 4

Related State Auditor's Office Reports		
Number	Report Name	Release Date
10-042	<i>An Audit Report on the State Securities Board</i>	December 2010



Copies of this report have been distributed to the following:

### **Legislative Audit Committee**

The Honorable Dan Patrick, Lieutenant Governor, Joint Chair

The Honorable Dade Phelan, Speaker of the House, Joint Chair

The Honorable Joan Huffman, Senate Finance Committee

The Honorable Robert Nichols, Member, Texas Senate

The Honorable Greg Bonnen, House Appropriations Committee

The Honorable Morgan Meyer, House Ways and Means Committee

### **Office of the Governor**

The Honorable Greg Abbott, Governor

### **State Securities Board**

Members of the State Securities Board

Mr. E. Wally Kinney, Chair

Mr. Robert Belt

Mr. Kenny Koncaba

Mr. Ejike E. Okpa

Ms. Melissa Tyroch

Mr. Travis Iles, Securities Commissioner



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