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SEC's Oversight of Bear Stearns and Related Entities (SEC OIG Report)

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U.S. Securities and Exchange Commission

Office of Inspector General

Office of Audits

SEC's Oversight of Bear Stearns and Related Entities:

Broker-Dealer Risk Assessment Program

Sections of this report have been redacted to delete information that SEC believes is non-public and confidential.

September 25, 2008
Report No. 446-B

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

OFFICE OF
INSPECTOR GENERAL

MEMORANDUM

September 25, 2008

To: Christopher Cox, Chairman
Erik R. Sirri, Director, Division of Trading and Markets
Lewis W. Walker, Office of Information Technology, Acting Director and Chief Information Officer

From: H. David Kotz, Inspector General

Subject: *SEC's Oversight of Bear Stearns and Related Entities: Broker-Dealer Risk Assessment Program*, Report No. 446-B

This memorandum transmits the Securities and Exchange Commission, Office of Inspector General's final report, detailing the results of our audit on the Division of Trading and Market's (TM) Broker-Dealer Risk Assessment program. This audit was conducted pursuant to a Congressional request from Ranking Member Charles E. Grassley of the United States Senate Committee on Finance.

The final report contains 10 recommendations, which if implemented, should improve the Broker-Dealer Risk Assessment program. TM and the Office of Information Technology's (OIT) written responses to the draft report are included in their entirety in Appendix VI in the audit report. TM concurred with 9 of the report's 10 recommendations and OIT concurred with the two recommendations that pertained to OIT.

Should you have any questions regarding this report, please do not hesitate to contact me. We appreciate the courtesy and cooperation that you and your staff extended to our auditors during this audit.

Attachment

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SEC Risk Assessment Program

Executive Summary

Background. Section 17(h) of the Securities and Exchange Act of 1934 was amended in 1990, and temporary rules 17h-1T and 17h-2T became effective in September 1992. These rules require broker-dealers that are part of a holding company structure with at least $20 million in capital to file with the Commission disaggregated, non-public information on the broker-dealer, the holding company, and other entities within the holding company, and to maintain and preserve records and other information concerning entities related to the broker-dealer. Currently, there are 146 broker-dealers that file the *Risk Assessment Report for Brokers and Dealers* (Form 17-H or 17(h) documents) with the Commission under the Broker-Dealer Risk Assessment program.

The purpose of the Broker-Dealer Risk Assessment program is for staff in the Division of Trading and Markets (TM) to assess the risks to registered broker-dealers that may stem from affiliated entities, including holding companies and keep apprised of significant events that could adversely affect broker-dealers, customers and the financial markets. TM tracks the filing status of the 146 broker-dealers that file 17(h) documents with the Commission, but only reviews in detail the filings from six prominent firms, because they have a significant number of customer accounts and TM has, therefore deemed them to be material firms.

Congressional Request. On April 2, 2008, the Office of Inspector General (OIG) received a letter from Ranking Member Charles E. Grassley of the United States Senate Committee on Finance, requesting that the OIG analyze the Commission's oversight of Consolidated Supervised Entities (CSE) firms and broker-dealers subject to the Commission's Risk Assessment program.[1] This letter noted that TM was responsible for regulating the largest broker-dealers, and their associated holding companies. The letter requested that the OIG provide an update of findings made in its previous audit report on the Commission's Broker-Dealer Risk Assessment program (*Broker-Dealer Risk Assessment Program*, Report no. 354, issued on August 13, 2002).

The United States Senate Committee on Finance letter also requested a review of TM's oversight of the CSE it directly oversees, with a special emphasis on The Bear Stearns Companies, Inc (Bear Stearns). The letter requested that the OIG analyze how the CSE program is run, the adequacy of the Commission's monitoring of Bear Stearns, and to make recommendations to improve the Commission's CSE program.[2]

[1] A copy of this request letter is attached to this report in full in Appendix II.

[2] The United States Senate Committee on Finance letter also requested that the Office of Inspector General (OIG) conduct an investigation into the facts and circumstances surrounding the Commission's decision to

Objectives. In response to the April 2, 2008 Congressional Request, the OIG conducted two separate audits with regard to the Commission's oversight of Bear Stearns and related entities. This audit's objectives were to follow up on the current status of recommendations made in the OIG's prior audit report of the Risk Assessment program (*Broker-Dealer Risk Assessment Program*, Report no. 354, issued on August 13, 2002); and to examine the Broker-Dealer Risk Assessment Process to determine whether improvements are needed.

The OIG performed a second audit of the Commission's CSE program. This audit's objectives were to evaluate the Commission's CSE program, emphasizing the Commission's oversight of Bear Stearns and to determine whether improvements are needed in the Commission's monitoring of CSE firms and its administration of the CSE program. The CSE program is a voluntary program that was created by the Commission in 2004, which allows the Commission to supervise certain broker-dealer holding companies on a consolidated basis. The report found that the Commission's oversight of Bear Stearns and the other CSE firms should be improved, the guidelines regarding the CSE firms' capital and liquidity requirements should be reassessed and the Commission, in consultation with the Board of Governors of the Federal Reserve, should determine whether leverage ratio limits should be imposed. The report also found that the Commission should adequately incorporate the CSE firms' concentration of securities into the CSE program's assessment of the firms' risk management systems, more aggressively prompt CSE firms to take action to mitigate such risks, and be more skeptical of the firms' risk models. The report contained 26 recommendations to improve the CSE program. Audit report number 446-A, examining the Commission's CSE program was issued simultaneously with this report on September 25, 2008.

Prior OIG Audit Report. The prior OIG report on the Broker-Dealer Risk Assessment program contained 14 recommendations to improve the program. TM addressed several of the prior OIG report's recommendations. However, one of the very significant recommendations in the prior OIG report stated that the Commission should update and finalize temporary rules 17h-1T and 17h-2T. As of this date, six years later, these temporary rules still have not been updated. The result is that several aspects of these rules are not effective mainly because they do not require firms to file certain pertinent information with the Commission and many filings are not reviewed by TM staff. Additionally, while TM has claimed that the rules currently require too many firms to file 17(h) documents with the Commission, TM has not taken any steps to update these rules.

The prior OIG report also recommended that TM explore the feasibility of having firms electronically file 17(h) documents. In 2005, TM in consultation with the Office of Information Technology launched the Broker-Dealer Risk Assessment (BDRA) system, which enables firms to file Form 17-H electronically. As of

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not pursue an Enforcement Action against Bear Stearns. This issue was addressed in an OIG investigative report dated September 25, 2008.

September 2008, however, three years later, only 20 of the 146 firms filing 17(h) documents were filing electronically and the remaining firms still file paper documents.

Results. TM is not fulfilling its obligations in accordance with the underlying purpose of the Broker-Dealer Risk Assessment program in several respects. First, TM has failed to update and finalize the rules governing the program, which would ensure that broker-dealers file pertinent information with the Commission in a timely manner. Second, TM has failed to enforce the temporary rules' document retention and filing requirements that are incumbent upon broker-dealers. As a result, nearly one-third of the firms failed to file 17(h) documents as required by the rules. Third, even after the collapse of Bear Stearns, in March 2008, two related broker-dealers still exist, one of which carries a significant number of customer accounts. However, TM has not yet determined whether these broker-dealers are obligated to file Form 17-H. Fourth, although TM tracks the filing status of 146 broker-dealers that file quarterly and annual reports with the Commission, TM only conducts an in-depth review of the filings for six of the 146 firms that TM determined are most significant. TM generally does not review the filings for the remaining 140 firms, yet they are required to file under the Broker-Dealer Risk Assessment program. Fifth, TM does not timely process and review the filings from the six firms upon which its staff focus their review. Sixth and finally, TM does not maintain documentation to identify all of the broker-dealers that are exempt from the filing process.

TM's failure to carry out the purpose and goals of the Broker-Dealer Risk Assessment program hinders the Commission's ability to foresee or respond to weaknesses in the financial markets. This may impact TM's ability to protect customers from financial or other problems experienced by broker-dealers.

Summary of Recommendations. This report reasserts an OIG recommendation made in 2002, that TM should update and finalize temporary rules 17h-1T and 17h-2T, which govern the Broker-Dealer Risk Assessment program and enforce broker-dealer compliance with these rules. It is also critical for TM to determine whether the broker-dealers associated with Bear Stearns are required to file Form 17-H with the Commission in light of the significant amount of customer accounts carried by these broker-dealers. We also recommend that TM process all 17(h) filings in a timely manner, ensure that firms required to file Form 17-H actually file, and maintain documentation to identify all of the broker-dealers that are exempt from filing Form 17-H. We further recommend that TM aggressively encourage firms to file electronically with the Commission, and resolve the technical problems that have been identified with the BDRA filing system. A detailed list of our recommendations can be found in Appendix V.

TM concurred with 9 of the report's 10 recommendations and the Office of Information Technology (OIT) concurred with the two recommendations that pertained to OIT. Management's responses to the report are included in its

entirety in Appendix VI. OIG's response to Management's comments is included in Appendix VII.

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Background and Objectives

Background

In 1990, Drexel Burnham Lambert Group, Inc. (Drexel), the holding company of a formerly prominent broker-dealer, experienced financial difficulties. In a period of about three weeks and without the knowledge of the Commission or the New York Stock Exchange, approximately $220 million of capital was transferred from the broker-dealer to its holding company, in the form of short-term loans. By the time the Commission learned about the transaction, Drexel or its associated entities had amassed a significant amount of short-term liabilities that were due to mature within a month and they could not meet these obligations. As a result, Drexel's broker-dealer filed for bankruptcy and was subsequently liquidated. This case illustrates that the financial difficulties of associated entities may lead to the demise of the broker-dealer itself.

Section 17(h) of the Securities and Exchange Act of 1934 (Exchange Act)[3] was added in 1990 by the Market Reform Act of 1990, and temporary rules 17h-1T and 17h-2T[4] became effective in 1992, following Drexel's collapse. These rules require broker-dealers with at least $20 million in capital that are part of a holding company structure to file Form 17-H, *Risk Assessment Report for Brokers and Dealers* (Form 17-H or 17(h) documents) with the Commission and to maintain and preserve records and other information concerning the broker-dealer's Material Associated Persons (MAP). [5]

Form 17-H filings consist of disaggregated, non-public information on the broker-dealer, the holding company, and other entities within the holding company. Form 17-H consists of two parts and broker-dealers are required to file the form quarterly and also file an annual report with the Commission. Part I of Form 17-H requires reporting in four areas: (1) Organizational Structure; (2) Financing, Capital Adequacy and Risk-Management Policies and Procedures; (3) Pending Legal Matters and Contingencies; and (4) Consolidated and Consolidating Financial Data. Part II of the form requires reporting financial information about the broker-dealer's MAPs.

TM's Program Oversight and Responsibilities. The Division of Trading and Markets (TM) oversees the Broker-Dealer Risk Assessment program and is

[3] 15 U.S.C. §78q(h).
[4] 17 C.F.R. §§ 240.17h-1T & 240.17h-2T.
[5] MAPs are defined as affiliates of broker-dealers that are subject to the 17(h) filing requirement. The determination of whether an entity is a MAP is made by the reporting broker-dealer, subject to Commission oversight and involves consideration of all aspects of the activities of, and the relationship between both entities as described in Rule 17h-1T.

responsible for receiving and reviewing 17(h) filings. The Broker-Dealer Risk Assessment program is staffed with a full-time regulatory specialist and a part-time Certified Public Accountant, who manage the program. The purpose of this program is for TM staff to assess the risks to registered broker-dealers that may stem from affiliated entities, including holding companies and to keep TM's staff apprised of significant events that could adversely affect broker-dealers, customers and the financial markets.

Six Broker-Dealers Receive Comprehensive Reviews. There are 146 broker-dealers that currently file 17(h) documents with the Commission.[6] However, TM only conducts a detailed review of six of the 146 broker-dealers' filings because TM designated these six firms as material broker-dealers based on their size and the significant amount of customer accounts that they carry. According to first quarter 2008 data provided by the Financial Industry Regulatory Authority (FINRA),[7] these six broker-dealers carry approximately 43 percent of the customer accounts and 11 percent of the free credit balances of all United States broker-dealers that are regulated by FINRA. Free credit balances represent the cash held by a broker in a customer's margin account that the customer can withdraw at any time, without restriction.

Increased Monitoring of Select Broker-Dealers. Of the 146 broker-dealers, 10 additional firms carry approximately 11 percent of the customer accounts and 3 percent of the free credit balances of all United States broker-dealers that are regulated by FINRA.[8] However, TM does not currently monitor these 10 firms on a regular basis, because TM does not believe they are as material as the 6 broker-dealers that it regularly monitors. TM may review information from these 10 filers if an issue arises. For example, if one of these firms experiences financial difficulties or undergoes a major change, TM may review the firm's 17(h) filings. TM has stated that it plans to monitor these firms on a regular basis in fiscal year 2008. As of August 2008, however, TM had not reviewed in detail any of these firms.

Regulation of Firms Through the CSE and SIBHC Programs. In addition to the 146 firms filing 17(h) documents, TM regulates six additional firms through the Commission's Consolidated Supervised Entity (CSE) program and one firm through the Commission's Supervised Investment Bank Holding Company (SIBHC) program. Thus, there are seven firms that are regulated under the CSE

[6] It is possible that additional firms are required to file Form 17-H that are not filing either because the Commission is not aware of these firms or the Commission has not required these firms to file Form 17-H. This issue is discussed later in the report.

[7] FINRA is the largest non-governmental regulator for all securities firms doing business in the United States. FINRA oversees more than 5,000 brokerage firms. FINRA was created in July 2007 through the consolidation of the National Association of Securities Dealers and the regulation committee of the New York Stock Exchange.

[8] Source: FINRA Data as of March 31, 2008.

and SIBHC programs. The intent of the CSE and SIBHC programs is for the Commission to provide consolidated supervision at the holding company level. The CSE and SIBHC firms are required to file more comprehensive information with the Commission than is required under the Broker-Dealer Risk Assessment program and TM reviews these firms in greater depth than the 17(h) filers.

These seven firms carry approximately 21 percent of all customer accounts and 70 percent of all the free credit balances of all the broker-dealers that are regulated by FINRA.[9] Approximately 15 full-time TM personnel with backgrounds in finance and economics manage these programs.

Overall Monitoring of Firms by the Commission and the Federal Reserve. According to FINRA data as of March 31, 2008, the firms monitored by the Commission through the Broker-Dealer Risk Assessment, CSE and SIBHC programs carry approximately 64 percent of the customer accounts and 80 percent of the free credit balances of all United States broker-dealers that are regulated by FINRA.

Additional firms regulated by the Board of Governors of the Federal Reserve System (Federal Reserve) constitute up to 24 percent of the customer accounts and up to 17 percent of the free credit balances of all United States broker-dealers that are regulated by FINRA.

Thus, total monitoring by either the Commission or the Federal Reserve constitutes as much as 88 percent of customer accounts and 97 percent of the free credit balances of all United States broker-dealers that are regulated by FINRA.

Authority to Exempt Broker-Dealers from Filing Form 17-H. Temporary Rule 17h-2T gives the Commission the authority to exempt broker-dealers from filing Form 17-H. Using its authority, TM may permit broker-dealers that it does not monitor in-depth, to only file Form 17-H on an annual basis (instead of quarterly) and only submit information as warranted by media sources and business developments.

Staff Review of Filings. TM staff has described its review of filings as follows. The organization chart is the starting point for its review. The organization chart sets forth the entities which are MAPs, associated broker-dealers and all other entities within the holding company.

TM staff focus on the consolidating financial statements, which identify each MAP, broker-dealer and significant unregulated entity in a separate column. TM staff review the consolidated financial statements for trends in financial condition

[9] Source: FINRA Data as of March 31, 2008.

and operating results. The staff look at the parent company and unregulated entities' data for evidence of significant business, measured by revenues or balance sheet activity. If there is significant unregulated business within the holding company, staff analyze the nature, risk and profitability of the business to determine if it is supported by capital and the ability of the group to maintain liquidity during a downward trend in business or other event. TM staff look at inter-company money flows, liquidity, the types of assets held in each entity and the types of maturities of funding for the assets.

As warranted, TM staff may supplement filing reviews with on-site visits. TM staff have documented their review of broker-dealers' filings in written memoranda, which were provided to the program's Assistant Director. TM stated that the memoranda are still produced, however, the most recent written memorandum was dated August 2007. TM currently tracks quarterly financial data of the six firms it reviews in a spreadsheet.

The BDRA Electronic Filing System. The Broker-Dealer Risk Assessment (BDRA) system is an electronic filing system, created by the Office of Information Technology (OIT), in consultation with TM. The Commission started using the BDRA system in 2005. This system allows firms monitored under the Broker-Dealer Risk Assessment, CSE and SIBHC programs to submit required filings electronically. However, as of September 2008, only 20 of the 146 broker-dealers that are required to file 17(h) documents with the Commission have opted to use BDRA. In contrast, all seven of the firms monitored under the CSE and SIBHC programs use BDRA to file required documents.

Objectives

As a result of the collapse of Bear Stearns in March 2008, we received a Congressional request to perform this audit of the Commission's Risk Assessment program, in addition to an audit of the Commission's CSE program (see Appendix II).

The objectives of this audit were to follow up on recommendations made in the OIG's prior audit report of the Risk Assessment program (Broker-Dealer Risk Assessment Program, Report no. 354, issued on August 13, 2002); and to examine the Commission's broker-dealer review process to determine whether improvements are needed.

The objectives of the audit on the Commission's CSE program were to evaluate the Commission's CSE program, emphasizing the Commission's oversight of Bear Stearns and to determine whether improvements are needed in the Commission's monitoring of CSE firms and its administration of the CSE program. The CSE program is a voluntary program that was created by the

Commission in 2004, which allows the Commission to supervise certain broker-dealer holding companies on a consolidated basis. The report found that the Commission's oversight of Bear Stearns and the other CSE firms should be improved, the guidelines regarding the CSE firms' capital and liquidity requirements should be reassessed and the Commission, in consultation with the Board of Governors of the Federal Reserve, should determine whether leverage ratio limits should be imposed. The report also found that the Commission should adequately incorporate the CSE firms' concentration of securities into the CSE program's assessment of the firms' risk management systems, more aggressively prompt CSE firms to take action to mitigate such risks, and be more skeptical of the firms' risk models. The report contained 26 recommendations to improve the CSE program. Audit report number 446-A, examining the Commission's CSE program was issued simultaneously with this report on September 25, 2008.

Findings and Recommendations

Finding 1: TM Has Not Finalized Temporary Rules 17h-1T and 17h-2T

> Temporary rules 17h-1T and 17h-2T were adopted in 1992, and TM has neither updated nor made the rules permanent, despite significant changes in broker-dealer operations and risks that have occurred since the temporary rules were implemented.

In August 2002, the OIG issued an audit report on the Broker-Dealers Risk Assessment program that contained 14 recommendations to improve the program. One of the most significant recommendations in the report was that the Commission needed to update and finalize temporary rules 17h-1T and 17h-2T. As of this date, six years later, these temporary rules have still not been updated or finalized.

TM's failure to update these rules has resulted in inefficiencies that include the Commission's receipt of numerous filings that TM does not review, while it does not receive all pertinent information from the firms that do file with the Commission. Instead of updating and finalizing the rules, TM has made informal policy decisions to compensate for the rules' shortcomings.

TM Focuses Its Efforts on Only Six Broker-Dealers. Currently, there are 146 broker-dealers that file 17(h) documents with the Commission. Rather than updating temporary rules 17h-1T and 17h-2T, TM's policy has been to focus its efforts on reviewing only six of the 146 broker-dealers that carry the largest number of customer accounts (43.18 percent) and comprise the most significant free credit balances (10.64 percent) of the more than 5,000 broker-dealers that are regulated by FINRA.[10]

TM reviews information from the remaining 140 filing firms only if a pertinent issue arises. For example, TM recently reviewed a 17(h) filing of a broker-dealer in order to provide information about the firm to another regulator. However, TM's review of these other 140 firms is sporadic and random and cannot be considered effective monitoring.

[10] Source: FINRA Data as of March 31, 2008.

TM informed OIG that it plans to expand its review of 17(h) filings in 2008 to include an additional 10 of the 146 firms that file 17(h) documents. These firms carry approximately 11 percent of all customer accounts and 3 percent of all the free credit balances for all of the broker-dealers that are regulated by FINRA. As of August 2008, however, TM had not reviewed in detail any of these firms.

Impact of the Gramm-Leach-Bliley Act on the Broker-Dealer Review Process. The Gramm-Leach-Bliley Act (GLBA),[11] became effective on March 13, 2000, and significantly impacted temporary rule 17h-2(T). The Act permitted banks, securities firms and holding companies to affiliate with each other, and resulted in banks engaging in the securities business. As a result, the Federal Reserve became a principal regulator for certain securities firms subject to the Broker-Dealer Risk Assessment program's reporting requirements, which was not the case prior to the GLBA. Some of these securities firms are subject to filing Form 17-H.

TM made an internal and undocumented policy decision[12] to forgo the review of numerous 17(h) filings from broker-dealers that already had a principal regulator, such as the Federal Reserve or a foreign regulator. All reporting broker-dealers in the United States are regulated by FINRA and firms with a principal regulator have dual regulation. Therefore, TM has stated that it believes it is not necessary to review 17(h) filings from firms with principal regulators. However, temporary rule 17h-2(T) still requires these firms to file Form 17-H.

Broker-Dealer Capital Threshold Should Be Increased. Temporary rule 17h-2T requires all broker-dealers with at least $20 million in capital that are part of a holding company structure to file 17(h) documents with the Commission. TM believes that the capital threshold that triggers the filing requirement should be raised so that fewer broker-dealers file Form 17-H. TM believes that the $20 million capital threshold was appropriate in 1992, but that it is now too low, resulting in firms unnecessarily filing Form 17-H. Because of the threshold requirement, TM is receiving filings from 140 of 146 broker-dealers that it generally does not review. This has created an unnecessary filing burden for the firms and gives the impression that the Commission is monitoring and overseeing all 146 firms that are filing 17(h) documents and not just the six firms that TM reviews in detail. To the contrary, TM rarely, if ever reviews the filings from 140 firms.

While TM believes that temporary rule 17h-2T should be revised to increase the capital threshold, TM has not taken any measures to revise this rule or temporary rule 17h-1T. As such, 146 broker-dealers are required to file 17(h) documents with the Commission but TM does not review most of these filings. TM stated

[11] Public Law 106-102 (Nov. 12, 1999).
[12] TM verbally informed OIG of this decision, which is not memorialized in writing.

that limited staff resources and a lack of prioritization have prevented its staff from revising and finalizing these rules.

In order to revise the temporary rules, TM must engage in a formal rulemaking process. The rulemaking process involves issuing a rule proposal for public review and comment and considering the public's views. The Commission then considers and incorporates the public's comments into the final rule, which is adopted by vote of the full Commission. Once adopted, the rule becomes a part of the official rules that govern the securities industry.

TM has avoided this formal rulemaking process in favor of making an internal and unwritten policy decision to not review many of the firms' 17(h) filings. This decision has ramifications for the 17(h) filers, the securities industry and the investing public.

Temporary Rules Need to Be Updated. In addition to any modification of the threshold requirements that TM believes should be made, the rules have additional shortcomings which require immediate revision as follows:

- The time allotted for broker-dealers to send quarterly and annual filings should be shortened to accommodate more timely receipt of information. Currently, broker-dealers have 60 and 105 days to send quarterly and annual filings, respectively. Firms are able to send this information in a much shorter time period. Receiving information 60 to105 days after the quarter-end or year-end hinders TM's ability to timely review a firm's filings, because the data may no longer be relevant.

- The year-end financial statements that broker-dealers submit to the Commission should be audited. Currently, the financial statements are not required to be audited and as a result, may not comply with Generally Accepted Accounting Principles (GAAP).[13] Compliance with GAAP is important because it proscribes the standard guidelines to follow in preparing financial statements for private companies and companies trading publicly in the United States.

- The rules should be updated to allow TM to collect relevant information about risks posed by derivative products and transactions. The current rules only request peripheral information about a broker-dealer's derivative activities, such as the notional amounts. This information is currently provided in Part II of Form 17-H. This information does not provide TM with an overview of a firm's risks related to derivative activities; nor does it

[13] Broker-dealers are generally required to file financial statements in accordance with GAAP. If the financial statements are not prepared in accordance with GAAP, the broker-dealers are required to disclose the accounting principles upon which the financial statements are based.

allow for TM to make an adequate assessment of a firm's current risk management activities and measurement criteria.

- All broker-dealers subject to filing Form 17-H should be required to file consolidating financial statements with the Commission. Broker-dealers that already have a principal regulator at the holding company level, such as the Federal Reserve or a foreign regulator are not required to file consolidating financial statements. The consolidating financial statements are one of the most useful parts of the filing because they provide information broken out by each affiliated entity of the broker-dealer. Information provided in this manner would provide TM with a greater understanding of a broker-dealer's business and each of its counterparts, and would enable TM to evaluate the potential impact of each entity on the broker-dealer.

- Broker-dealers should be required to file footnote disclosures that accompany the financial statements and the statement of cashflows. Broker-dealers are permitted to omit these items from the consolidating financial statements. The footnote disclosures are important because they disclose the accounting methodologies firms use to record and report transactions and details additional information that is omitted from the financial statements, such as the balance sheet and income statement. The statement of cash flows is important because it provides information regarding a company's cash receipts, cash payments and its ability to meet its short-term obligations.

- The organizational charts that broker-dealers file should be supplemented with a narrative description of each entity associated with the broker-dealer and its ultimate holding company. TM staff stated that the organization chart is the starting point for its review. If the organizational chart contained this additional information, it would further assist TM to understand a broker-dealer's operations and risks. Therefore, TM would be in a better position to respond to problems experienced by a broker-dealer.

- Rule 17h-1T should be revised to ensure that firms preserve all pertinent documents. Rule 17h-1T does not require broker-dealers to preserve all pertinent documents, such as information pertaining to derivative contracts and laws, which impacted broker-dealers after 1992, when temporary rule 17h-1T was implemented.

Recommendation 1
Within six months from the issuance of this report, the Division of Trading and Markets (TM) should establish a timeframe to update and finalize temporary rules

17h-1T and 17h-2T. The new rules should reflect TM's Broker-Dealer Risk Assessment program's review process and program priorities. The rules should be revised to:

- Raise the capital threshold that triggers the 17(h) filing requirement (if TM believes the threshold is too high);
- Shorten the time allotted firms to send quarterly and annual 17(h) filings to the Commission;
- Require broker-dealers to file audited year-end financial statements;
- Allow for the collection of relevant information about risks posed by derivative products and transactions;
- Require all broker-dealers subject to filing Form 17-H to file consolidating financial statements with the Commission;
- Require broker-dealers to file the footnote disclosures that accompany the financial statements and the statement of cash flows;
- Require broker-dealers to supplement the organizational charts they file with a narrative description of each entity associated with the broker-dealer and its ultimate holding company;
- Require broker-dealers to preserve all pertinent documents; and
- Incorporate any additional changes that reflect TM's policy decisions on how to administer the Broker-Dealer Risk Assessment program.

Finding 2: TM Has Not Determined Whether Bear Stearns' Broker-Dealers are Subject to the Broker-Dealer Risk Assessment Program.

> Since the purchase of Bear Stearns in May 2008 by JP Morgan Chase & Co. (JP Morgan), TM has not determined whether Bear Stearns' broker-dealers are subject to filing Form 17-H with the Commission.

In mid-March 2008, Bear Stearns suffered a liquidity crisis at the holding company level and determined that unless it received outside funding (from the Federal Reserve or another lender) or the company was sold, it would be forced to file for bankruptcy protection. In May 2008, JPMorgan purchased Bear Stearns. This purchase resulted in JPMorgan becoming the parent company of two broker-dealers, that were formerly associated with Bear Stearns. These broker-dealers still exist, despite the collapse of the Bear Stearns holding company.

Prior to its collapse, TM regulated Bear Stearns as part of the CSE program and therefore, its broker-dealers were exempt from filing Form 17-H. Subsequent to its collapse, Bear Stearns' broker-dealers may now be required to file Form 17-H with the Commission. It is especially important for TM to determine whether these broker-dealers need to file Form 17-H because one of Bear Stearns' broker-dealers holds a significant percentage of customer accounts and free credit balances. Additionally, given the catastrophic collapse of Bear Stearns and serious questions that have been raised regarding the Commission's and the CSE program's monitoring of Bear Stearns, we believe that TM should have immediately contacted Bear Stearns to discuss its potential 17(h) filing requirements.[14]

In September 2008, the other four firms that are or were regulated in the Commission's CSE program had undergone significant changes.[15] These firms were in the process of being purchased or merged into other firms, or filed to be bank holding companies. It is possible that these other firms have broker-dealers as well and therefore, TM would also need to determine if these firms' broker-dealers would be subject to the 17(h) filing requirement.

TM informed OIG that it had not yet determined whether the Bear Stearns' broker-dealers are required to file Form 17-H, or if they are exempt from doing so because their new holding company, JP Morgan, is subject to filing documentation under the Commission's CSE program. TM further stated that if it is determined that the broker-dealers are required to file Form 17-H, to avoid receiving duplicate information, they will likely require only one broker-dealer to file Form 17-H with the Commission.

Recommendation 2

The Division of Trading and Markets (TM) should determine whether Bear Stearns and the broker-dealers of the other CSE firms are required to file Form 17-H. If TM determines that these broker-dealers are required to file Form 17-H, the Division of Trading and Markets should enforce their compliance with this filing requirement and timely process and review these filings.

[14] For a detailed discussion of the CSE program, see OIG report, *SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program,* Report No. 446-A, September, 25, 2008, which was issued simultaneously with this report.

[15] These other four firms are Lehman Brothers Holdings, Inc., Merrill Lynch & Co., JP Morgan, and Goldman Sachs Group, Inc.

Finding 3: TM Does Not Enforce Compliance with Rules 17h-1T and 17h-2T and Its Own Policies

> TM does not have a mechanism in place to ensure that broker-dealers retain certain information and file 17(h) documents with the Commission, as required by Rules 17h-1T and 17h-2T, nor does TM enforce compliance with its own policies and procedures.

Temporary Rule 17h-1T. This rule requires broker-dealers subject to the Broker-Dealer Risk Assessment program to retain information about their risk management policy, financial data, securities and commodities position data, trading records and information concerning certain associated entities. However, TM does not monitor whether broker-dealers maintain this information and TM has not reminded the broker-dealers of this requirement. It is important for firms to retain this information because it is required by the rule and TM may need to rely upon this information if a firm experiences financial difficulties or undergoes a major change, or if the information is requested from sources internal or external to the Commission.

Recommendation 3
At least annually, the Division of Trading and Markets should remind the broker-dealers subject to the Broker-Dealer Risk Assessment program of their obligation to retain the information specified in Rule 17h-1T. In addition, the Division of Trading and Markets should take appropriate steps to determine if the firms retain this information in accordance with Rule 17h-1T.

Temporary Rule 17h-2T. This rule requires certain broker-dealers to file 17(h) documents with the Commission. However, nearly one-third of the firms that are required to file Form 17-H failed to do so. In fact, according to TM's records, 47 of 146 firms and 44 of 146 firms failed to file Form 17-H for the fourth quarter of 2007 and third quarter of 2007, respectively.

Of the six firms that TM actively monitors, one firm failed to file its fourth quarter 2007 submission as of July 23, 2008. The submission was due March 31, 2008. Additionally, TM failed to process and review the fourth quarter filings for two firms as of June 24, 2008. These two submissions were due on March 31, 2008. This illustrates that TM is not effectively monitoring or timely reviewing information from the six firms that it claims it focuses its review upon.

TM acknowledged that it generally does not follow-up with firms that do not file Form 17-H because TM's staff would not likely review these filings even if the

firms submitted the documents. TM staff also admitted that there may be other firms that are subject to filing Form 17-H, but TM made an informal and undocumented policy decision to only contact non-filers when a firm's size is substantial and it holds customer assets. Finally, TM stated that some firms that consistently fail to file Form 17-H with the Commission may be exempt from filing, due to a merger with another firm. However, TM did not have supporting documentation to verify this assertion.

While TM made a policy decision to focus its review on only six out of 146 firms, temporary rule 17h-2T still requires filings from many firms that TM does not review. Until the temporary rules are revised, TM is responsible for ensuring that all of the firms required to file, are in fact filing. TM is also responsible for staying abreast of the information in the filings. This is important because if a firm collapses or experiences other problems, TM should readily have access to the firm's most recent information in order to respond timely to an incident or provide Commission staff with further information. The 17(h) filing information also assists the Commission to monitor the firms that file 17(h) documents.

Recommendation 4
The Division of Trading and Markets should establish a procedure to ensure that the required broker-dealers file Form 17-H in a timely manner and conduct reviews of the 17(h) filings in a timely manner.

TM's Policies and Procedures. TM's policies and procedures state that TM's quarterly review of the filings from the six firms it monitors should be documented with a one to two page memorandum describing TM's review, any findings or business developments, and note any discussions held with firm personnel. However, TM verbally told us that its policy only entails writing memoranda describing its review one time a year, after receiving the broker-dealers' annual filings, rather than quarterly as its polices and procedures require.

TM's most recent memoranda describing its review of the six firms it focuses its review upon were dated as early as November 1, 2006 and as late as August 30, 2007. This illustrates that TM is neither complying with its written policies and procedures to write quarterly memoranda, nor its verbal assertion to write annual memoranda.

We believe that TM should comply with its documentation requirement because this helps TM's staff to stay abreast of the broker-dealers' operations and new developments.

Recommendation 5
The Division of Trading and Markets should either comply with its written policy to document its review of quarterly 17(h) filings with a written memorandum

describing its review or update its written policy to reflect an appropriate way to ensure that its review of 17(h) filings is properly and adequately documented.

Finding 4: TM Does Not Process 17(h) Filings in a Timely Manner.

> We observed a large backlog of 17(h) filings that were waiting to be processed and filed by TM. This hampers TM's program staff from efficiently and effectively locating and reviewing pertinent information in the 17(h) filings.

We selected the ten firms that TM plans to review in 2008. From the date the filings were received by the Commission, it took TM from two to 112 days, with an average of 48 days, to process the filings.

Although we understand that TM has chosen not to review the majority of the 17(h) filings and believes that the rules should be updated to reflect this decision, the fact remains that temporary rule 17h-2T is still in place and requires all reporting broker-dealers to file Form 17-H with the Commission. As such, the Commission is responsible for, and therefore, should process these filings in a timely manner. Timely processing of these filings would provide the Commission with the information needed in order to respond in a timely manner to a major problem or change that a firm may experience.

Recommendation 6
The Division of Trading and Markets should establish a procedure to ensure that its staff process and disseminate the 17(h) filings in a defined period of time, which ensures that the information in the filings is current and relevant when the filings are processed.

Finding 5: TM's List of Exempt Firms is Incomplete and Erroneous

> TM does not maintain adequate documentation in support of the firms that it listed as being exempt from filing Form 17-H.

TM staff provided OIG with a list of 112 firms they identified as being exempt from filing Form 17-H. TM said some firms were exempt because they had merged with another firm, or they otherwise no longer met the requirements for

filing Form 17-H. TM maintains information in its file room on firms that are exempt from filing Form 17-H.

Of the list of 112 firms that TM identified as being exempt from filing Form 17-H, we judgmentally selected 20 firms from this list to determine if there was documentation to support the exemption.[16] Of the 20 firms we reviewed, the OIG found that:

- In 14 cases, TM could not locate the related file or the proof of exemption. One firm that was on the exemption list was one of the six firms that TM reviews; and
- In six cases, TM located the files. In three of the six cases, we found proof of each firm's exempt status in TM's files. In the remaining three cases, proof of each firm's exempt status was not in the file, but TM staff provided OIG with information from a non-Commission system, which substantiated these firms' exempt status.

We also randomly selected TM's files of six firms, that TM indicated were exempt from filing Form 17-H.[17] Our purpose was to determine if these firms were included in TM's list of 112 exempt firms. From the six firms we selected, only three were on TM's list of exempt firms.

These reviews illustrated that TM does not maintain adequate documentation to support its assertion that certain broker-dealers are exempt from filing Form 17-H. Accordingly, TM's list of exempt firms is erroneous and incomplete. It is important for TM to maintain this documentation and to have an accurate and complete list of exempt firms to better ensure that TM does not mistakenly exempt any firms from the review process.

Recommendation 7
Within three months after the issuance of this report, the Division of Trading and Markets (TM) should develop and maintain a current list, with supporting documentation, which identifies all of the broker-dealers that are exempt from filing Form 17-H. TM should continuously update this list as new firms are exempted from filing Form 17-H.

[16] See Appendix III for the sampling methodology that was used.
[17] See Appendix III for the sampling methodology that was used.

Finding 6: TM Has Not Effectively Encouraged Firms to Electronically File 17(h) Documents

> Only 20 of the 146 firms that TM collects Form 17-H from file electronically using the BDRA system.

The OIG report, issued in August 2002, recommended that TM explore the feasibility of having firms electronically file 17(h) documents. In 2005, TM in consultation with OIT launched the BDRA system, which enables firms to file electronically. TM's policies and procedures state that TM will place additional emphasis on encouraging firms to file Form 17-H electronically. TM has also acknowledged that electronic filing is preferable to receiving paper filings.

Currently, however, three years later, only 20 of the 146 firms from which TM collects Form 17-H from file electronically using the BDRA system. Of the six firms that TM reviews, only two firms file electronically. In contrast, all seven firms that TM monitors through the CSE and SIBHC programs file electronically using the BDRA system. While TM has made some efforts to encourage additional firms to file electronically, TM has not aggressively encouraged firms to use the BDRA system.

The Government Paperwork Elimination Act[18] and the E-Government Act of 2002[19] were enacted to promote the use and availability of electronic methods to interact with Federal government agencies. These Acts encourage Federal Agencies to allow individuals or entities that deal with the Federal Government the option to submit information or transact electronically. In accordance with these Acts, TM should more aggressively encourage firms to file 17(h) documents using the BDRA system.

Additionally, electronic filing is more secure, it would improve the timeliness of the filings and all Commission staff with access to BDRA could simultaneously view the filings. Electronic filing would also eliminate TM's processing backlog of paper filings.

Recommendation 8
The Division of Trading and Markets should aggressively encourage firms to file electronically using the BDRA system. The Division of Trading and Markets should especially encourage the firms that it reviews to file electronically. This could be accomplished by calling the firms and periodically sending the firms information on how to file electronically.

[18] Public Law 105-277 (October 21, 1998).
[19] Public Law. 107-347 (December 17, 2002).

Finding 7: TM Should More Effectively Utilize the BDRA System

> TM is not using the BDRA system to store information about the firms it reviews or to produce management reports.

Currently, TM only uses the BDRA system as a portal to store filings. TM staff could better utilize the system by storing in BDRA financial information about the firms it reviews, staff notes and written documents. It could also use the system to generate management reports. Currently, TM's staff maintain documentation on the firms they review in their own files or on TM's shared drive. Storing this information in the BDRA system would be beneficial because the data would be more centrally organized and would enable TM staff to generate management reports.

TM has already discussed these capabilities with OIT. The BDRA system currently allows TM to store staff notes in BDRA. OIT would need to be further configure BDRA to enable it to create financial information and to generate management reports.

Recommendation 9
In coordination with the Office of Information Technology, the Division of Trading and Markets (TM) should ensure that the BDRA system includes financial information, staff notes and other written documentation about the firms TM reviews and that BDRA is used to generate management reports.

Finding 8: Several Technical Problems Exist with the BDRA System That Need to be Addressed.

> Technical problems exist with the BDRA system, thus hampering the system's effectiveness and firms' willingness to file electronically with the Commission.

The BDRA System. Although the BDRA system has several features that could assist TM with its review of 17(h) filings as described above, the BDRA system has several problems as follows, which can be resolved:

- Only parts of a filing appear in the BDRA system if TM staff access the information in a particular manner. OIT stated that it is reviewing the BDRA system to identify and fix this problem.

- A digital signature does not consistently accompany filings that firms upload into BDRA. A digital signature is an electronic signature that can be used to authenticate the identity of the sender of a message or the signer of a document. The digital signature is important because it helps ensure that information the broker-dealers send to the Commission has not been altered. OIT stated that the BDRA system needs to be reprogrammed to ensure the firms include this signature.

- If a filing is larger than 16 megabytes, the entire filing will not upload into BDRA. TM has told firms to check the size of their filings prior to uploading them and to divide filings over 16 megabytes into more than one submission. TM stated that it plans to work with OIT to see if the system can be configured to allow users to upload filings greater than 16 megabytes in one submission.

  In addition to filings greater than 16 megabytes, TM also told us that filings less than 16 megabytes do not consistently upload into BDRA. For example, in August 2008, a filing that was only eight megabytes failed to upload into BDRA.

- Users were unable to access the BDRA system for at least two days in June 2008. OIT stated that the system was inoperable because it was making changes to the system.

Recommendation 10

The Office of Information Technology, in coordination with the Division of Trading and Markets, should ensure that technical problems with the BDRA system are resolved so that:

- All filings in the BDRA system can be properly and fully accessed;
- A digital signature accompanies all required filings;
- All filings, including those that are greater than and less than 16 megabytes, can be completely and accurately uploaded into BDRA in one submission; and
- Access to the BDRA system is consistently available to users and TM should promptly notify all users when it is unavailable.

Acronyms

BDRA	Broker Dealer Risk Assessment
CSE	Consolidated Supervised Entity
FINRA	Financial Industry Regulatory Authority
GAAP	Government Accepted Accounting Principles
GLBA	Gramm-Leach-Bliley Act
MAP	Material Associated Person
OIG	Office of Inspector General
OIT	Office of Information Technology
SIBHC	Supervised Investment Bank Holding Company
TM	Division of Trading and Markets

Congressional Request for Audit

United States Senate
COMMITTEE ON FINANCE
WASHINGTON, DC 20510–6200

April 2, 2008

Via Electronic Transmission

The Honorable David Kotz
Inspector General
US Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-2736

Dear Inspector General Kotz:

According to regulatory filings and a December 2007 *Wall Street Journal* article, the SEC Enforcement Division declined to bring a case against Bear Stearns for improperly valuing mortgage-related investments. Given the later collapse and federally backed bail-out of Bear Stearns, Congress needs to understand more about this case and why the SEC ultimately sought no enforcement action.

Moreover, I am particularly interested in this case in light of the SEC's failed investigation of Pequot Capital Management. As you know, in the final report of the Senate's inquiry into that matter, we found that senior SEC officials showed extraordinary deference to a particular witness because of his "prominence" as the head of Morgan Stanley.

Request for Investigation

In light of my earlier investigation I need to know whether the same problems identified in the Pequot investigation were repeated in the Bear Stearns case. Accordingly, I request that you conduct a thorough investigation into the facts and circumstances surrounding the decision to not pursue an enforcement action against Bear Stearns. Please provide a final report on whether there was any improper action or misconduct relating to SEC investigation of Bear Stearns and its decision to close the investigation. The report should also describe and assess:

1. the nature, extent, and propriety of communications between Bear Stearns executives or their representatives and senior SEC officials;

2. the decision-making process which led to the SEC's failure to bring an enforcement action following the drafting of a Wells notice;

3. the reasons for declining to proceed with an enforcement action; and

4. the degree to which more aggressive action by the Enforcement Division may have led to an earlier and more complete understanding of the issues that contributed to the collapse of Bear Stearns.

Request for Audit

In addition to this investigative request, I would also like your office to follow-up on previous audit work relevant to issues surrounding Bear Stearns. The Division of Trading and Markets (Division) is responsible for regulating the largest broker-dealers and the associated holding companies. Offices within the Division are staffed with accountants and economists who are responsible for reviewing the market and credit-risk exposures of the broker dealers. Their review includes assessing broker-dealers' quarterly financial filings, ensuring broker-dealers are meeting net-capital requirements and that other financial ratios, such as liquidity ratios, are adequate. There is a special emphasis in reviewing the five very large broker-dealers, including Bear Stearns, known as the Consolidated Supervised Entity (CSE) Program. The Division staff exercises additional oversight of these firms and examines their risk models.

I understand that the OIG conducted a prior audit of these responsibilities in 2002. Please provide an update of the previous findings, determine whether earlier recommendations were implemented, and analyze the current function of these offices. The review should include a description and assessment of their missions, how the programs are run, their policies and procedures, the adequacy of any reviews conducted regarding Bear Stearns, and recommendations for improvements in the process.

If you have any questions about these requests, please contact Jason Foster or Emilia DiSanto at (202) 225-4515.

Sincerely,

Charles E. Grassley
Ranking Member

Scope and Methodology

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

Scope. We obtained from TM, information showing all the firms currently filing Form 17-H, delinquent filers, exempt firms and sample 17(h) filings. We obtained information illustrating TM's review of six firms and related financial information from 2006 to 2008. We obtained information allowing us to test TM's timeliness in processing filings. We obtained information showing the status of TM's implementation of prior OIG audit recommendations on this program (*Broker-Dealer Risk-Assessment Program*, Audit No. 354, August 13, 2002). We also obtained information from FINRA showing the amount of customer accounts and free credit balances held by reporting broker-dealers as of March 31, 2008.

We conducted our fieldwork from April 2008 to August 2008. We reviewed documentation on the Broker-Dealer Risk Assessment program covering the years 2006 to 2008.

Methodology. We reviewed TM's policies and procedures governing the Broker-Dealer Risk Assessment program, documentation showing all firms that file Form 17-H and documents showing delinquent filers and exempt firms. We also reviewed documentation of TM's review of 17(h) filers. We reviewed and relied upon workpapers from our prior audit report on this program (*Broker-Dealer Risk-Assessment Program*, Audit No. 354, issued August 13, 2002). In addition, we held discussions with representatives from TM and OIT to learn about the program and to discuss and confirm our findings.

We conducted detailed testing to determine whether TM enforced compliance with temporary rules 17h-1T and 17h-2T and whether TM complied with its policies and procedures. We also performed testing to measure TM's timeliness in processing filings, and to determine the accuracy of TM's list of exempt firms. We analyzed data from FINRA to determine the amount of customer assets and free credit balances that were attributable to filing and non-filing broker-dealers.

Internal/Management Controls. We reviewed internal/management controls as they pertained to the objectives of our audit.

Use of Computer-Processed Data. We determined the umber of firms that file electronically by relying on data from the Commission's BDRA system. Firms use the BDRA system to transmit filings electronically to TM. The BDRA system does not process any of the data contained in the filings but rather only stores the filings in electronic format. As a result, we considered the relevant risks to be:

- TM's failure to receive a filing sent by a firm; and
- Whether information in the BDRA system could be compromised (information security risks).

We identified an instance where TM failed to receive a filing that a firm transmitted through BDRA and where only parts of filings could only be viewed if TM staff accessed the BDRA system in a particular way. During the audit TM was working with OIT to address these issues.

We considered the risk surrounding information security. In July 2008, OIT certified and accredited the BDRA system, as required by the Federal Information Security Management Act of 2002. Therefore, we believe that we can rely upon the information in the BDRA system as it pertains to information security.

Judgmental Sampling. TM provided us with a list of 112 firms considered exempt from the 17(h) filing process. We judgmentally selected every fifth firm on the list (22 firms) to determine if TM had documentation on file indicating that the firms were actually exempt from filing Form 17-H. We deleted two firms from our sample because they were CSE firms, which are no longer part of the Broker-Dealer Risk Assessment program.

TM stores information on exempt firms in file folders in a file room. Each folder contains information on a particular firm. We randomly selected six folders to determine if the firms were included in TM's list of exempt firms.

In another analysis we selected the ten firms that TM plans to review in the near future and measured how long it took TM to process these filings, from the date the Commission received the filings. We originally tried to review processing times for the six firms that TM is currently reviewing, but this information was not available.

Prior Audit Coverage. From March to May 2002, the OIG audited and assessed the Commission's Risk Assessment program and issued a related report *Broker-Dealer Risk-Assessment Program*, Report No. 354, August 13, 2002. The report contained 14 recommendations aimed to improve the program.

Criteria

Final Temporary Risk Assessment Rules. Governs the Broker-Dealer Risk Assessment program. Adopted July 16, 1992 in Commission Release no. 34-30929.

A Study and Evaluation of the Effectiveness of the Final Temporary Risk Assessment Rules. Issued December 1996. Discusses the effectiveness of the Risk Assessment Rules.

TM's Policies and Procedures Governing the Broker-Dealer Risk Assessment program. Issued September 2007. Discusses TM's review of 17(h) filings and the purpose of the program.

Report to the Congress on Financial Holding Companies under the Gramm-Leach-Bliley Act. Issued November 2003. Discusses how the implementation of the Gramm-Leach-Bliley Act, enacted on November 12, 1999, permitting banks, securities firms and holding companies to affiliate with one another and the effects of the Act on regulated entities.

The Government Paperwork Elimination Act. Enacted on October 21, 1998. The Act is designed to improve customer service and governmental efficiency through the use of information technology.

The E-Government Act of 2002. Enacted on December 17, 2002. This Act was designed to promote the use of the Internet and other information technologies to improve government services for citizens, internal government operations, and opportunities for citizen participation in government.

List of Recommendations

Recommendation 1
Within 6 months from the issuance of this report, the Division of Trading and Markets (TM) should establish a timeframe to update and finalize temporary rules 17h-1T and 17h-2T. The new rules should reflect the TM's Broker-Dealer Risk Assessment program's review process and program priorities. The rules should be revised to:

- Raise the capital threshold that triggers the 17(h) filing requirement (if TM believes the threshold is too high);
- Shorten the time allotted firms to send quarterly and annual 17(h) filings to the Commission;
- Require broker-dealers to file audited year-end financial statements;
- Allow for the collection of relevant information about risks posed by derivative products and transactions;
- Require all broker-dealers subject to filing Form 17-H to file consolidating financial statements with the Commission;
- Require broker-dealers to file the footnote disclosures that accompany the financial statements and the statement of cash flows;
- Require broker-dealers to supplement the organizational charts they file with a narrative description of each entity associated with the broker-dealer and its ultimate holding company;
- Require broker-dealers to preserve all pertinent documents; and
- Incorporate any additional changes that reflect TM's policy decisions on how to administer the Broker-Dealer Risk Assessment program.

Recommendation 2
The Division of Trading and Markets (TM) should determine whether Bear Stearns and the broker-dealers of the other CSE firms are required to file Form 17-H. If TM determines that these broker-dealers are required to file Form 17-H, the Division of Trading and Markets should enforce their compliance with this filing requirement and timely process and review these filings.

Recommendation 3
At least annually, the Division of Trading and Markets should remind the broker-dealers subject to the Broker-Dealer Risk Assessment program of their obligation to retain the information specified in Rule 17h-1T. In addition, the Division of Trading and Markets should take appropriate steps to determine if the firms retain this information in accordance with Rule 17h-1T.

Recommendation 4
The Division of Trading and Markets should establish a procedure to ensure that the required broker-dealers file Form 17-H in a timely manner and conduct reviews of the 17(h) filings in a timely manner.

Recommendation 5
The Division of Trading and Markets should either comply with its written policy to document its review of quarterly 17(h) filings with a written memorandum describing its review or update its written policy to reflect an appropriate way to ensure that its review of 17(h) filings is properly and adequately documented.

Recommendation 6
The Division of Trading and Markets should establish a procedure to ensure that its staff process and disseminate the 17(h) filings in a defined period of time, which ensures that the information in the filings is current and relevant when the filings are processed.

Recommendation 7
Within three months after the issuance of this report, the Division of Trading and Markets (TM) should develop and maintain a current list, with supporting documentation, which identifies all of the broker-dealers that are exempt from filing Form 17-H. TM should continuously update this list as new firms are exempted from filing Form 17-H.

Recommendation 8
The Division of Trading and Markets should aggressively encourage firms to file electronically using the BDRA system. The Division of Trading and Markets should especially encourage the firms that it reviews to file electronically. This could be accomplished by calling the firms and periodically sending the firms information on how to file electronically.

Recommendation 9
In coordination with the Office of Information Technology, the Division of Trading and Markets (TM) should ensure that the BDRA system includes financial information, staff notes and other written documentation about the firms TM reviews and that BDRA is used to generate management reports.

Recommendation 10
The Office of Information Technology, in coordination with the Division of Trading and Markets (TM), should ensure that technical problems with the BDRA system are resolved so that:

- All filings in the BDRA system can be properly and fully accessed;
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- All filings, including those that are greater than and less than 16 megabytes, can be completely and accurately uploaded into BDRA in one submission; and
- Access to the BDRA system is consistently available to users and TM should promptly notify all users when it is unavailable.

Management Comments (TM)

DIVISION OF TRADING AND MARKETS MANAGEMENT COMMENTARY

The Division of Trading and Markets ("Division") appreciates the opportunity to comment on the Office of Inspector General ("OIG") Report "SEC Risk Assessment Program."

1. The Division acknowledges that the risk assessment rules promulgated under Section 17(h) of the Exchange Act ("the 17(h) rules") need to be reviewed and modified to assure that relevant information is collected from an appropriate set of firms to meet the objective of the program, namely to assess the risks to registered broker-dealers that may stem from activities conducted in affiliates. Review of the rule set has already begun. The effort will accelerate with the arrival of a new attorney who is scheduled to begin work on September 29. The Division believes that essentially all of the issues raised in the OIG report will be addressed through an appropriate revision of the rules. For example, such an effort can assure that an appropriate population of broker-dealers is filing risk assessment information, and mandate that this information be filed electronically.

2. As noted in the Division's informal comments to OIG, the staff is concerned that the report repeatedly describes the program as reviewing "only" six firms in detail. The report does not recognize the compelling reason for focusing limited resources on six firms: these six firms, together with the firms supervised by the Commission or the Federal Reserve at the consolidated level, hold substantially all customer free credit balances.

   More specifically, as of the first quarter 2008, some $605 billion in total free credit balances are held by firms filing Form 17-H (or former filers now exempted because of CSE or SIBHC status). Broker-dealers affiliated with the CSE firms supervised by the Commission on a consolidated basis account for $356 billion of this $605 billion. Broker-dealers affiliated with holding companies supervised by the Federal Reserve, as either a US Bank Holding Company or a Foreign Banking Organization, account for another $175 billion of the total. Thus only $74 billion in free credit balances are held at broker-dealers affiliated with holding companies not subject to Commission or Federal Reserve supervision.

   The risk assessment program focused on six of these firms, which account for $60 billion of that $74 billion in free credit balances. This focus accords with the aims of the 17(h) rules to assess risks that affiliates might pose to the broker-dealer. The remaining 140 firms that file Form 17-H but are not reviewed in depth account for only $14 billion of free credit balances, or 2.3 percent. While the staff believes that

the current allocation of resources is compelling, the staff also recognizes that additional efficiencies can be gained by revising the 17(h) rules.

3. As noted in the Division's informal comments to OIG, the report suggests that the Division's responsibilities with regard to the 17(h) rules are unusually broad. Finding 3 suggests that the Division should "enforce" compliance with Rules 17h-1T and 17h-2T. The report also recommends that the Division at least annually "should remind broker-dealers subject to the 17(h) Risk Assessment Program of their obligation to retain the information specified." Given that these requirements are mandated by rules, the staff believes that registrants must fulfill obligations even without prompting from the SEC, and instituting a systematic process of providing "reminders" could inadvertently weaken the Commission's position when taking action against registrants in cases of non-compliance with other rules and requirements.

4. As noted in the Division's informal comments to OIG, the staff does not believe that the issue involving the Bear Stearns merger is sufficiently material to be one of the eight primary findings in the report. The matter is one of minimal substance that will be resolved in due course along with numerous other open issues associated with the Bear Stearns – JP Morgan merger ("Merger"). The Merger resulted in two broker-dealers, Bear Stearns & Co. and Bear Stearns Securities Corporation, becoming affiliates of JP Morgan, a bank holding company overseen by the Federal Reserve on a consolidated basis. Therefore, prior to the Merger, comprehensive holding company information was provided by The Bear Stearns Companies Inc. pursuant to the CSE rules. Subsequent to the Merger, comprehensive holding company information (although in reduced quantity due to the Federal Reserve's role as holding company supervisor) is filed by JP Morgan pursuant to the CSE rules. In both cases, the information serves the purposes of the 17(h) rules, namely to allow for assessing the potential risks to the registered broker-dealers. In addition, the information provided pursuant to the CSE rules both before and after the merger constitutes a superset of the information required under the 17(h) rules. Discussions are still ongoing among the Commission, JP Morgan, and FINRA regarding which of the broker-dealers of the merged entity will be reorganized and how this will occur. When this is resolved, one of the surviving entities will request to be designated as the reporting broker-dealer for purposes of the 17(h) rules. Obviously, similar determinations may be necessary to the extent that other broker-dealers have been involved in corporate reorganizations or otherwise subject to changes in regulatory status.

5. As noted in its informal comments to OIG, the Division believes that there is unnecessary, negative language throughout the report, especially in the Executive Summary. We believe that this language is unfair and does not accurately describe the issues presented,. Just to highlight several instances: The report finds that "TM is not fulfilling its obligations." The report also opines that "[a] dditionally, given the catastrophic collapse of Bear Stearns and serious questions that have been raised

regarding the Commission's and CSE program's monitoring of Bear Stearns, we believe that TM should have immediately contacted Bear Stearns to discuss its potential 17(h) filing requirements." After noting that "TM reviews information from the remaining 140 firms only if a pertinent issue arises," this approach is described as "sporadic and random." The report notes that rules have not been updated due to a "lack of prioritization," rather than reflecting the fact that other projects were accorded a higher priority.

Please indicate your concurrence or non-concurrence with each recommendation that applies to your Division or Office.

Recommendation 1: Within 6 months from the issuance of this report, the Division of Trading and Markets should establish a timeframe to update and finalize temporary rules 17h-1T and 17h-2T. The new rules should reflect the Division of Trading and Market's 17(h) program review process and program priorities.

The Division concurs with this recommendation, and has already begun the process of addressing the need to revise the cited rules.

Recommendation 2: The Division of Trading and Markets should determine whether Bear Stearns and the broker-dealers of the other CSE firms are required to file Form 17-H. If TM determines that these broker-dealers are required to file Form 17-H, the Division of Trading and Markets should enforce their compliance with this filing requirement and timely process and review these filings.

The Division concurs, and will make these determinations per usual course. However, as described in more detail in the management response, the staff is confident in the case of Bear Stearns that all relevant information to permit assessment of risks to the broker-dealers affiliated with JP Morgan is currently being provided.

Recommendation 3: At least annually, the Division of Trading and Markets should remind the broker-dealers subject to the 17(h) Risk Assessment Program of their obligation to retain the information specified in Rule 17h-1T. In addition, the Division of Trading and Markets should take appropriate steps to determine if the firms retain this information in accordance with Rule 17h-1T.

The Divsion does not concur that broker-dealers should be notified to comply with Commission rules, for the reasons noted in the management response.

Recommendation 4: In accordance with Rule 17h-2T, the Division of Trading and Markets should establish a procedure to ensure that the required broker-dealers file Form 17-H in a timely manner and conduct reviews of the 17(h) filings in a timely manner.

The Division concurs.

Recommendation 5: The Division of Trading and Markets should either comply with its written policy to document its review of quarterly 17(h) filings with a written memorandum describing its review or update its written policy to reflect an appropriate way to ensure that its review of 17(h) filings is properly and adequately documented.

The Division concurs, but notes that the FY2008 Planning Document, provided during the course of OIG's review, does document this particular change in procedure.

Recommendation 6: The Division of Trading and Markets should establish a procedure to ensure that its staff process and disseminate the 17(h) filings in a defined period of time, which ensures that the information in the filings is current and relevant when the filings are processed.

The Division concurs.

Recommendation 7: Within three months after the issuance of this report, the Division of Trading and Markets should develop and maintain a current list, with supporting documentation, which identified all of the broker-dealers that are exempt from filing Form 17-H. The Division of Trading and Markets should continuously update this list as new firms are exempted from filing Form 17-H.

The Division concurs.

Recommendation 8: The Division of Trading and Markets should aggressively encourage firms to file electronically using the BDRA system. The Division of Trading and Markets should especially encourage the firms that it reviews to file electronically. This could be accomplished by calling the firms and periodically sending the firms information on how to file electronically.

The Division concurs that electronic filing should be encouraged. However, the staff notes that it has called firms, sent e-mail to firms, and otherwise encouraged what would be a voluntary migration to electronic filing. Such outreach was undertaken with more than 60 firms filing Form 17-H. Despite concerted efforts by the Office of Information Technology ("OIT"), technical issues involving the BDRA system have remained a significant obstacle to the success of these initiatives in migrating substantial numbers of

firms to the BDRA system. The staff is hopeful that the continued cooperation with OIT on the technical issues, combined with a mandatory electronic filing requirement in a revised rule, will succeed in eliminating non-electronic filing of Form 17-H.

Recommendation 9: In coordination with the Office of Information Technology, the Division of Trading and Markets should ensure that the BDRA system includes financial information, staff notes and other written documentation about the firms TM reviews and that BDRA is used to generate management reports.

The Division concurs, recognizing however that rule revisions could substantially alter the population of filers as well as the information filed. Thus it is important to design and implement any enhancement to the BDRA system in conjunction with rule revisions.

Management Comments (OIT)

Memorandum

To: Jacqueline M. Wilson
Assistant Inspector General for Audits

From: Lewis W. Walker
Chief Information Officer (Acting)

Subject: Responses to Formal Draft Report, SEC Risk Assessment Program, Report No. 446-B

Date: September 11, 2008

Thank you for the opportunity to respond to the above captioned report. OIT is responding only to those two recommendations for which it is assigned some responsibility for action.

Recommendation 9: In coordination with the Office of Information Technology, the Division of Trading and Markets should ensure that the BDRA system includes financial information, staff notes and other written documentation about the firms TM reviews and that BDRA is used to generate management reports.

Management Response and comments:

Although OIT does not object to this recommendation, it notes that decisions about the functionality of the BDRA system, what data it contains, and how the system is used reside solely with TM. To the extent that TM determines to implement any portions of this recommendation, OIT will provide support to the extent it is consistent with the agency's enterprise architecture and other agency priorities for IT resources and funding.

With respect to current efforts to assist TM with respect to the suggested enhancements to the BDRA application:

- OIT staff has discussed with the users adding financial information to the report generation function. After the next release of Business Objects XI is implemented (currently estimated as December 2008), OIT's Walk-in Development Center can help the user create financial reports.

- Within the current release, there is a "Staff Notes" tab for each filing that is meant to be used for the user's notes. Storing TM's staff documentation

using the BDRA application is a requirement that possibly could be fulfilled in a future release (there is already a tab labeled “Attachments” that could provide the ability to store these documents). However, OIT will consider all options for best satisfying TM’s document management requirements when it is approached to architect the solution.

Recommendation 10: The Office of Information Technology, in coordination with the Division of Trading and Markets should ensure that technical problems with the BDRA system are resolved so that:

- All filings in the BDRA system can be properly and fully accessed;
- A digital signature accompanies all required filings;
- All filings, including those that are greater than and less than 16 megabytes, can be completely and accurately uploaded into BDRA in one submission; and
- Access to the BDRA system is consistently available to users and TM should promptly notify all users when it is unavailable.

Management Response and comments:

Release 1.7 to the BDRA application was successfully deployed on September 5, 2008 and addressed almost all of recommendation 10 as noted in the following list of system changes:

1) **Access to All Filing Information** - The BDRA Form Parser was modified so that the submission will include all attachments. This change resolves the problem of having only parts of a filing appear in the BDRA system.

2) **Digital Signatures** – The capability for digital signatures existed in BDRA. In the new version, a digital signature will be required when the radio button for Digital Signature is selected on the Form 17H. However, the decision to require that a digital signature accompany all filings is a business decision that must be made by TM.

3) **Size Limit Notification** - The system no longer accepts filings that are greater than 16MB. It will stop large submissions from being accepted and tell the user why the submission is not being accepted. This size limitation is necessary at this time due to the configuration of the underlying database. OIT plans is to upgrade the database to the latest version of the MYSQL database by no later than March 31, 2009 which will eliminate the need to impose size limits for filings.

4) Notification for All System Downtime - In the future, the OIT Project team will ensure that all users are notified prior to any system downtime or future maintenance releases.

In view of the above, OIT requests that recommendation 10 be revised to remove all recommendations except that BDRA be able to accept filings greater than 16 megabytes. If the recommendation for digital signatures is retained, responsibility for its implementation should be assigned to TM.

Cc: Srini Bangarbale
George Eckard
Remi Pavlik-Simon
Jeff Thomas

OIG Response to Management's Comments

The Division of Trading and Markets (TM) and the Office of Information Technology (OIT) responded to this report. TM concurred with 9 out of 10 of the report's recommendations and OIT concurred with the two recommendations that were addressed to their office.

We are pleased with the willingness on the part of the Commission to implement the report's recommendations. However, we are disappointed that TM disagrees with recommendation no. 3, which states that TM should remind broker-dealers subject to the 17(h) Risk Assessment Program of their obligation to retain the information specified in Rule 17h-1T and take appropriate steps to determine if the firms retain this information in accordance with Rule 17h-1T. We believe that enforcing the rule's requirements is prudent and we request that TM reconsider its position and remind broker-dealers of the requirement to preserve information, as stated in recommendation 3. In addition, although not specifically mentioned in the report, we also believe that TM should remind the broker-dealers of their requirement to file Form 17-H. The OIG found that approximately one-third of the firms required to file this form, failed to do so.

Audit Request and Ideas

The Office of Inspector General welcomes your input. If you would like to request an audit in the future or have an audit idea, please contact us at:

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