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## SEC's Carlo di Florio Speaks About the Commission's National Examination Program with a Focus on Broker-Dealer Examinations

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On May 15, 2012, Carlo di Florio, Director of the Office of Compliance Inspections and Examinations at the Securities and Exchange Commission, spoke about the SEC's National Examination Program at the SIFMA Compliance and Legal Society monthly luncheon held at the Harvard Club in New York City. Focusing on the broker-dealer examination program, Mr. di Florio discussed key findings from the 2011 examinations and highlighted the Commission's areas of concern for 2012.

### Updates on the National Examination Program

The following highlights key areas of change and development in the National Examination Program:

#### a. A Uniform Program with a Predictable Set of Procedures

The Commission has undertaken a great effort to create and implement one national examination program for its twelve regional offices. The goal is to have a uniform set of procedures providing predictability and consistency in examinations across the country. The milestones reached towards establishing a national program include the formation of a governing structure around the national team and the development of one strategic plan for the year. In January, the Commission rolled out the National Examination Program Policies and Procedures Manual that is to be applied by all regional offices.

#### b. Industry Experienced Professionals Heading the National Program

Valuable new staff additions have contributed to bring expertise, balance and perspective to the national examination program. Julius Leiman-Carbia, head of the Broker-Dealer Examination Program, joined with extensive industry experience from Citigroup, Goldman Sachs and JP Morgan Chase. In addition, Andrew Bowden joined as head of the Investment Adviser/Investment Company Examination Program after many years at Legg Mason in senior legal, compliance and business roles.

#### c. Recruiting of Specialized Talent

Strong recruiting efforts have brought in a number of other specialists with much needed skills to provide consulting and support to the examination teams. These specialists include people with PhD's in math, computer science, quantitative analytics, trading, complex structured products and derivatives, among other areas.

#### d. An Automated Examination Program

On the technology front, the examination process moved to an automated system built on an Oracle platform. This automated process is flexible, allows for a more fluid involvement of the examination program, and for sophisticated analytics of the data obtained in examinations.

## **e. Development of Specialized Expertise**

In an effort to foster specialization and allow people in the examination program to develop critical expertise, the Commission has created three “specialized areas,” moving away from the traditional “generalist” approach. These specialized areas are the Office of Risk Analytics and Surveillance, the Office of Data Analytics, and the Office of Large Firm Monitoring.

## **f. Risks Alerts**

In order to inform the public about key issues, deficiencies and problems identified in examinations, as well as good business practices seen in firms, the Commission has begun issuing “Risk Alerts.” To date, the Commission has issued 7 such alerts (including, most recently, alerts concerning underwriting of municipal securities, unauthorized trading and use of social media by investment advisers) and there are others in the pipeline. The Commission sees these risk alerts as a valuable tool for firms to both enhance their compliance systems and learn about effective practices implemented by others in the industry.

## **g. A Better Understanding of the Firm Being Examined**

The Commission continues to engage in efforts to better understand each firm and its core risk governance model, *i.e.*, how does the business take and manage risk, how do the risk and control functions (risk and compliance officers) work together to set standards and manage risk, and what are the firm’s internal controls, audit reports, and compliance controls. The Commission is also engaging with senior management, CEOs, and the board of directors to understand their role in overseeing and

supporting the risk and compliance functions. This analysis has been completed at a number of large firms and will continue to take place in other large and medium-sized firms.

## **Key Findings from the 2011 Broker-Dealer Examinations**

Next, Mr. di Florio briefly discussed the seven key findings that were identified in the 2011 broker-dealer examinations:

- a. Deficiencies in the reserve formula and net capital computation;
- b. Proper accounting for and safekeeping of customer funds;
- c. Deficiencies and concerns with key risks and control functions in firms;
- d. Supervision, particularly in the context of an independent contractor business model;
- e. Sales practices (including suitability, churning, misrepresentation and unauthorized trading);
- f. Order handling and execution; and
- g. Underwriting and distribution issues.

Referrals to Enforcement occurred mostly in the areas of fraudulent transactions, misrepresentations/omissions, inadequate supervisory practices or information barriers, and suitability.

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## SEC's Focus for the 2012 Broker-Dealer Examinations

During 2012, the SEC's examinations of broker-dealers have and will continue to focus on the following areas:

a. New issue due diligence, particularly in the areas of municipal securities and private placements.

See Risk Alert, <http://www.sec.gov/about/offices/ocie/riskalert-muniduediligence.pdf>.

b. Supervision of broker-dealer employees, with a focus on duly registered firms, recommendations of structured products/complex products and the training of representatives making such recommendations, products which generate high commissions such as private placements, supervision of employees in remote locations, and supervision of trading activity.

See Risk Alerts, <http://www.sec.gov/about/offices/ocie/riskalert-bdbranchinspections.pdf> and <http://www.sec.gov/about/offices/ocie/riskalert-unauthorizedtrading.pdf>.

c. Fraud. Findings of fraudulent activity such as Ponzi schemes, pump and dumps and market manipulation are referred to Enforcement as soon as they are uncovered, even if the examination is still underway. Examiners also look for abusive practices in the retail distribution channels, with a focus on seniors and affinity fraud (religious groups, military families and the like).

d. Unregistered activity or misuse of the limited exceptions to registration under the securities laws. Of note here are issues concerning master and subaccounts and harmful activities that take place in that area, such as the use of excessive margin debt, money laundering, insider trading, and market manipulation.

See Risk Alert, <http://www.sec.gov/news/press/2011/2011-198.htm>.

e. Trading risks. Examinations will continue to cover traditional issues such as short sales and best execution, but the examiners will also turn their focus to high frequency trading, algorithmic trading, and alternative trading systems ("ATS"). The new talent hired by the Commission, discussed above, has been extremely helpful in assisting and consulting with examiners to understand these novel areas.

f. Recently raised regulatory risks include the new Market Access Rule, new municipal advisor registrations, incentive compensation rules, new swap registrants and the Volcker Rule. As these new rules are implemented, the Commission is working to prepare its examination teams through hiring, training and the preparation of modules.

g. Large firm risks, including issues relating to FINOPs (registered financial and operations principals), risk management, liquidity, net capital requirements, and sales practices.

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Mr. di Florio closed his remarks by answering questions from the audience, during which he discussed in more detail how the national examination teams evaluate the strength of a firm's compliance program. He explained that such programs are viewed under two different parameters. First, by looking at the classic elements, the core fundamental processes that are in place: good policies and procedures, changes in management procedures, communication and training tailored to the business, effective

monitoring and testing of the program, effective risk assessment, and good issues management (escalation, remediation). Second are the intangible elements, including and most importantly, the culture of compliance in the organization set by senior management. In this arena, examiners would like to see, for instance, concrete examples of decisions that were made demonstrating the firm's focus on compliance, the interplay between the Chief Compliance Officer and senior business management, and the independence of the compliance function. ■

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