FIRMA Regulatory Update
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Editor's Note: In this edition of the Regulatory Update I thought it would be beneficial to outline the recent testimony of various regulatory agencies before Congress discussing the lessons learned and the current focus on risk management and compliance within the financial industry. The comments made before Congress should give all of us a good indication of the focus of the regulatory agencies. In addition, I have included a discussion on FINRA's Letter to CEOs discussing 2009 examination priorities. And finally, in light of all the identified Ponzi schemes, I have outlined EBSA guidance for fiduciaries relating to the Madoff scandal. As always, should you have specific items you would like to be presented/discussed in the Regulatory Update, please send your requests to the attention of the FIRMA Forum Editor, or myself.

OCC – Testimony of Senior Deputy Comptroller Timothy Long Before the Subcommittee on Securities, Insurance, and Investment of the Committee on Banking, Housing, and Urban Affairs, United States Senate

Background

On March 18, 2009 Senior Deputy Comptroller (SDC) Timothy Long testified before the Subcommittee on Securities, Insurance, and Investment of the Committee on Banking, Housing, and Urban Affairs, United States Senate. SDC Long discussed the OCC's perspective on the recent lessons learned regarding risk management, as well as the steps the OCC has taken to strengthen their supervision and examination processes in this critical area, and how they supervise the risk management activities at the largest national banking companies. In addition, SDC Long presented observations on the findings of the GAO regarding the OCC's oversight of bank risk management.

Information

Below are excerpts from SDC Long's testimony; these comments while not specific to fiduciary and asset management arena, do provide insight into the focus and temperature of the OCC's attention to an effective risk mitigation function at financial institutions.

Role of Risk Management

The unprecedented disruption that we have seen in the global financial markets over the last eighteen months, and the events and conditions leading up to this disruption, have underscored the critical need for effective and comprehensive risk management processes and systems. As I will discuss in my testimony, these events have revealed a number of weaknesses in banks' risk management processes that we and the industry must address. Because these problems are global in nature, many of the actions we are taking are in coordination with other supervisors around the world. More fundamentally, recent events have served as a dramatic reminder that risk management is, and must be, more than simply a collection of policies, procedures, limits and models. Effective risk management requires a strong corporate culture and corporate risk governance. As noted in the March 2008 Senior Supervisors Group report on “Observations on Risk Management Practices During the Recent Market Turmoil,” companies that fostered a strong risk management culture and encouraged firm-wide identification and control of risk, were less vulnerable to significant losses, even when engaged in higher risk activities.

While current economic conditions have brought renewed attention to risk management, it is during periods of expansionary economic growth when risk management can be most critical and challenging both for bankers and supervisors. Financial innovation and expansion of credit are important drivers of our economy. Banks must be able to respond to customer and investor demand for new and innovative products and services. They must also be able to compete with firms that may be less regulated and with financial service companies across the globe. Failure to allow this competition risks ceding the prominent role that U.S. financial firms have in the global marketplace.

Banks are in the business of managing financial risk. Competing in the marketplace and allowing market innovation means that there will be times when banks lose money. There will also be times when, despite a less favorable risk/reward return, a bank will need to maintain a market presence to serve its customers and to retain its role as a key financial intermediary. These are not and should not be viewed as risk management failures. The job of risk management is not to eliminate losses or risk, but rather to ensure that risk exposures are fully identified and understood so that bank management and directors can make informed business decisions about the firm’s level of risk.

In this regard, a key issue for bankers and supervisors is determining when the accumulation of risks either within an individual firm or across the system has become too high, such that corrective or mitigation actions are needed. Knowing when and how to strike this balance is one of the most difficult jobs that supervisors and examiners face. Taking action too quickly can constrain economic growth and impede credit to credit worthy borrowers; waiting too long can result in an overhang of risk becoming embedded into banks and the marketplace. Effective risk management systems play a critical role in this process.

Risk Management Lessons Learned

It is fair to ask what the banking industry and supervisors have learned from the major losses that have occurred over the past 18 months. The losses have been so significant, and the damage to the economy and confidence so great, that we all must take stock of what we missed, and what we should have done differently to make sure that we minimize the possibility that something like this happens again. Below are some of our assessments:

Underwriting Standards Matter, Regardless of Whether Loans are Held or Sold – The benign economic environment of the past decade, characterized by low interest rates, strong economic growth and very low rates of borrower defaults led to complacency on the part of many lenders. Competitive pressures drove business line managers to ease underwriting standards for the origination of credit and to assume increasingly complex and concentrated levels of risk. Increased investor appetite for yield and products, fueled by a global abundance of liquidity, led many larger banks to adopt the so-called "originate-to-distribute" model for certain commercial and leveraged loan products, whereby they originated a significant volume of loans with the express purpose of packaging and selling them to investors. Many of these institutional investors were willing to accept increasingly liberal repayment terms, reduced financial covenants, and higher borrower leverage on these transactions in return for marginally higher yields. Similar dynamics were occurring in the residential mortgage markets, where lenders, primarily non-bank lenders, were aggressively relaxing their underwriting standards.

Risk Concentrations Can Accumulate Across Products and Business Lines and Must be Controlled – Risk concentrations can arise as banks seek to maximize their expertise or operational efficiencies in a highly competitive business. Community banks can often develop significant concentrations as their lending portfolios tend to be highly concentrated in their local markets. For larger institutions, a key issue has been the ability to aggregate risk exposures across business and product lines and to identify risks that may be highly correlated. Because of inadequate communication within these firms, those structuring businesses were aggressively expanding activity at the same time that retail lending professionals in the bank were avoiding or exiting the business because of their refusal to meet weak underwriting conditions prevalent in the market. These failures were compounded when products, markets, and geographic regions that previously were looked to as a source of risk diversification became more highly correlated as contagion effects spread across the globe. Additionally, significant corporate acquisitions, especially if they were not consistent with the bank's business strategy and corporate culture, affected the institutions' financial well being, their risk positions and reputations, and placed significant strains on their risk management processes.

Asset-Based Liquidity Provides a Critical Cushion –There is always a tension of how much of a bank's balance sheet capacity should be used to provide a cushion of liquid assets – assets that can be readily converted to liquid funds should there be a disruption in the bank's normal funding markets or in its ability to access those markets. Because such assets tend to be low risk and, thus, low yielding, many banks have operated with very minimal cushions in recent years. These decisions reflected the abundance of liquidity in the market and the ease with which banks could tap alternative funding sources through various capital and securitization markets. Here again, when these markets became severely constrained, many banks faced significant short-term funding pressures. For some firms, these funding pressures, when combined with high credit exposures and increased leverage, resulted in significant strains and, in some cases, liquidity insolvency.

Systemically Important Firms Require State-of-the-Art Infrastructure – As noted in a number of visible cases during this period of market turmoil, a large firm's ability to change its risk profile or react to the changing risk tolerance of others is dependent on an extremely robust supporting infrastructure. The velocity with which information is transmitted across financial markets and the size, volume and complexity of transactions between market participants has been greatly expanded through technology advancements and globalization of markets. Failure to have sufficient infrastructure and backroom operations resulted in failed trades and increased counterparty exposures, increasing both reputation and credit risks.

Need for Robust Capital Levels and Capital Planning Processes –Although we are clearly seeing strains, the national banking system, as a whole, has been able to withstand the events of the past 18 months due, in part, to their strong levels of regulatory capital. The strong levels of capital in national banks helped to stabilize the financial system. National banking organizations absorbed many weaker competitors (e.g., Bear Stearns, Countrywide, and WAMU). This relative strength is more apparent when compared to the highly leveraged position of many broker-dealers. Nonetheless, it is clear that both banks' internal capital processes and our own supervisory capital standards need to be strengthened to more fully incorporate potential exposures from both on- and off-balance sheet transactions across the entire firm. In addition, capital planning and estimates of potential credit losses need to be more forward looking and take account of uncertainties associated with models, valuations, concentrations, and correlation risks throughout an economic cycle.

These findings are consistent with reports issued by the SSG's report on "Risk Management Practices," the Financial Stability Forum's (FSF) report on "Enhancing Market and Institutional Resilience," the Joint Forum's report on "Cross –Sectoral Review of Group-wide Identification and Management of Risk Concentrations," and the Basel Committee on Banking Supervision's consultative paper on "Principles for Sound Stress Testing Practices and Supervision."3 Two common themes from these reports and other studies in which the OCC has actively participated are the need to strengthen risk management practices and improve stress testing and firm-wide capital planning processes. The reports also note several areas where banking supervisors need to enhance their oversight regimes. The recommendations generally fall into three broad categories: 1) providing additional guidance to institutions with regard to the risk management practices and monitoring institutions' actions to implement those recommendations; 2) enhancing the various aspects of the Basel II risk-based capital framework; and 3) improving the exchange of supervisory information and sharing of best practices.

OCC Supervisory Responses

The OCC has been actively involved in the various work groups that issued these reports, and we are taking a number of steps, primarily in our large bank supervision program, to ensure that our supervisory process and the risk management practices of our institutions incorporate these recommendations.

Enterprise Risk Management

As previously noted, the recent market turmoil has highlighted the importance of a comprehensive firm-wide risk management program. The SSG report advised that striking the right balance between risk appetite and risk controls was a distinguishing factor among firms surveyed in its study. Additionally, the FSF report noted that, "Supervisors and regulators need to make sure that the risk management and control framework within financial institutions keeps pace with the changes in instruments, markets and business models, and that firms do not engage in activities without having adequate controls." Proper risk governance was a key focus of guidance that the OCC, the SEC, and other federal banking regulators issued in January 2007 on complex finance activities. That guidance stressed the need for firms to have robust internal controls and risk management processes for complex structured finance transactions. The guidance emphasized the importance of a strong corporate culture that includes and encourages mechanisms that allow business line and risk managers to elevate concerns to appropriate levels of management and to ensure the timely resolution of those concerns. It also stressed the need to ensure appropriate due diligence at the front-end, before products are offered, to ensure that all risks have been appropriately considered and can be effectively identified, managed and controlled. At the OCC, approval of new or novel banking activities is predicated on the bank having sufficient risk management controls in place.

Assessing management's ability to effectively identify, measure, monitor, and control risk across the firm and to conduct effective stress testing is a key focus of our examination strategies for large national banks this year.

OCC's Supervision of Risk Management at Large National Banks

Let me now turn to how we apply and incorporate our perspective on risk management into the supervision of large national banks. Our Large Bank program is organized with a national perspective. It is highly centralized and headquartered in Washington, and structured to promote consistent uniform coordination across institutions. The onsite teams at each or our 14 largest banks are led by an Examiner-In-Charge (EIC), who reports directly to the Deputy Comptrollers in our Large Bank Supervision Office in Washington, DC. The Large Bank Deputies are in ongoing communication with the EICs, in addition to holding monthly calls and quarterly face-to-face meetings with all EICs. To enhance our ability to identify risks and share best practices across the large bank population, we have established a program of examiner network groups in Large Banks. There are eight main network groups (Commercial Credit, Retail Credit, Mortgage Banking, Capital Markets, Asset Management, Information Technology, Operational Risk and Compliance) and numerous subgroups. These groups facilitate sharing of information, concerns and policy application among examiners with specialized skills in these areas. The EICs and leadership teams of each of the network groups work closely with specialists in our Policy and Risk Analysis Divisions to promote consistent application of supervisory standards and coordinated responses to emerging issues.

All of this enables the OCC to maintain an on-going program of risk assessment, monitoring, and communication with bank management and directors. Nonetheless, given the volume and complexity of bank transactions, it is not feasible to review every transaction in each bank, or for that matter, every single product line or bank activity. Accordingly, we focus on those products and services posing the greatest risk to the bank through risk-based supervision.

Our supervisory goal is to ensure banks have sound risk governance processes commensurate with the nature of their risk-taking activities. Risk management systems must be sufficiently comprehensive to enable senior management to identify and effectively manage risk throughout the firm. Therefore, examinations of our largest banks focus on the overall integrity and effectiveness of risk management systems.

The first step in risk-based supervision is to identify the most significant risks and then to determine whether a bank has systems and controls to identify and manage those risks. Next, we assess the integrity and effectiveness of risk management systems, with appropriate validation through transaction testing. This is accomplished through our supervisory process which involves a combination of ongoing monitoring and targeted examinations. The purpose of our targeted examinations is to validate that risk management systems and processes are functioning as expected and do not present any significant supervisory concerns. Our supervisory conclusions, including any risk management deficiencies, are communicated directly to bank senior management. Thus, not only is there ongoing evaluation, but there is also a process for timely and effective corrective action when needed. To the extent we identify concerns; we "drill down" to test additional transactions.

These concerns are then highlighted for management and the Board as "Matters Requiring Attention" ("MRAs") in supervisory communications. Often these MRAs are line of business specific, and can be corrected relatively easily in the normal course of business. However, a few MRAs address more global concerns such as enterprise risk management or company-wide information security. We also have a consolidated electronic system to monitor and report outstanding MRAs. Each MRA is assigned a due date and is followed-up by on-site staff at each bank. If these concerns are not appropriately addressed within a reasonable period, we have a variety of tools with which to respond, ranging from informal supervisory actions directing corrective measures, to formal enforcement actions, to referrals to other regulators or law enforcement.
Our supervision program includes targeted and on-going analysis of corporate governance at our large national banks. This area encompasses a wide variety of supervisory activities including:

- Analysis and critique of materials presented to directors;
- Review of board activities and organization;
- Risk management and audit structures within the organization, including the independence of these structures;
- Reviews of the charters, structure and minutes of significant decision making committees in the bank;
- Review of the vetting process for new and complex products and the robustness of new product controls; and
- Analysis of the appropriateness and adequacy of management information packages used to measure and control risk.

It is not uncommon to find weaknesses in structure, organization, or management information, which we address through MRAs and other supervisory processes described above. But more significantly, at some of our institutions what appeared to be an appropriate governance structure was made less effective by a weak corporate culture, which discouraged credible challenge from risk managers and did not hold lines of business accountable for inappropriate actions. When the market disruption occurred in mid 2007, it became apparent that in some banks, risk management lacked support from executive management and the board to achieve the necessary stature within the organization, or otherwise did not exercise its authority to constrain business activities. At institutions where these issues occurred, we took strong supervisory actions, and we effected changes in personnel, organization and/or processes.

Just as we adjust our strategies for individual banks, we also make adjustments to our overall supervisory processes, as needed. And of course we are adjusting our supervisory processes to incorporate the lessons we have learned during this period of extreme financial distress.

Our supervisory activities at individual banks are often supplemented with horizontal reviews of targeted areas across a group of banks. These horizontal reviews can help us to identify emerging risks that, while not posing a significant threat to any one institution could, if not corrected, pose more system-wide implications for the industry.

Summary

To summarize, the goal of our supervision is to ensure that banks are managed in a safe and sound manner, to identify problems or weaknesses as early as possible and to obtain corrective action. The events of the past 18 months have highlighted and reinforced the need for effective risk management programs and revealed areas where improvements are needed. I believe the OCC and the banking industry are taking appropriate steps to implement needed changes. Through our examinations and reviews, we have directed banks to be more realistic in assessing their credit risks; to improve their valuation techniques for certain complex transactions; to raise capital as market opportunities permit; to aggressively build loan loss reserves; and to correct various risk management weaknesses.

Successful execution of our supervisory priorities requires an effective working relationship with other supervisors, both domestically and internationally. The events of the past 18 months highlight the global nature of the problems we are facing and the need for global responses. The OCC has taken a significant leadership role in the interagency work underway to address risk management issues raised during this period of market turmoil. Close coordination with our supervisory colleagues at the other banking agencies, as well as the securities agencies, has proven beneficial for all parties – firms, supervisors and policy makers.

As I have described in my testimony, the OCC has a strong, centralized program for supervising the largest national banks. But clearly, the unprecedented global disruptions that we have witnessed across the credit and capital markets have revealed risk management weaknesses across banking organizations that need to be fixed and we are taking steps to ensure this happens. In this regard, it is important to recognize that risk management systems are not static. These systems do and must evolve with changes in markets, business lines, and products. For example, improving and validating risk models is an ongoing exercise at our largest institutions. Therefore it should not be surprising that we routinely have outstanding MRAs that direct bank management to make improvements or changes to their risk models and risk management practices. This is an area where we continuously probe to look for areas of improvement and best practices. As I described earlier, we have systems in place to monitor and track these MRAs and, when we determine that the bank is not making sufficient progress to address our concerns, we can and do take more forceful action.

OCC – Statement of Comptroller of the Currency John Dugan Before the Committee on Banking, Housing, and Urban Affairs United States Senate

Background
On March19, 2009 Comptroller of the Currency John Dugan provided testimony before the Committee on Banking, Housing, and Urban Affairs United States Senate. His testimony was specific to the restructuring and reform of the financial regulatory system. His testimony covered five key recommendations which are outlined below.

Information
First, we support the establishment of a systemic risk regulator, which probably should be the Federal Reserve Board. In many ways, the Board already serves this role with respect to systemically important banks. But no agency has had similar authority with respect to systemically important financial institutions that are not banks, which created real problems in the last several years as risk increased in many such institutions. It makes sense to provide one agency with authority and accountability for identifying and addressing such risks across the financial system. This authority should be crafted carefully, however, to address the very real concerns of the Board taking on too many functions to do all of them well, while at the same time concentrating too much authority in a single government agency.

Second, we support the establishment of a regime to stabilize, resolve, and wind down systemically significant firms that are not banks. The lack of such a regime this past year proved to be an enormous problem in dealing with distressed and failing institutions such as Bear Stearns, Lehman Brothers, and AIG. The new regime should provide tools that are similar to those the FDIC currently has for resolving banks, as well as provide a significant funding source if needed to facilitate orderly dispositions, such as a significant line of credit from the Treasury. In view of the systemic nature of such resolutions and the likely need for government funding, the systemic risk regulator and the Treasury Department should be responsible for this new authority.

Third, if the Committee decides to move forward with reducing the number of bank regulators, we have two general recommendations. The first may not surprise you: to preserve the role of a dedicated prudential banking supervisor that has no job other than bank supervision. Dedicated supervision produces no confusion about the supervisor's goals or mission; no potential conflict with competing objectives; responsibility and accountability are well defined; and the result is a strong culture that fosters the development of the type of seasoned supervisors we need. But my second recommendation here may sound a little strange coming from the OCC, given normal turf wars: Congress should preserve a supervisory role for the Federal Reserve Board, given its substantial experience with respect to capital markets, payments systems, and the discount window.

Fourth, Congress should establish a system of national standards that are uniformly implemented for mortgage regulation. While there were problems with mortgage underwriting standards at all mortgage providers, they were least pronounced at regulated banks, whether state or nationally chartered. But they were extremely severe at the nonbank mortgage companies and mortgage brokers regulated exclusively by the states, accounting for a disproportionate share of foreclosures. Let me emphasize that this was not the result of national bank preemption, which in no way impeded states from regulating these providers. National mortgage standards with comparable implementation by state and federal regulators would address this regulatory gap and ensure better mortgages for all consumers.

Finally, the OCC believes the best way to implement consumer protection regulation of banks – the best way to protect consumers – is to do so through prudential supervision. Supervisors' continual presence in banks through the examination process creates especially effective incentives for consumer protection compliance, as well as allowing examiners to detect compliance failures much earlier than would otherwise be the case. They also have strong enforcement powers and exceptional leverage over bank management to achieve corrective action. That is, when examiners detect consumer compliance weaknesses or failures, they have a broad range of corrective tools, from informal comments to formal enforcement action – and banks have strong incentives to move back into compliance as expeditiously as possible. Finally, because examiners are continually exposed to the practical effects of implementing consumer protection rules for bank customers, the prudential supervisory agency is in the best position to formulate and refine consumer protection regulations for banks.

Summary

Proposals to remove consumer protection regulation and supervision from prudential supervisors, instead consolidating such authority in a new federal agency, would lose these very real benefits. If Congress believes that the consumer protection regime needs to be strengthened, the best answer is not to create a new agency that would have none of the benefits of a prudential supervisor. Instead, the better approach is for Congress to reinforce the agencies consumer protection mission, and directing them to toughen the applicable standards and close any gaps in regulatory coverage. The OCC and the other prudential bank supervisors will rigorously apply any new standards, and consumers will be better protected.

Federal Reserve: Testimony of Federal Reserve Director, Division of Banking Supervision and Regulation, Roger Cole Before the Subcommittee on Securities, Insurance, and Investment of the

Committee on Banking, Housing, and Urban Affairs, United States Senate

Background
On March 18, 2009 Federal Reserve Director Roger Cole testified before the Subcommittee on Securities, Insurance, and Investment of the Committee on Banking, Housing, and Urban Affairs, United States Senate. Director Cole outlined the supervisory actions that have been taken by the Federal Reserve to improve risk management practices. Below are excerpts from Director Cole's testimony. These comments will assist in providing insight regarding the current and future focus of the Federal Reserve.

Information
The Federal Reserve has been actively engaged in a number of efforts to understand and document the risk management lapses and shortcomings at major financial institutions revealed during the current crisis. A key initiative of the Federal Reserve and other supervisors since the issuance of the March 2008 SSG report has been to assess the response of the industry to the observations and recommendations on the need to enhance key risk management practices. The work of the SSG has been helpful, both in complementing our evaluation of risk management practices at individual firms and in our discussions with bankers and their directors. It is also providing perspective on how each individual firm's risk management performance compares with that of a broad cross-section of global financial services firms.

Liquidity risk management: Since the beginning of the crisis, we have been working diligently to bring about needed improvements in institutions' liquidity risk management practices. One lesson learned in this crisis is that several key sources of liquidity may not be available in a crisis. For example, Bear Stearns collapsed in part because it could not obtain liquidity even on a basis fully secured by high-quality collateral, such as U.S. government securities. Others have found that back-up lines of credit are not made available for use when most needed by the borrower.

These lessons have heightened our concern about liquidity and improved our approach to evaluating liquidity plans of banking organizations. Along with our U.S. supervisory colleagues, we are monitoring the major firms' liquidity positions on a daily basis, and are discussing key market developments and our supervisory views with the firms' senior management. We also are conducting additional analysis of firms' liquidity positions to examine the impact various scenarios may have on their liquidity and funding profiles.

We use this ongoing analysis along with findings from examinations to ensure that liquidity and funding risk management and contingency funding plans are sufficiently robust and that the institutions are prepared to address various stress scenarios. We are aggressively challenging those assumptions in firms' contingency funding plans that may be unrealistic.

Our supervisory efforts require firms to consider the potential impact of both disruptions in the overall funding markets and idiosyncratic funding difficulties. We are also requiring more rigor in the assessment of all expected and unexpected funding uses and needs. Firms are also being required to consider the respective risks of reliance on wholesale funding and retail funding, as well as the risks associated with off-balance sheet contingencies. These efforts include steps to require banks to consider the potential impact on liquidity that arises from firms' actions to protect their reputation, such as an unplanned increase in assets requiring funding that would arise with support given to money market funds and other financial vehicles where no contractual obligation exists. These efforts also pertain to steps banks must take to prepare for situations in which even collateralized funding may not be readily available because of market disruptions or concern about the health of a borrowing institution. As a result of these efforts, supervised institutions have significantly improved their liquidity risk management practices, and have taken steps to stabilize and improve their funding sources as market conditions permit.

In conducting work on liquidity risk management, we have used established supervisory guidance on liquidity risk management as well as updated guidelines on liquidity risk management issued by the Basel Committee on Banking Supervision last September--a process in which the Federal Reserve played a lead role. So that supervisory expectations for U.S. depository institutions are aligned with these international principles, the U.S. banking agencies plan to update their own interagency guidance on liquidity risk management practices in the near future. The new guidance will emphasize the need for institutions of all sizes to conduct meaningful cash flow forecasts of their funding needs in both normal and stressed conditions and to ensure that they have an adequately diversified funding base and a cushion of liquid assets to mitigate stressful market conditions. Our supervisory efforts at individual institutions and the issuance of new liquidity risk management guidance come on top of broader Federal Reserve efforts outside of the supervision function to improve liquidity in financial markets, such as introduction of the Term Auction Facility and the Term Asset-Backed Securities Loan Facility.

Capital planning and capital adequacy: Our supervisory activities for capital planning and capital adequacy are similar to those for liquidity. We have been closely monitoring firms' capital levels relative to their risk exposures, in conjunction with reviewing projections for earnings and asset quality and discussing our evaluations with senior management. We have been engaged in our own analysis of loss scenarios to anticipate institutions' future capital needs, analysis that includes the potential for losses from a range of sources as well as assumption of assets currently held off balance sheet. We have been discussing our analysis with bankers and requiring their own internal analyses to reflect a broad range of scenarios and to capture stress environments that could impair solvency. As a result, banking organizations have taken a number of steps to strengthen their capital positions, including raising substantial amounts of capital from private sources in 2007 and 2008.

We have stepped up our efforts to evaluate firms' capital planning and to bring about improvements where they are needed. For instance, we recently issued guidance to our examination staff--which was also distributed to supervised institutions--on the declaration and payment of dividends, capital repurchases, and capital redemptions in the context of capital planning processes. We are forcefully requiring institutions to retain strong capital buffers--above the levels prescribed by minimum regulatory requirements--not only to weather the immediate environment but also to remain viable over the medium and long term.

Our efforts related to capital planning and capital adequacy are embodied in the interagency supervisory capital assessment process, which began in February. We are conducting assessments of selected banking institutions' capital adequacy, based on certain macroeconomic scenarios. For this assessment, we are carefully evaluating the forecasts submitted by each financial institution to ensure they are appropriate, consistent with the firm's underlying portfolio performance, and reflective of each entity's particular business activities and risk profile. The assessment of capital under the two macroeconomic scenarios being used in the capital assessment program will permit supervisors to ascertain whether institutions' capital buffers over the regulatory capital minimum are appropriate under more severe but plausible scenarios.

Federal Reserve supervisors have been engaged over the past few years in evaluating firms' internal processes to assess overall capital adequacy as set forth in existing Federal Reserve supervisory guidance. A portion of that work has focused on how firms use economic capital practices to assess overall capital needs. We have communicated our findings to firms individually, which included their need to improve some key practices, and demanded corrective actions. We also presented our overall findings to a broad portion of the financial industry at a System-sponsored outreach meeting last fall that served to underscore the importance of our message.

Firm-wide risk identification and compliance risk management: One of the most important aspects of good risk management is risk identification. This is a particularly challenging exercise because some practices, each of which appears to present low risk on its own, may combine to create unexpectedly high risk. For example, in the current crisis, practices in mortgage lending--which historically has been seen as a very low-risk activity--have become distorted and, consequently riskier, as they have been fueled by another activity that was designed to reduce risk to lenders--the sale of mortgage assets to investors outside the financial industry.

Since the onset of the crisis, we have been working with supervised institutions to improve their risk identification practices where needed, such as by helping identify inter-connected risks. These improvements include a better understanding of risks facing the entire organization, such as interdependencies among risks and concentrations of exposures. One of the key lessons learned has been the need for timely and effective communication about risks, and many of our previously mentioned efforts pertaining to capital and liquidity are designed to ensure that management and boards of directors understand the linkages within the firm and how various events might impact the balance sheet and funding of an organization. We have demanded that institutions address more serious risk management deficiencies so that risk management is appropriately independent, that incentives are properly aligned, and that management information systems (MIS) produce comprehensive, accurate, and timely information.

In our 2006 guidance on nontraditional mortgage products, we recognized that poor risk management practices related to retail products and services could have serious effects on the profitability of financial institutions and the economy; in other words, there could be a relationship between consumer protection and financial soundness. For example, consumer abuses in the subprime mortgage lending market were a contributing cause to the current mortgage market problems. Here, too, we are requiring improvements. The Federal Reserve issued guidance on compliance risk management programs to emphasize the need for effective firm-wide compliance risk management and oversight at large, complex banking organizations. This guidance is particularly applicable to compliance risks, including its application to consumer protection, that transcend business lines, legal entities, and jurisdictions of operation.

SEC: Testimony of SEC Director, Division of Trading and Markets Erik Sirri Before the Subcommittee on Securities, Insurance, and Investment of the Committee on Banking, Housing, and Urban Affairs, United States Senate

Background

On March 18, 2009 SEC Director Erik Sirri testified before the Subcommittee on Securities, Insurance, and Investment of the Committee on Banking, Housing, and Urban Affairs, United States Senate. Director Sirri discussed the SEC's perspective on the recent lessons learned regarding risk management, as well as the steps the SEC has taken to strengthen their supervision and examination processes in this critical area. Below are excerpts from Director Sirri's testimony. These comments will assist in providing insight regarding the current and future focus of the SEC.

Information

The Bear Stearns and Lehman Brothers' experience as well as the continuing financial distress and government support of commercial banks and insurance companies has challenged a number of assumptions held by the SEC. We are working with other regulators to ensure that the proper lessons are derived from these experiences, and changes will continue to be made to the relevant regulatory processes to reflect those lessons. Long before the CSE program existed, the SEC's supervision of investment banks recognized that capital is not synonymous with liquidity — that a firm could be highly capitalized — that is, it can have far more assets than liabilities — while also having liquidity problems. While the ability of a securities firm to withstand market, credit, and other types of stress events is linked to the amount of its capital, the firm also needs sufficient liquid assets — cash, and high-quality instruments such as U.S. Treasury securities that can be used as collateral — to meet its financial obligations as they arise.

The CSE program built on this concept and required stress testing and substantial liquidity pools at the holding company to allow firms to continue to operate normally in stressed market environments. But what neither the CSE regulatory approach nor most existing regulatory models have taken into account was the possibility that secured funding, even that backed by high-quality collateral such as U.S. Treasury and agency securities, could become unavailable. The existing models for both commercial and investment banks are premised on the expectation that secured funding, would be available in any market environment, albeit perhaps on less favorable terms than normal.

Thus, one lesson from the SEC's oversight of CSEs — Bear Stearns in particular — is that no parent company liquidity pool can withstand a "run on the bank." Supervisors simply did not anticipate that a run-on-the-bank was indeed a real possibility for a well-capitalized securities firm with high quality assets to fund. Given that the liquidity pool was sized for the loss of unsecured funding for a year, such a liquidity pool would not suffice in an extended financial crisis of the magnitude we are now experiencing, where firms are taking significant write downs on what have become illiquid assets over several quarters while the economy contracts. These liquidity constraints are exacerbated when clearing agencies seize sizable amounts of collateral or clearing deposits to protect themselves against intraday exposures to the firm. Thus, for financial institutions that rely on secured and unsecured funding for their business model, some modification, such as government backstop emergency liquidity support, may well be necessary to plug a liquidity gap on an interim basis, to guarantee assets over the longer term, or to provide a capital infusion. Indeed, as we have seen, such facilities can be necessary even for deposit-taking institutions. The role of the government in providing any such backstop liquidity should be carefully circumscribed, and the effects on incentives considered.

Another lesson relates to the need for supervisory focus on the concentration of illiquid assets held by financial firms, particularly in entities other than a U.S. registered broker-dealer. Such monitoring is relatively straightforward with U.S. registered broker-dealers, which must disclose illiquid assets on a monthly basis in financial reports filed with their regulators. Also, registered U.S. broker-dealers must take capital charges on illiquid assets when computing net capital. As a result, illiquid assets often are held outside the registered U.S. broker-dealer in other legal entities within the consolidated entity. So, for the consolidated entity, supervisors must be well acquainted with the quality of assets on a group wide basis, monitor the amount of illiquid assets, and drill down on the relative quality of such illiquid assets.

We currently inquire, through FINRA, about the amount of Level 3 assets at broker-dealers, but such information must be known with specificity about affiliates in the group as well. A thorough understanding of illiquid assets would be a more useful measure of financial health than a leverage metric that is broadly applied across a complex financial institution. The SEC has noted on numerous occasions that leverage tests are not accurate measures of financial strength, especially in firms with a sizable matched book or derivatives business. Leverage ratios do not account for the risk or liquidity of the underlying assets or associated hedging positions. Therefore, leverage ratios can overstate or understate actual risk due to leverage. For example: a 10-1 leverage ratio involving

Treasury bills involves little risk of loss; however, the same 10-1 leverage ratio applied to uncollateralized loans would be extremely risky, and would not be prudent in a broker-dealer. The same could be said of repo transactions involving treasuries versus mortgages. Rather than rely on such overly simplistic measures of risk, regulators of financial firms have gone to great lengths to develop capital rules that are risk sensitive and act as limiters on the amount of risk that can be taken on by a firm.

While the SEC knew the importance of supervisory focus on illiquid assets, I do not believe any regulator truly understood that market perception of the integrity of the financial statements, which involves both the amount of illiquid assets and the valuation of such assets, could erode so precipitously and ignite a run on a securities firm. This brings me to a related point — and lesson.

A knowledge of illiquid assets also requires supervisors to review valuation thoroughly, and understand how mark-to-market (MTM) is executed within the firm — with a particular focus on the strength of control processes, the independence of the price verification function, and the disclosures made by the firm on its valuation processes. The challenges of valuing illiquid or complex structured products should not cast doubt on the process of marking-to-market, however. In fact, marking-to-market is part of the solution. This is another lesson from the events of 2008.

MTM informs investment bank senior managers of trading performance and asset price and risk factor volatilities, supports profit and loss (p/l) processes and hedge performance analyses, facilitates the generation and validation of risk metrics, and enables a controlled environment for risk-taking In short, the MTM process helps ensure consistency between p/l reporting, hedging, and risk measurement. Without this, discipline across these activities would be more difficult to maintain and risk management would be significantly weaker. The act of marking-to-market provides necessary information and can impose discipline on risk-taking and risk management.

At securities firms and elsewhere, to protect the accuracy and integrity of the financial institution's books and records and to support the CFO's attestation concerning the fair value of the firm's inventory as of a certain date, an independent group of financial controllers verifies monthly that traders' marks are accurate and unbiased. Once the price verification is completed, summary mark review reports are provided to senior managers at investment banks which provides insight into the composition of the portfolio, as different methods signal different degrees of liquidity, complexity or model risk. Internally, one of the primary aims of the control function performed by price verification is to reduce the risk of a position or portfolio being mis-marked. Obviously, this risk rises with the degree of subjectivity that may be applied to a given mark or position (and gets multiplied by the exposure). Given its critical contribution to the integrity of valuation and books and records, supervisors must engage fully in understanding the price verification controls at financial institutions, ensure that it is well-resourced, has independent authority to push back on the business line valuations, and is in ready communication with and has the active support and involvement of firm senior management.

Recent events have proven the limitations of certain risk metrics such as Value-at-Risk (VaR) and the necessity of rigorous stress testing of financial models. VaR, among other things, assumes certain historical correlations, which may be inapplicable during times of extreme stress. In addition, VaR does not measure liquidity or concentration risk. Therefore, a lesson learned is while VaR and other risk metrics may be useful during normal market conditions, risk managers and supervisors must recognize their imbedded limitations and assumptions and plan accordingly. That is, supervisors and risk managers must supplement their usage with stress testing that incorporates not only likely economic scenarios, but also low probability, extreme events. In addition, the market-wide failure to appreciate and measure the market risk of mortgage-related assets, including structured credit products, has shown that the Basel market risk standards as then in force were not adequate. Each is in need of serious improvement.

Another important lesson is that critical financial and risk management controls cannot just exist on paper. They must be staffed appropriately and well-resourced. Whether a supervisory program maintains staff on-site at regulated entities, or engages in frequent in- person meetings, the quality of the program must combine an ability to focus and follow up on risk management issues as they develop with an ability to gain the attention of senior management of the firm. Within the firm, senior management must engage with firm risk managers and support them as an independent function. Firm boards of directors must participate actively in setting the risk appetite of the firm, hold senior management accountable for following the board's direction on risk taking, and force management to take action, as appropriate. For instance, risk managers should have some degree of authority over trading decisions, and any decision by senior management to deviate from their recommendations should be documented and reviewed by the board.

One final observation relates to the challenges any single regulator has in overseeing an entity — in the SEC's case, sizable broker-dealers — that reside within a complex institution with multiple material affiliates, regulated or not, in numerous countries. Any regulator must have an ability to get information about the holding company and other affiliates, particularly about issues and transactions that could impact capital and liquidity. For instance, whether directed by a holding company supervisor here or abroad, a poorly capitalized and not very liquid affiliate could require infusions from the parent and become the source of financial weakness for the entire organization. This could occur while the registered U.S. broker-dealer is well-capitalized and liquid. As was true in the case of Lehman Brothers, the bankruptcy filing of a material affiliate has a cascading effect that can bring down the other entities in the group. Also, in some instances, affiliates try to involve the well-capitalized broker-dealer in their business in a manner that is not prudent. For these reasons, and to protect the broker-dealer and its customer assets, the SEC would want, not only to be consulted before any such liquidity drain occurs at the parent, but to have a say, likely in coordination with other interested regulators, in the capital and liquidity standards the holding company must maintain. Our experience last year with the failure of Lehman's UK broker-dealer, and the fact that the U.S. registered broker-dealers were well-capitalized and liquid throughout the turmoil, has redoubled our belief that we must rely on and protect going forward the soundness of the regulatory regime of the principal subsidiaries. Nothing in any future regulatory regime, or systemic regulator, should operate to weaken the regulatory standards of these subsidiaries.

Having learned all of these lessons, we at the SEC are focusing on how best to deploy our broker-dealer expertise in a new regulatory paradigm. As Congress considers the financial services regulatory structure, we believe that regulatory expertise should be recognized and deployed efficiently. For a certain set of large broker-dealer holding companies that are not affiliated with banks, the SEC supports a program that would permit us to also set capital standards at the holding company level (perhaps, in consultation with a holding company supervisor, if any), and to obtain financial information about, and examine, the holding company and material affiliates. Such broker-dealer holding companies may also have an emergency liquidity provider (not the SEC). The SEC would determine the universe of broker-dealer holding companies that would be subject to parent company capital standards. The remaining broker-dealer holding companies not affiliated with banks would be subject to material affiliate reporting requirements, similar to the reporting regime under Section 17(h) of the Exchange Act.

Given the recent dialogue about systemic regulation, I must note that our experience with the bankruptcy filing of a foreign affiliate of Lehman Brothers has demonstrated the innate difficulties of any multi-jurisdictional approach to regulation. While cross border coordination and dialogue is important, jurisdictions nonetheless have unique bankruptcy and financial regulatory regimes-and creditors wherever they are located shall always act in their own interest during a crisis. Thus, a U.S. liquidity provider might be faced with the difficult choice of guaranteeing the assets of the holding company globally, or else risk creditors exercising their rights against foreign affiliates or foreign supervisors acting to protect the regulated subsidiaries in their jurisdictions, either of which could trigger bankruptcy of the holding company. These are thorny issues that Congress should consider carefully.

FINRA – Letter to Chief Executives Outlining 2009 Examination Priorities

Background
On March 9, 2009 FINRA sent a letter to all Chief Executives outlining the organizations 2009 examination priorities. The primary focus purpose of the letter is to provide information to the industry and to highlight new and existing areas of particular significance to FINRA's examination program. Specifically the letter states that the information *should help to assess your firm's compliance and supervisory programs.* The letter also indicates that it is critical to have strong compliance, supervision and risk management programs and structures. FINRA also expresses concern about expense reductions taking place in the non-income producing areas, including compliance and risk management activities. FINRA stresses that firms carefully consider the impact of headcount reductions in areas such as compliance, finance and operations, and other

control functions to determine whether they are commensurate with the business-line reductions in those areas.

Outlined below are topics that remain a high priority for firms to consider when reviewing their supervisory and compliance programs as outlined in FINRA's Letter to Chief Executives.

Consolidated FINRA Rulebook

As you are aware, following the consolidation of NASD and NYSE's member regulation functions into FINRA, we established a process to develop a new FINRA Rulebook that will eventually replace the current NASD and Incorporated NYSE Rules. FINRA has proposed, and will continue to propose in phases, new consolidated rules for approval by the SEC.

The first phase of new consolidated FINRA rules, approved by the SEC in August and September 2008, became effective on December 15, 2008. In November 2008, the SEC approved additional consolidated rules relating to warrants, options and security futures, which became effective on February 17, 2009. And in January 2009, the SEC approved a new consolidated rule on trading ahead of research reports, which will take effect on April 20, 2009.

Firms have inquired about our expectations for updating written supervisory procedures (WSPs) to reflect new consolidated FINRA rules. We expect firms to have a process in place to periodically review and update their WSPs as new rules become effective. For instance, when your firm goes through its regular review and update, you should make the necessary changes to reflect the new FINRA rules.

FINRA also expects firms to communicate the specific requirements of rule amendments to appropriate firm personnel and provide education and training to the extent deemed necessary for full compliance with the requirements.

FTC's Red Flags Rule

Pursuant to the 2003 Fair and Accurate Credit Transactions Act (FACT Act), the Federal Trade
Commission (FTC) implemented the Red Flags Rule and other regulations applicable to broker dealers. While all of these regulations became effective November 1, 2008, the FTC delayed the enforcement of the Red Flags Rule until May 1, 2009. FINRA issued *Regulatory Notice 08-69* to alert firms about these regulations. Among other things, the *Notice* provides specific details regarding the requirement that, pursuant to the Red Flags Rule, firms subject to the rule must develop and implement a written identity theft program.

Alternative Investments

Given recent market conditions, investors may seek alternative investments to conventional equity and fixed-income investments. For instance, investors may be seeking higher yield products, such as high-yield bonds and bond funds, structured products and other non-conventional investments.

FINRA reminds firms to take appropriate steps to understand the terms, conditions, risks and rewards of any security that they sell to retail customers by performing a reasonable-basis suitability analysis. Firms also must determine that such an investment is appropriate for a particular customer before recommending it to that customer by performing a customer-specific suitability analysis. Sales materials and oral presentations must be fair and balanced regarding both the risks and benefits of investing in alternative investments. Any presentation to a customer concerning an investment's yield should be balanced with a discussion of any applicable credit risk or risk of default associated with the issuer, and how that risk might affect the safety of the invested principal. The discussion should also address interest rate risk—the risk that interest rate changes might affect the market value of an instrument prior to its call or maturity date—and liquidity risk—the risk that sell orders may not be executed immediately or may be executed at prices well below the purchase price or anticipated market price.

Cash Alternatives

Firms sell a wide variety of investments as alternatives to cash holdings, and these can represent an important component of an investment portfolio. Sales materials and oral presentations regarding cash alternatives must present a fair and balanced picture regarding both the risks and benefits of investing in these products. In virtually all cases, a statement to retail investors that an investment is a "cash equivalent," that it is as "safe as cash" or that it carries no market or credit risk would raise serious questions under FINRA's advertising rules.

Before recommending a cash alternative, firms must reasonably believe that the product is suitable for a customer seeking a cash alternative. Firms must perform appropriate due diligence and have a reasonable basis for characterizing an investment as a cash alternative; it is not sufficient to simply rely upon a third-party's characterization. Firms must monitor market and economic developments that may affect the continued accuracy of characterizing an investment as a cash alternative and must have procedures to quickly alert their sales and marketing staff to developments that will make such a characterization unwarranted. Firms must also ensure that a particular investment is suitable as a cash alternative for a specific customer. Firms should consider, along with typical suitability concerns such as financial status, the customer's need for liquidity and price stability, and the ability of the investment to meet that need.

Supervision

Comprehensive supervisory procedures and their effective administration are the keys to compliance for all business activities in which a firm engages. Accordingly, examiners will continue to focus on the extent to which firms establish, maintain and administer their supervisory systems. FINRA reminds firms of their ongoing obligation, pursuant to NASD Rule 3012, to test and verify that their supervisory procedures are reasonably designed to achieve compliance with applicable securities laws, regulations and FINRA rules, and to amend those supervisory procedures when such testing identifies a need to do so. As noted above, differing market conditions can affect both trading patterns and the types of sales activity in which registered representatives engage. Each firm's testing and verification procedures should address not only whether its exception reports are functioning as intended, but also whether such exception reports are reasonably designed to capture and highlight potential regulatory problems for high-risk business activities.

In most circumstances, office inspections may not be conducted by any person with supervisory responsibilities for the office or any individual who is directly or indirectly supervised by such person(s). As previously mentioned, the need for strong compliance and supervision is more critical than ever, and this includes a robust inspection program for both branch and non-branch locations.

Firms are also reminded of their annual CEO certification requirements pursuant to FINRA Rule 3130 and, for NYSE member firms, the additional requirements under NYSE Rule 342.30(a) through (c) which include the submission to FINRA of each NYSE member organization's CEO certification as part of an Annual Report addressing prescribed supervision and compliance efforts during the previous year.

Senior Investors

FINRA continues to pay close attention to sales practices aimed at senior investors and baby boomers. FINRA's efforts include educating investors, firms and registered representatives on key issues surrounding investors in or approaching retirement. In September 2008, FINRA again participated in the SEC's Seniors Summit and coordinated with the SEC and NASAA to issue a report on sales practices and other issues related to senior investors. The report provides practical examples to firms seeking to strengthen their infrastructure and work with senior investors in an ethical, respectful and informed manner.

Anti-Money Laundering

FINRA examiners continue to focus on anti-money laundering (AML) requirements. Firms should ensure that their AML policies and procedures are appropriately tailored to the firm's business model, risk profile and volume of transactions, particularly with regard to monitoring, detecting and reporting suspicious activity. Procedures and systems that focus solely on money movements and do not address potentially suspicious activities related to securities transactions may not be appropriate.

Of note in 2008, FinCEN issued no-action guidance stating that only introducing firms are required to comply with the requirements of the customer identification program rule with respect to customers introduced to a clearing firm, so long as the clearing agreement allocates functions in the manner described in the guidance. Firms are reminded to review their clearing agreements to understand the allocation of functions and AML responsibilities.

Variable Annuities

Examiners continue to focus on the sale and supervision of variable annuities and to closely review recommendations made to senior investors to purchase or redeem variable annuities. They also continue to review the rationale for instances where a variable annuity is exchanged for another annuity, including exchanges that involve equity-indexed annuities, exchanges resulting from a representative's change in employment and exchanges that may be based on the financial condition of the issuing insurance company

Protection of Customer Information and IT Security

While technology can create significant efficiencies, it can also expose a firm to new and increased risks. As such, firms should review their IT security procedures to ensure they are sufficient to deter security breaches, hacking, cyber attacks, account intrusions and other security threats. Brokerage account intrusions, whereby persons illegally access customer accounts, continue to affect the industry. Intruders can use a number of methods to obtain login credentials needed to access customer accounts, such as stealing customer login credentials or robbing firm employees of their system passwords. Once inside an account, the intruders may wire out funds or use the account for a market manipulation scheme in tandem with other accounts. Account intrusions affect introducing and clearing firms of all sizes and securities of many types.

Insider threats remain an elevated risk, especially during this time of corporate downsizing in response to current economic conditions. FINRA has seen several high-profile problems result from poor IT account management within the employee ranks. Systems that are used to control employee activities and provide a check and balance should be reviewed to ensure that only currently authorized personnel are granted access to these systems. The same holds true for other systems, such as trading systems that can be used to commit firms to a trade or contract. Weaknesses in these controls can be costly and can significantly damage a firm's business and/or reputation. The SEC's Regulation S-P requires firms to have policies and procedures that address administrative, technical and physical safeguards for the protection of customer information and records. Firms must ensure that their policies and procedures are reasonably designed to protect against any anticipated threats or hazards to the security and integrity of customer records and information.

Among other things, firms should consider how they protect customer information stored on electronic devices, such as hard drives, CDs, flash drives, floppy disks, laptops and PD As when they are in use and after they are discarded by the firm. Firms also should consider how they mitigate the risk of insider threats, such as through internal surveillance monitoring and controls. In addition, firms offering online customer access and trading should assess their internal surveillance and develop plans for handling account intrusions. This assessment might include a review of the online interface with customers to determine if there are any inefficiencies or gaps that can be strengthened in order to reduce the ability of intruders to access customer accounts and records. Introducing and clearing firms should work together to mitigate the risk of intrusions. Firms should also be diligent in their review of account activity for red flags that may indicate suspicious activity.

Outsourcing

During the last several years, the number of broker-dealers that outsource key operational functions, including many back office securities processing activities, has increased. As discussed in *Notice to Members 05-48* while certain functions may be outsourced, supervision and oversight may not be. Firms must perform the necessary due diligence and counterparty risk assessment when outsourcing functions to service providers, and must also establish controls and procedures to ensure that vendors are fulfilling their duties responsibly and in compliance with applicable rules and service agreements. These ongoing obligations may be fulfilled by requiring vendors to meet measurable performance standards, meeting frequently with vendor personnel and management, and assigning qualified personnel to monitor, review and supervise the activities of the service provider. In addition, firms should consider the risks of activities that are outsourced to entities operating in foreign jurisdictions and determine the impact of outsourcing arrangements on the firm's business continuity plans.

Information Barriers

FINRA reminds firms that they must have procedures in place to monitor or otherwise control the flow of material, non-public information within the firm and with its affiliates, clients and others to prevent insider trading or other misuse of material and non-public information. Firms must tailor their information barrier procedures to their business activities and organizational structure. Firms should have robust procedures addressing the use of restricted and watch lists, monitoring systems, supervision, review of proprietary and employee trading (both at the firm and away from it), review of questionable activities and recordkeeping requirements. Procedures should identify the appropriate department(s) or individual(s) with responsibility for executing the firm's policy on monitoring for insider trading. Given the importance of this issue, FINRA's special review of information barriers is ongoing.

Inventory and Collateral Valuations

Firms are reminded of the importance of having controls in place to independently value inventory and collateral positions, particularly positions that are less liquid and more complex. Our examiners continue to identify issues in this area, primarily as a result of the continued reliance on traders for inputs to pricing models. Senior front office personnel are reminded to pay diligent attention not only to each trader's value at risk, but also to the notional size of positions, the daily marks on positions and the effectiveness of hedging. Product controllers and other independent valuation groups must have the resources and the support of senior management to effectively challenge traders' valuations in these difficult markets, and the basis for such reliance should be adequately documented. Management should consider extending best practices used for valuation of inventory to the valuation of collateral for reverse repo and securities borrowed transactions.

Funding and Liquidity

Firms are encouraged to revisit their funding and liquidity practices to incorporate lessons learned from recent market events. In this respect, firms should evaluate the quality and reliability of funding sources, liquidity stress tests and contingency funding plans to ensure the viability of the broker-dealer under both normal and stressed market conditions.

Intercompany Reconciliations

Firms are reminded of the importance of both accurately recording bona fide intercompany transactions and reconciling intercompany accounts. In difficult market environments, it is especially important to understand the nature of any differences that may result from a review of the reconciliation of intercompany accounts. Once a firm identifies the cause of the difference, it should take prompt action to resolve the difference.

Suspense Account Reconciliations

FINRA examiners have noted inaccurate books and records resulting from firms' failures to promptly establish and reconcile suspense accounts. System conversions in connection with mergers and acquisitions are particularly troubling as they can increase balances in suspense and difference accounts and stock record breaks that may remain unresolved for a period of time. These breaks, no matter what the cause, affect the accuracy of a firm's books and records and often result in significant net capital charges and increased customer reserve requirements. Firms should reconcile promptly all suspense accounts and take appropriate action, such as treating any balances as customer related when no clear determination can be made otherwise.

Bank Sweep Programs

As a result of 2008 credit market events, we have seen increased use of bank deposit programs for the sweeping of customer free credit balances. Firms considering establishing new programs or making changes to existing programs are urged to contact their FINRA Coordinator ahead of time. Our examiners will continue to review the disclosures made to customers with respect to FDIC and SIPC protection, methodology for determining interest rates on the balances swept and disclosure of any compensation the broker-dealer and/or registered representative receives arising from the arrangement. The examiners also will review the documentation between the bank where the funds are maintained as well as an intermediary bank that may be used to facilitate the arrangement. Further, examiners will review the reconciliations performed with the deposit bank to determine whether any differences are promptly resolved.

Marking the Close

Given the overall decline in market prices and the increase in market volatility, evidenced particularly in the wide price swings in the last hour of trading, FINRA has intensified its focus on activity around the market close. Firms should review their internal controls, procedures and surveillance practices with regard to marking-the-close issues to ensure that potential misconduct is identified and reviewed in a timely manner.

Trade Reporting

Transaction reporting is a constant focus of FINRA's automated surveillance and on-site examinations. Firms are again reminded that they are responsible for the accuracy of the transaction information reported by them or on their behalf, regardless of the means by which that information is reported to FINRA. FINRA has developed a set of frequently asked questions on equity transaction reporting, which is available at *www.finra.org/tradereportingfaq*.

Order Audit Trail System (OATS)

On February 2, 2009, OATS implemented several enhancements to assist firms in the processing of daily OATS submissions. First, new rejection processing was implemented to allow for more efficient and accurate identification of repaired rejections. OATS provides firms with a unique identifier with each rejection that must be submitted back to FINRA with the repaired order event; this allows the order event to be recognized as repaired. FINRA also introduced enhanced processing to better facilitate name and/or MPID changes related to mergers and acquisitions involving member firms.

Other changes include additional special handling codes and a new account type designation for firm error accounts. Firms are encouraged to review the OATS Frequently Asked Questions, reporting specifications and other information available on the OATS Web site *(www.finra.org/oats)* for more details regarding these and other OATS reporting requirements.

EBSA: Statement on “Duties of Fiduciaries in Light of Recent Events Regarding Bernard L. Madoff Investment Securities, LLC

Background

On February 9, 2009 EBSA released a statement outlining guidance for fiduciaries regarding the Madoff scandal. Recent events regarding Bernard L. Madoff Investment Securities LLC have resulted in fiduciaries, investment managers and other investment service providers asking the Department of Labor about steps they should be taking in connection with employee benefit plans they believe may have exposure to losses as a result of plan assets being invested with Madoff entities. Below is the guidance offered by EBSA.

Information

Fiduciaries of employee benefit plans covered by the Employee Retirement Income Security Act of 1974 (ERISA) should address these events in a manner consistent with their fiduciary duties of prudence and loyalty to the plan’s participants and beneficiaries.

Where plan fiduciaries determine that plan assets were invested with Madoff entities and material losses are likely, appropriate steps should be taken to assess and protect the interests of the plan and its participants and beneficiaries. Such steps may include:

- Requesting disclosures from investment managers, fund managers, and other investment intermediaries regarding the plan’s potential exposure to Madoff-related losses.
- Seeking advice regarding the likelihood of losses due to investments that may be at risk.

- Making appropriate disclosures to other plan fiduciaries and plan participants and beneficiaries.
- Considering whether the plan has claims that are reasonably likely to lead to recovery of Madoff-related losses that should be asserted against responsible fiduciaries or other intermediaries who placed plan assets with Madoff entities, as well as claims against the Madoff bankruptcy estate. Fiduciaries must ensure that claims are filed in accordance with applicable filing deadlines such as those applicable to bankruptcy claims and for coverage by the Securities Investor Protection Corporation (SIPC).

The web site of the court-appointed trustee for the liquidation of Bernard L. Madoff Investment Securities LLC is www.madofftrustee.com. This web site contains the liquidation notice, claim forms and related claims information, and deadlines for the filing of claims with the trustee.