

TEXAS STATE SECURITIES BOARD
Austin, Texas

ANNUAL INTERNAL AUDIT REPORT

Fiscal Year 2015



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Annual Internal Audit Report
Fiscal Year 2015

TABLE OF CONTENTS

Internal Auditor's Report	1
Introduction	2
Internal Audit Objectives	3
Executive Summary	
Inspections Area	
Background	4-7
Audit Scope/Objective	7
I. Compliance with Texas Government Code 2102: Required Posting of Internal Audit Information.....	8
II. Internal Audit Plan for Fiscal Year 2015	8-9
III. Consulting and Nonaudit Services Completed.....	9
IV. External Quality Assurance Review.....	9
V. Observations/Findings and Recommendations	10-11
VI. External Audit Services Procured in Fiscal Year 2015.....	12
VII. Reporting Suspected Fraud and Abuse.....	12
VIII. Proposed Internal Audit Plan for Fiscal Year 2016	12
IX. Organizational Chart	13

Garza/Gonzalez & Associates

CERTIFIED PUBLIC ACCOUNTANTS



Board Members and
Audit Committee Members
Texas State Securities Board
Austin, Texas

We performed tests of management's assertion about the effectiveness and efficiency of the internal control structure over the Inspections Area of the Texas State Securities Board (SSB); and, its compliance with applicable State requirements, and SSB's established policies and procedures for the 7 months ended March 31, 2015.

The results of our tests disclosed that such controls were adequate and no material instances of noncompliance were noted; however, we noted a certain matter that is included in this report, which is an opportunity for strengthening internal controls, and ensuring compliance with SSB's established policies and procedures.

We also performed a follow-up of the findings and recommendations included in the most recent state comptroller post-payment audit dated December 9, 2014, and of the findings that were presented in the prior year annual internal audit report. This report reflects the results and implementation status of our follow-up procedures performed; and, includes all information required for the Annual Internal Audit Report.

We have discussed the comment and recommendation from the Inspections Area audit; and, the implementation status from the follow-up performed, with various SSB personnel; and, will be pleased to discuss them in further detail; to perform an additional study of these matters; or, to assist you in implementing the recommendations.

*Garza/Gonzalez
& Associates*
July 24, 2015

TEXAS STATE SECURITIES BOARD

Annual Internal Audit Report

Fiscal Year 2015

INTRODUCTION

The State Securities Board (SSB) is charged with the administration and enforcement of the Texas Securities Act (the Act). SSB's mission is to protect Texas investors. Consistent with that purpose, SSB seeks to ensure a free and competitive securities market for Texas, increase investor confidence; and, thereby encourage the formation of capital and the creation of new jobs in Texas. SSB investigates suspected violations of the Act and ensures that administrative, civil, or criminal enforcement actions are taken in appropriate circumstances. SSB also registers securities sold in Texas and the firms and individuals who sell securities or render investment advice in the state.

SSB was created in 1957 pursuant to the Act passed by the 55th Texas Legislature. This legislation was the culmination of four earlier statutes dating back to 1913. The Act provides for the registration of securities offered or sold in Texas and of firms and individuals who sell securities or render investment advice in the state. In certain circumstances a particular security or transaction may be exempt from the registration requirements of the Act. Whether or not an exemption from the registration provisions is available, the Act prohibits fraud in the offer or sale of securities in Texas.

2015 Internal Audit Plan

Following are the internal audits and other functions performed, as identified in SSB's approved 2015 Internal Audit Plan:

- Inspections Area
- Follow-up of Post Payment Audit (Report Date December 9, 2014)
- Follow-up of Prior Year Internal Audits
- Other Tasks

This report contains the results of our audit of the Inspections Area; the results of the follow-up procedures performed of the most recent state comptroller post-payment audit dated December 9, 2014, and of the findings that were presented in the prior year annual internal audit report; and, meets the Annual Internal Audit Report requirements.

TEXAS STATE SECURITIES BOARD

Annual Internal Audit Report

Fiscal Year 2015

INTERNAL AUDIT OBJECTIVES

In accordance with the **International Standards for the Professional Practice of Internal Auditing**, the audit scope encompassed the examination and evaluation of the adequacy and effectiveness of SSB's system of internal control and the quality of performance in carrying out assigned responsibilities. The audit scope included the following objectives:

- **Reliability and Integrity of Financial and Operational Information** – Review the reliability and integrity of financial and operating information and the means used to identify, measure, classify, and report such information.
- **Compliance with Policies, Procedures, Laws, Regulations and Contracts** – Review the systems established to ensure compliance with those policies, procedures, laws, regulations, and contracts which could have a significant impact on operations and reports, and determine whether the organization is in compliance.
- **Safeguarding of Assets** – Review the means of safeguarding assets and, as appropriate, verify the existence of such assets.
- **Effectiveness and Efficiency of Operations and Programs** – Appraise the effectiveness and efficiency with which resources are employed.
- **Achievement of the Organization's Strategic Objectives** – Review operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.

TEXAS STATE SECURITIES BOARD

Annual Internal Audit Report

Fiscal Year 2015

EXECUTIVE SUMMARY

BACKGROUND

Inspections Area

Section 13-1 of the Texas Securities Act (Act) authorizes the Texas State Securities Board (SSB) to conduct inspections of registered broker dealers (BD) and investment advisors (IA). As such, SSB's Inspections and Compliance Division (Division) has been tasked with the responsibility of administering the inspection program, to ensure registered BD's and IA's comply with the Act and SSB's rules and regulations.

The Division is comprised of a Director, 3 Assistant Directors, 2 Staff Attorneys, 3 Administrative Assistants and 17 Financial Examiners; and, operates in the Austin office and 2 branch offices located in Dallas and Houston. The Dallas office is responsible for the Dallas-Fort Worth area; the Houston office, for the greater Houston area; and, the Austin office, for the remaining areas of Texas.

On a quarterly basis, the SSB Programmer/Database Administrator provides the Director with the total number of State registered IAs and non-Financial Industry Regulatory Authority (FINRA) BD firms based in Texas. From this number, the Director determines, and communicates to each Assistant Director, the number of inspections that each of the 3 office locations is required to perform within the quarter to meet the annual goal of inspecting at least 25% of these registrants.

Each Assistant Director generates a listing from their database of active IAs and non-FINRA BD firms (within their jurisdiction). The listing is sorted by last inspection date and firms are first selected for inspection based on the Divisions 4 year cycle goal of inspecting each firm at least once every 4 years. An inspections risk assessment tool is available for Assistant Directors to use in finalizing the selection of firms to inspect, which considers other factors; such as, the firm's size and total assets. However, the general basis of determining which firms to inspect is the last inspection date.

Following are the types of inspections that can be performed:

1. Cycle – routine;
2. For Cause – prompted by a complaint or other specific concern;
3. Follow-Up – follow-up of an order, undertaking, or caution letter generated by a prior inspection; and,
4. Sweep Review – performed as part of an issue-based inspection sweep.

The Financial Examiner completes a pre-exam checklist prior to visiting the registrant and performing the inspection. The pre-exam checklist, which includes background and profile information of the registered BD or IA, must be approved by the respective Assistant Director before the Financial Examiner may perform the inspection.

Inspections are performed pursuant to the following procedures:

1. Conducting an interview with the BD or IA and office staff and completing the interview module;
2. Taking an office tour to identify all registered and unregistered personnel and their functions;
3. Completing the appropriate modules, sub-modules, and review worksheets;
4. Conducting an exit interview with the BD or IA to discuss any findings; and,
5. Preparing the response letter to be issued to the BD or IA.

TEXAS STATE SECURITIES BOARD

Annual Internal Audit Report

Fiscal Year 2015

The Division utilizes the North American Securities Administrations Association (NASAA) modules, sub-modules, and review worksheets to conduct inspections. These modules and worksheets are designed to identify violations and/or noncompliance with the Act or SSB rules and regulations.

The Financial Examiner completes a home or branch office examination module for BD inspections and the IA examination module for IA inspections, which includes a review of the following attributes:

BD Inspections	IA Inspections
<ul style="list-style-type: none">• Nature of business• Books of record• Operations• Financial responsibility• Customer protection• Margin requirements• Sales practice	<ul style="list-style-type: none">• Nature of business• Disciplinary history• Financial matters• Advisory contracts and fees• Performance reporting• Registration• Complaints• Advertising• Conflict of interest• Sales practice• Privacy• Supervision

Upon completion of each inspection, the respective Assistant Director reviews the inspection file, which includes the completed examination module, and any completed sub-modules or review worksheets. A draft of a response letter, as completed by a Financial Examiner, is also submitted to the Assistant Director for review and approval. The Assistant Director will communicate any recommended changes to the Financial Examiner, who will update the inspection file and response letter accordingly. The response letter is then signed by the Financial Examiner and issued to the Firm. Following are the different types of response letters issued:

- No Action Letter – Informs the Firm that the inspection is complete and no violations were noted.
- Recommendation Letter – Informs the Firm that the inspection is complete and includes best practice recommendations proposed by SSB.
- Caution Letter – Informs the Firm of rule violations noted by SSB and requests that the Firm addresses these violations and provide a written response.

The BD or IA is required to respond to the Caution Letter within 30 days describing the steps taken to correct the noted deficiencies and/or violations. Once the Firm's responses are deemed satisfactory, the Inspection will be considered complete and closed and a letter or email correspondence is provided to the Firm informing them that the inspection is considered complete.

The Division utilizes the Inspections & Compliance Case Management System (I&C Database) to track, among other information, the inspection start date and the Division's progress in meeting their annual goal. As of March 31, 2015, the Division has performed 155 and closed 140 inspections during fiscal year 2015.

TEXAS STATE SECURITIES BOARD

Annual Internal Audit Report

Fiscal Year 2015

Complaint Process

The Division must comply with requirements of Section 2-6 of the Act with respect to any complaint filed with SSB relating to an individual or entity registered under the Act.

A complaint pertaining to a securities dealer, agent, investment adviser, or investment adviser representative registered under the Act must be submitted to SSB's Austin office in writing, via a complaint form. If a complaint is received by telephone, the employee who accepts the call should advise the complainant of this requirement and direct them to complete the complaint form located on SSB's website. Anonymous complaints received by the Division can be treated as a tip from the public, which may result in an inspection, an agent/firm review, or could be treated as a regular complaint. The complaint form includes a copy of the Board's policies and procedures to inform the complainant of SSB's complaint investigation and resolution process.

Upon receipt of a written complaint, and determination that the entity or individual is registered with SSB, the Austin Administrative Assistant will generate an Activity Report, which documents firm/agent contact information, description of services provided by firm/agent, and history of complaints filed for the firm/agent; and, provides it along with the complaint to the Financial Examiner assigned to the complaint so that an investigation may be performed. An acknowledgement letter is then sent to the complainant, and a complaint file is established in the I&C database.

A complaint file is immediately submitted to the Enforcement Division in those instances where the entity or individual is not found to be registered with SSB.

Section 2-6 of the Act requires that a record (complaint file) be maintained that includes the following:

1. Name of person who filed a complaint;
2. Date complaint received;
3. Subject matter of complaint;
4. Name of each person contacted relating to complaint;
5. Summary of review or investigation of the complaint; and,
6. Explanation of reason it was closed, if closed without action other than to investigate.

Within one week of the date the complaint is received, the assigned Financial Examiner will send the individual or entity who is the subject of the complaint, an information request letter to request materials relevant to the complaint and informing them of the due date, which is generally 30 days from the date of the request. At least quarterly, until the complaint file is closed, the Administrative Assistant will notify the complainant and each individual or entity who is the subject of the complaint of the complaint status.

Upon completion of the investigation, the assigned Financial Examiner will prepare a memo of findings with his/her conclusion and submit it to the designated supervisor for review. The memo of findings will include one of the following complaint resolutions:

- No Action – Complaints that show no merit and are recommended to be closed.
- Letter or Target – Complaints that involve issues that are of concern, but do not merit a recommendation for administrative or other actions. These resolutions are submitted with a recommendation to:
 - 1) be closed with a letter of caution issued
 - 2) be closed and placed on the inspection target list

TEXAS STATE SECURITIES BOARD

Annual Internal Audit Report

Fiscal Year 2015

- Legal Referral – Complaints that show an apparent violation of the Act or Board Rules, and/or appear to merit some type of administrative or other action. These resolutions are submitted with a recommendation to:
 - 1) issue an administrative undertaking;
 - 2) issue an administrative order; or,
 - 3) other action.

When a complaint has been closed by the Austin Assistant Director, it will be provided to the assigned Financial Examiner, who will send a closing letter to the complainant and update the I&C database.

As of March 31, 2015, there were 90 complaints submitted to SSB during fiscal year 2015. Of those 90, 54 were referred to the Enforcement Division, 17 were investigated with a No Action resolution, 12 remain open, and SSB had no jurisdiction over 7.

Audit Scope/Objective

The scope of our audit was the Inspections Area. The objective of our audit was to gain an understanding of the processes in place for conducting inspections to determine whether SSB applied and complied with established policies and procedures and applicable laws and regulations.

The procedures performed to achieve the objective of our audit were as follows:

1. Reviewed and obtained an understanding of Section 2-6, 13-1 and 28 of the Texas Securities Act and Section 115 and 116 of the Texas Administrative Code.
2. Obtained and reviewed the Division's written policies and procedures, examination modules, sub-modules, review worksheets, and internally generated reports; and, conducted interviews to obtain an understanding of, and document formal/informal processes and controls.
3. Obtained a listing of inspections conducted from September 1, 2014 through March 31, 2015 and selected a sample of 10 for testing the following attributes:
 - Inclusion of the –
 - Pre-exam checklist,
 - Interview module,
 - Examination modules, sub-modules, and review worksheets.
 - Adherence to written policies, procedures, and applicable laws and regulations; such as, review by the respective Assistant Director, and communication of results to the inspected IA or BD.
4. Obtained a listing of complaints received from September 1, 2014 through March 31, 2015 and selected a sample of 10 for testing the following attributes:
 - Complaint file included all required documents required by Section 2-6 of the Act,
 - Form letter was sent to complainant acknowledging receipt of complaint,
 - Form letter was sent to the firm within one week of complaint received date
5. Ensured open investigations were reasonable and had not been opened for an excessive time period.
6. Obtained the Risk Assessment Tool and reviewed SSB's process for selecting firms to be inspected.

TEXAS STATE SECURITIES BOARD

Annual Internal Audit Report

Fiscal Year 2015

I. Compliance with Texas Government Code 2102: Required Posting of Internal Audit Information

To comply with the provisions of Texas Government Code, 2102.015 and the State Auditor's Office, within 30 days after approval by SSB's Board, SSB will post the following information on its website:

- An approved fiscal year 2016 audit plan, as provided by Texas Government Code, Section 2102.008.
- A fiscal year 2015 internal audit annual report, as required by Texas Government Code, Section 2102.009.

The internal audit annual report includes any weaknesses, deficiencies, wrongdoings, or other concerns raised by internal audits and other functions performed by the internal auditor as well as the summary of the action taken by SSB to address such concerns.

II. Internal Audit Plan for Fiscal Year 2015

The Internal Audit Plan (Plan) included one audit to be performed during the 2015 fiscal year. The Plan also included a follow-up of the findings and recommendations included in the most recent state comptroller post-payment audit dated December 9, 2014, a follow-up of the findings that were presented in the prior year annual internal audit report, other tasks as assigned by the Board, and preparation of the Annual Internal Audit Report for fiscal year 2015.

Risk Assessment

Utilizing information obtained through the inquiries and background information reviewed, 15 audit areas were identified as potential audit topics. A risk analysis utilizing our 8 risk factors was completed for each individual audit topic and then compiled to develop an overall risk assessment.

Following are the results of the risk assessment performed for the 15 potential audit topics identified:

HIGH RISK	MODERATE RISK	LOW RISK
Purchasing/Contracting for Services/Travel	Conducting Inspections	Accounting and Financial Reporting
Payroll and Human Services	Fixed Assets/Property Accounting	Budget and Planning
	Processing Cash Receipts and Disbursements	Processing Securities Applications
	Processing Dealer Applications	Performance Measures
	Enforcement	Registration and Filing Fees
	Records Retention	Customer Service
		Information Technology

TEXAS STATE SECURITIES BOARD

Annual Internal Audit Report

Fiscal Year 2015

In the prior 3 years, internal audits were performed in the following areas:

Fiscal Year 2014:

- Processing Cash Receipts and Disbursements

Fiscal Year 2013:

- Processing Securities Applications

Fiscal Year 2012:

- Accounting and Financial Reporting
- Information Technology

The area recommended for internal audit and other tasks to be performed for fiscal year 2015 were as follows:

<u>Report No.</u>	<u>Audits/Report Titles</u>	<u>Report Date</u>
1.	Conducting Inspections	7/24/2015
1.	Other Activities – Follow-Up of Post Payment Audit Dated December 9, 2014	7/24/2015
1.	Annual Internal Audit Report – Follow-Up of Prior Year Internal Audits	7/24/2015
-	Other Tasks Assigned by the Board	None

III. Consulting and Nonaudit Services Completed

The internal auditor did not perform any consulting services, as defined in the Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing* or any non-audit services, as defined in the *Government Auditing Standards*, December 2011 Revision, Sections 3.33-3.58.

IV. External Quality Assurance Review

The internal audit department's most recent *System Review Report*, dated October 26, 2012, indicates that its system of quality control has been suitably designed and conforms to applicable professional standards in all material respects.

TEXAS STATE SECURITIES BOARD
 Annual Internal Audit Report
 Fiscal Year 2015

V. Observations/Findings and Recommendations

Report No.	Report Date	Name of Report	Observations/Findings and Recommendations	Status (Implemented, Partially Implemented, Implementation Delayed, No Action Taken, Do Not Plan to Take Corrective Action, or Other)	Fiscal Impact/Other Impact
1	7/24/2015	Conducting Inspections	<p>1. Pre-Inspection Checklist</p> <p>The Inspection Division's policies and procedures require that a pre-exam checklist be completed by a Financial Examiner for approval by an Assistant Director before an inspection is conducted. The pre-exam checklist, which captures information for the respective IA or BD; such as, last exam date, complaints filed, disciplinary history, potential conflicts of interest, etc., is used to establish the areas to be reviewed during the inspection.</p> <p>Our testing of 10 investigation files denoted 1 instance in which a pre-exam checklist was not included in the file.</p> <p>We recommend that the Inspection Division consider implementing a quality control process whereby on a periodic basis, the population of completed inspection files are sampled and reviewed to provide added assurance that all required documentation is included.</p> <p>Management's Response</p> <p>The Inspections and Compliance Division will adhere to the internal audit recommendation by immediately implementing a quality control process to assure that all required documentation is included in completed inspection files. The new process requires the relevant Assistant Director to review the exam file for required documentation and to initial the exam file indicating this review has been completed. The process has been memorialized and provided to the appropriate Staff within the Division.</p>		Ensure compliance with SSB policies and procedures

TEXAS STATE SECURITIES BOARD
Annual Internal Audit Report
Fiscal Year 2015

Report No.	Report Date	Name of Report	Observations/Findings and Recommendations	Status (Implemented, Partially Implemented, Implementation Delayed, No Action Taken, Do Not Plan to Take Corrective Action, or Other)	Fiscal Impact/Other Impact
1	7/24/2015	2015 Follow-Up	<p>Follow-Up of Prior Year Audits</p> <p>Following is the status of the recommendations made during fiscal year 2014 that had not been fully implemented.</p> <p><u>Processing Cash Receipts & Disbursements</u></p> <ol style="list-style-type: none"> 1. Staff Services Procedures Manual (Manual) <p>Revise the Manual, as considered necessary, to ensure cash receipt related functions are performed in a uniform manner, as intended by management</p> 2. Deposit Documentation <p>Strengthen controls over retention of deposit documentation or consider scanning the documentation and keeping an electronic copy.</p> 3. Purchase Orders (P.O.) <p>Enhance compliance with internal policies and procedures and ensure cost, estimated cost, or not to exceed amount is documented on the P.O. before items or services are purchased.</p> 4. Employee Reimbursement <p>Strengthen controls to ensure employee reimbursement supporting documentation is date stamped to ensure payment is made within 30 days from the date received.</p> <p><u>Post-Payment Audit (Report Date December 9, 2014)</u></p> <ol style="list-style-type: none"> 1. Underpayment of Salary Amount <p>Strengthen controls to ensure calculations are reviewed on all totals that are submitted manually.</p> 2. Control Weakness Over Expenditure Processing <p>Review the controls over expenditure processing and segregate each task to the greatest extent practical to ensure that no individual is able to process payments without oversight.</p> 	<p>Implemented</p> <p>Implemented</p> <p>Implemented</p> <p>Implemented</p> <p>Implemented</p> <p>Implemented</p> <p>Implemented</p>	<p>Ensure policies and procedures reflect SSB's practices.</p> <p>Ensure deposit supporting documentation is properly maintained.</p> <p>Ensure compliance with policies and procedures.</p> <p>Ensure compliance with policies and procedures.</p> <p>Ensure accuracy of payroll disbursements.</p> <p>Ensure segregation of duties</p>

TEXAS STATE SECURITIES BOARD

Annual Internal Audit Report

Fiscal Year 2015

VI. External Audit Services Procured in Fiscal Year 2015

SSB procured the internal audit services documented in the Internal Audit Plan for fiscal year 2015.

VII. Reporting Suspected Fraud and Abuse

SSB has provided information on their home page on how to report suspected fraud, waste, and abuse to the State Auditor's Office (SAO) by posting a link to the SAO's fraud hotline. SSB has also developed a Fraud Prevention Policy that provides information on how to report suspected fraud.

VIII. Proposed Internal Audit Plan for Fiscal Year 2016

The risk assessment performed during the 2015 fiscal year was used to identify the following *proposed* areas that are recommended for internal audits and other tasks to be performed for fiscal year 2016. The Internal Audit Plan for Fiscal Year 2016 will be developed and presented to the Audit Committee and/or Board at a meeting to be determined at a later date.

- Enforcement
- Records Retention
- Follow-up of Prior Year Internal Audits
- Other Tasks Assigned by the Board

IX. Organizational Chart

