



NATIONAL EXAM PROGRAM

OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

Examination Priorities for 2013

February 21, 2013

I. Introduction

The National Examination Program (“NEP”) is publishing its examination priorities to communicate with investors and registrants about areas that are perceived by the staff to have heightened risk, and to support the SEC’s mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. These priorities, while set by the staff rather than by the Commission, are aligned with the SEC’s mission by seeking to improve compliance, prevent fraud, inform policy, and monitor firm-wide and systemic risk.

The examination priorities and focus areas for 2013 were selected collaboratively by senior exam staff and management from the NEP’s twelve offices, as well as senior representatives of other SEC divisions and offices, based upon an assessment of a variety of information, including:

- Information reported by registrants in required filings with the Commission;
- Information gathered through examinations conducted by the NEP and other regulators;
- Communications with other U.S. and international regulators and agencies;
- Industry and media publications;
- Comments and tips received directly from investors and registrants;
- Data maintained in third party databases; and
- Interactions with registrants, industry groups, and service providers (outside of examinations).

The NEP’s examination priorities address issues that span the entire market, as well as issues that relate specifically to particular business models and organizations. The market-wide priorities are addressed first, followed by the priorities for each of the NEP’s four distinct program areas: (i) investment advisers and investment companies, (ii) broker-dealers, (iii) clearing and transfer agents, and (iv) market oversight.

The priorities set forth in this memorandum are not exhaustive: while the NEP expects to allocate a significant portion of its resources throughout 2013 to the examination of the issues described below, the NEP will conduct additional examinations in 2013 focused on risks, issues, and policy matters that are not addressed here. Similarly, the NEP may focus its resources on a subset of the risks and issues identified here. Coordination with other federal and state regulators, as well as regulators from other nations, may also result in adjustments to these priorities.

II. NEP-Wide Initiatives

There are several risk areas and examination priorities that apply to nearly all registrants. These topics are described immediately below in general terms. More specific discussions of these and other topics are reviewed in the following sections, broken out by program area. The most significant initiatives across the entire NEP include:

Fraud Detection and Prevention. Our Nation's capital markets run, in large part, on trust. Nothing is more lethal to that trust than loss of investor capital for anything other than knowingly assumed risk, including scams, theft, and other fraudulent conduct. In its risk-based approach to targeting registrants and business practices, the NEP will continue to utilize and enhance its quantitative and qualitative tools and analyses to seek to identify market participants engaged in fraudulent or unethical behavior. The NEP also encourages tips, complaints, and referrals from investors, registrants, and other parties to help it identify potential frauds that harm investors and erode trust.

Corporate Governance and Enterprise Risk Management. The NEP will continue to meet with senior management and boards of entities registered with the Commission and their affiliates to discuss enterprise risk, and in particular, how a firm govern and manage financial, legal, compliance, operational, and reputational risks. This initiative is designed to: (i) understand firms' approach to enterprise risk management; (ii) evaluate firms' tone at the top; and (iii) initiate a dialogue on key risks and regulatory requirements. This effort provides the NEP with an opportunity to assess overall risk management at certain registrants through discussions with independent board members, senior management, internal audit, key risk and control functions, and leaders of business lines. It is also designed to better inform our examinations of such firms, as well as other registrants. The staff will also continue to engage in "discovery" reviews to inform both examination policy and rulemaking efforts and joint monitoring efforts with other regulators. For example, the Commission has joined the Federal Reserve in monitoring reform of tri-party repurchase agreements and practices. In addition, last fall Hurricane Sandy brought to light certain gaps in some registrants' business continuity plans. The staff is identifying the overall impact of the hurricane on certain entities' operations, including the obstacles they confronted when implementing their business continuity plans.

Conflicts of Interest. Conflicts of interest, when not eliminated or properly mitigated and managed, are a leading indicator and cause of significant regulatory issues for individuals, firms, and sometimes the entire market. Over the past several years, the NEP has identified conflicts of interest as a key focus of its risk-based strategy, and an integral part of our assessment of which firms to examine, what issues to focus on, and how to examine those areas. Conflicts of interest are a particularly important challenge for large and complex financial institutions. Due to these firms' extensive affiliations, and the dynamic nature of their businesses, conflicts are constantly arising and changing. The NEP will focus on specific conflicts of interest, steps registrants have taken to mitigate conflicts, and the sufficiency of disclosures made to investors. The staff will also look at the overall risk governance framework that firms have in place to manage conflicts on an ongoing basis.

Technology. The capital markets have experienced an ongoing revolution in technology over several decades, and the increasing complexity, interconnectedness, and speed fostered by technology is a continual challenge to market participants and regulators. A number of market events over the past two years have underscored how important it is for the Commission and other regulators to stay current on

new trading technologies and their implications for maintaining transparent, stable markets that do not give inappropriate advantages to some market participants over others. In 2013, the NEP may conduct examinations on governance and supervision of information technology systems for topics such as operational capability, market access, and information security, including risks of system outages, and data integrity compromises that may adversely affect investor confidence. Among other things, the NEP hopes that these examinations will help the industry and the Commission to better understand operational information technology risks and potential methods to help mitigate and effectively manage those risks.

III. Program Area Specific Initiatives

This section discusses risks faced by specific program areas of the NEP. The focus areas are generally divided into ongoing risks, new and emerging risks, and policy topics.

“Ongoing risks” are those risk areas that are common to all or many of the business models utilized by a particular category of registrant and that have existed for a sustained period and are likely to continue to be risks for the foreseeable future. Certain of these ongoing risks have been selected as focus areas in 2013 because of the inherent risk they present or their reoccurrence in recently conducted examinations.

“New and emerging risks” are issues and business practices that pose an increased risk due to changes and developments in the industry, including significant changes in financial conditions, new products or investment strategies, technology, regulation, business combinations, and business practices.

“Policy topics” are areas in which the NEP has an interest in gaining a better understanding of particular practices or learning the practical application of previously adopted rules and guidance.

Investment Adviser-Investment Company Exam Program

The Investment Adviser-Investment Company (“IA-IC”) Program has primary examination authority for approximately 11,000 registered investment advisers and 800 registered investment company complexes. Collectively, these entities manage nearly \$50 trillion for investors.

A. IA-IC Program Examination Focus Areas

The scope of an IA-IC examination is generally limited to the issues and business practices of the registrant that are perceived by the staff to present the highest risks to investors and the integrity of the market. Thus, the scope of exams will vary from registrant to registrant. Nevertheless, across the program, there are certain issues that predominate. In addition to the specific risk areas unique to each registrant, the staff will consider the following focus areas when scoping and conducting examinations in 2013.

➤ Ongoing Risks.

The staff anticipates that the ongoing risks selected as focus areas for IA-ICs in 2013 will include:

Safety of Assets. As it has in the past, the staff will continue to utilize a risk-based asset verification process to confirm the safety of client assets and compliance with custody requirements. The staff will

review the measures taken by registrants to protect client assets from loss or theft, the adequacy of audits of private funds, and the effectiveness of policies and procedures in this area. Recent examinations of investment advisers have found a high frequency of issues regarding the custody and safety of client assets under Advisers Act Rule 206(4)-2 (the “Custody Rule”). Therefore the staff will focus on issues such as whether advisers are: (i) appropriately recognizing situations in which they have custody as defined in the Custody Rule; (ii) complying with the Custody Rule’s “surprise exam” requirement; (iii) satisfying the Custody Rule’s “qualified custodian” provision; and (iv) following the terms of the exception to the independent verification requirements for pooled investment vehicles.

Conflicts of Interest Related to Compensation Arrangements. The staff will review financial and other records to identify undisclosed compensation arrangements and the conflicts of interest that they present. These activities may include undisclosed fee or solicitation arrangements, referral arrangements (particularly to affiliated entities), and receipt of payment for services allegedly provided to third parties. For example, some advisers that place client assets with particular funds or fund platforms are, in return, paid “client servicing fees” by such funds and fund platforms. Such arrangements present a material conflict of interest that must be fully and clearly disclosed to clients.

Marketing/Performance. Marketing and performance advertising is an inherently high-risk area due to the highly competitive nature of the investment management industry. Aberrational performance of certain registrants and funds can be an indicator of fraudulent or weak valuation procedures or practices. The staff will also focus on the accuracy of advertised performance, including hypothetical and back-tested performance, the assumptions or methodology utilized, and related disclosures and compliance with record keeping requirements. Where feasible, the staff will also review changes in advertising practices related to the JOBS Act, which requires modification of the rules restricting general solicitations.

Conflicts of Interest Related to Allocation of Investment Opportunities. Advisers managing accounts that do not pay performance fees (*e.g.*, most mutual funds) side-by-side with accounts that pay performance-based fees (*e.g.*, most hedge funds) face unique conflicts of interest. While reviewing portfolio management practices, the staff will confirm that the registrant has controls in place to monitor the side-by-side management of its performance-based fee accounts, such as certain private investment vehicles, and registered investment companies, or other non-incentive fee-based accounts, with similar investment objectives, especially if the same portfolio manager is responsible for making investment decisions for both kinds of client accounts or funds.

Fund Governance. Fund governance and assessing the “tone at the top” is a key component in assessing risk during any investment company examination. The staff will confirm that advisers are making full and accurate disclosures to fund boards and that fund directors are conducting reasonable reviews of such information in connection with contract approvals, oversight of service providers, valuation of fund assets, and assessment of expenses or viability.

➤ **New and Emerging Issues.**

The staff anticipates that the new and emerging risks for IA-ICs in 2013 will include:

New Registrants. Since the effective date in early 2012 of Section 402 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, approximately 2,000 investment advisers have registered with the SEC for the first time. The vast majority of these new registrants are advisers to hedge funds and private equity funds that have never been registered, regulated, or examined by the SEC. The IA-IC Program therefore intends to launch a coordinated national examination initiative designed to establish a meaningful presence with these newly registered advisers. The initiative is expected to run for approximately two years and consists of four phases: (i) engage with the new registrants; (ii) examine a substantial percentage of the new registrants; (iii) analyze our examination findings; and (iv) report to the industry on our observations. In addition to the new registrant initiative, the IA-IC Program will also prioritize examinations of private fund advisers where the staff's analytics indicate higher risks to investors relative to the rest of the registrant population, or there are indicia of fraud or other serious wrongdoing.

Dually Registered IA/BD. Due to the continued convergence in the investment adviser and broker-dealer industry, the IA-IC Program will continue to expand coordinated and joint examinations with the B-D Program of dually registered firms and distinct broker-dealer and investment advisory businesses that share common financial professionals. For example, it is not uncommon for a financial professional to conduct brokerage business through a registered broker-dealer that she does not own or control and to conduct investment advisory business through a registered investment adviser that she owns and controls, but that is not overseen by the broker-dealer. This business model presents multiple conflicts. Among other things, the staff will review how financial professionals and firms satisfy their suitability obligations when determining whether to recommend brokerage or advisory accounts, the financial incentives for making such recommendations, and whether all conflicts of interest are fully and accurately disclosed. In addition, the staff will review dually registered firms' policies and procedures to understand if such policies and procedures provide guidelines for when a financial professional makes a securities recommendation to a customer with a broker-dealer account versus an investment adviser account.

“Alternative” Investment Companies. The IA-IC Program is focusing on the growing use of alternative and hedge fund investment strategies in open-end funds, exchange-traded funds (“ETFs”), and variable annuity structures. More specifically, the staff will assess whether: (i) leverage, liquidity and valuation policies and practices comply with regulations; (ii) boards, compliance personnel, and back-offices are staffed, funded, and empowered to handle the new strategies; and (iii) the funds are being marketed to investors in compliance with regulations.

Payments for Distribution in Guise. The IA-IC Program is focusing on the wide variety of payments made by advisers and funds to distributors and intermediaries, the adequacy of disclosure made to fund boards about these payments, and boards' oversight of the same. These payments go by many names and are purportedly made for a variety of services, most commonly revenue sharing, sub-TA, shareholder servicing, and conference support. The staff will assess whether such payments are made in compliance with regulations, including Investment Company Act Rule 12b-1, or whether they are instead payments for distribution and preferential treatment.

➤ **Policy Topics.**

The staff anticipates that the policy topics for IA-ICs will include:

Money Market Funds. Recent amendments to Investment Company Act Rule 2a-7 require money market funds to periodically stress test their ability to maintain a stable share price based on hypothetical events, including changes in short-term interest rates, increased redemptions, downgrades and defaults, and changes in spreads from selected benchmarks. Among other things, the staff will review whether firms are conducting stress testing, what factors they are considering in the stress testing, and the results of the stress testing.

Compliance with Exemptive Orders. Where applicable, the staff will focus on compliance with previously granted exemptive orders, such as those related to closed-end funds and managed distribution plans, employee securities companies, ETFs and the use of custom baskets, and those granted to fund advisers and their affiliates permitting them to engage in co-investment opportunities with the funds.

Compliance with the Pay to Play Rule. To prevent advisers from obtaining business from government entities in return for political “contributions” (i.e., engaging in pay to play practices), the SEC recently adopted and subsequently amended, the Pay to Play rule. The staff will review for compliance in this area, as well as assess the practical application of the rule.

Broker-Dealer Exam Program.

The Broker-Dealer (“B-D”) Program operates the Commission’s examination program for more than 4600 registered broker-dealers with approximately 111 million customer accounts, over 160,000 branch offices, and over 630,000 registered representatives. The B-D Program applies a risk-targeted focus to the program and also assists in selecting particular broker-dealers for examination, taking into account: (i) the risks and activities associated with individual broker-dealers (or firms); and (ii) the risks identified in the course of regional risk assessment efforts. The B-D Program also coordinates closely with the Financial Industry Regulatory Authority (“FINRA”) and state regulators.

B-D reviews may involve activities by enterprises with related entities registered in multiple capacities (i.e., broker-dealer, investment adviser, transfer agent, etc.) acting in concert. The staff will reach out as necessary to the relevant program within the NEP and elsewhere to ensure that exam activities as well as ensuing investigations are properly coordinated.

A. B-D Program Examination Focus Areas

B-D examinations are primarily focused on issues and business practices that are perceived by the staff to present the highest risks to investors and the integrity of the market. For example, in 2012 a large number of issues centered around capital and financial controls of B-Ds. Exam scopes will vary from registrant to registrant, depending on the registrant’s business activity and the risk associated with such activity. Nevertheless, across the program, certain issues predominate. In addition to the specific risks unique to each registrant, the staff will consider the following focus areas when scoping and conducting examinations in 2013.

➤ Ongoing Risks

The staff anticipates that the ongoing risks that will be focus areas for B-Ds in 2013 include:

Sales Practices/Fraud. The B-D Program frequently finds fraud in connection with sales practices regarding retail investors, including:

- Affinity fraud or fraud targeting seniors;
- Unsuitable recommendations of higher yield products (e.g., unsuitable recommendations of municipal or corporate bonds), as well as improper supervision and due diligence processes regarding those recommendations or those products;
- Activities and products on the periphery of certain registered entities, such as outside business activities or an affiliated entity that the registrant claims is beyond the Commission's jurisdiction;
- Conflicts of interest that are not appropriately mitigated, and are not clearly disclosed in an understandable and timely manner; and
- Certain firms identified as recidivist or high-risk for potential misconduct.

Trading. The exact nature of trading risks tends to evolve over time as new technologies and market practices develop. For example, high-frequency and algorithmic trading, taken in isolation, might be considered a relatively new risk; however, trading risks are an ongoing challenge for individual firms and for the financial system precisely because market structures and practices are always dynamic and evolving. The staff intends to address certain trading risk areas, with particular focus on high frequency trading, algorithmic trading, proper controls around the use of technology, alternative trading systems and order routing practices.

Capital. The B-D Program intends to conduct exams of clearing firms with multiple correspondents engaging in high frequency/high volume trading, focusing on the clearing firms' internal controls for managing intraday liquidity risk, as well as assessing intraday net capital and other financial risks.

AML. The staff will identify clearing and introducing firms that appear to have weak anti-money laundering ("AML") programs, especially customer identification programs (CIP), suspicious activity identification and reporting deficiencies, and weak due diligence procedures regarding certain accounts. The B-D Program will focus on the firm's risk assessment of its business practices and implementation of the AML program related to those risks, including risks associated with taking on the accounts of failed or expelled firms.

➤ **New and Emerging Issues**

In addition to the joint examinations of dually registered IA-BDs with the IA-IC Program described above, the staff anticipates that new and emerging issues for the B-D program for 2013 will include:

Exchange Act Rule 15c3-5, (the Market Access Rule). The staff will focus on firms' compliance with this rule, with particular attention to master/sub-accounts relations and proper controls relating to proprietary trading. Some areas of particular focus:

- Master / Sub-Accounts: The structure of this model lends itself to potential issues related to money laundering activity, market manipulation, unregistered broker-dealers, excessive

margin, and inadequate minimum equity for pattern day traders. Staff will also look at the adequacy of books and records maintained by broker-dealers that provide market access;

- Proprietary Trading: Some firms are unaware that the Rule applies to, and requires capital thresholds on, proprietary trading, including error accounts. These thresholds must also encompass a methodology for accounting for open quotes, taking into account quotes associated with market making activities;
- Supervision of Registrants' Technology System Controls and Governance: The staff has observed a series of technology system problems that have caused firms' significant losses and eroded customer confidence in the markets. These technology system errors have occurred at both the exchange level as well as at multiple broker-dealers. These events have raised questions as to the effectiveness of broker-dealers' controls and oversight over technology systems and supervision of personnel, as well as the adequacy of firms' protocols to address systems that are acting counter to expectations, and the robustness of firms' risk management procedures; and
- Dual Registrants/ Regulatory Coordination: In the aftermath of notable problems encountered in the past year by certain broker-dealers dually registered as futures commission merchants, the B-D Program will maintain its focus in this area in coordination with the Commodity Futures Trading Commission ("CFTC"). More broadly, the B-D Program is emphasizing stronger coordination among Designated Examination Authorities.

Exchange-Traded Funds. Recent examinations have highlighted certain issues risks relating to ETFs , such as fails to deliver and compliance with Regulation SHO. In addition, the B-D Program will continue to review the suitability of recommendations of leveraged or inverse ETFs to retail investors.

➤ Policy Topics

The staff anticipates that the policy topics in the B-D program for 2013 will include:

JOBS Act. Upon approval of a final rule relating to the JOBS Act, which creates a new exemption from registration under the Securities Act for qualified "crowd funding" transactions, the staff intends to conduct reviews of entities participating in the crowd funding business, as appropriate.

Other Regulatory Requirements. The staff intends to assess compliance with the new registration and related rules applicable to municipal advisors as well as incentive compensation, pending adoption of final rules. Also, the staff intends to conduct examinations for compliance with Security-Based Swap Dealers rules pending the final adoption or compliance effective date for such rules.

Market Oversight Exam Program

OCIE's Office of Market Oversight is responsible for examining certain SROs and other entities to evaluate their compliance with applicable Federal securities laws and rules and the SRO's own rules. The SROs subject to Market Oversight's review include the national securities exchanges (both equity and options market centers), FINRA, and the Municipal Securities Rulemaking Board. Market Oversight also oversees the Public Company Accounting Oversight Board and the Securities Investor Protection Corporation. The staff anticipates that its risk-based exam focus in 2013 will include the following priorities:

Risk Assessment Examinations of Exchanges. Market Oversight will conduct targeted, risk focused SRO examinations. Through recent assessment examinations of each SRO, Market Oversight has established a baseline for comparing the effectiveness of compliance programs across the SROs. As part of its risk evaluation, Market Oversight has identified several specific areas for examination in 2013. Among these are examinations of equity exchanges to review the internal controls and governance around each exchange's rule making process and the supervision of regulatory service agreements by exchanges. In addition, as described below, Market Oversight will monitor closely industry developments and specific events to further enhance risk assessments and focus.

FINRA Oversight. Market Oversight will continue its efforts to enhance oversight of FINRA. As part of a risk-based approach to overseeing FINRA, the staff will evaluate and prioritize evolving and varying risks at FINRA to identify areas for review. The staff will consider both those program areas specifically outlined in Dodd-Frank Section 964, as well as areas not articulated in Section 964 for possible oversight.

Examinations of New Registrants. Market Oversight plans to inspect recently registered exchanges and will continue to meet with entities intending to register as an exchange. Market Oversight also will incorporate into its examination plan review of security-based swap execution facilities if the Commission adopts final rules requiring their registration.

Regulatory Responsibility Examinations. Market Oversight plans to continue its review of the SROs' obligations to enforce member compliance with financial responsibility requirements.

SRO Monitoring. To supplement its examination efforts, Market Oversight, along with the Division of Trading and Markets ("TM"), monitors the SROs' activities on an on-going basis. The monitoring functions include coordination with the SROs through joint regulatory conferences, evaluation of oversight issues identified through staff's broker-dealer examinations, and collaboration with TM on review of SRO activities and with the Division of Enforcement on related investigations. Market Oversight also reviews significant market events with the assistance of the SROs. Market Oversight conducts these activities, in part, to identify emerging risks and to work with the SROs on effective, real time mitigation strategies.

Systems Compliance. Market Oversight will continue to review and examine systems outages, systems errors, and system integrity through SRO self-reporting. Market Oversight also will continue to coordinate the interdisciplinary Market Event Response Team, which examines market events in real time.

Order Type Assessments. Market Oversight will conduct inspections of equities exchanges to determine the types of orders available and the internal governance process around how order types are proposed, implemented, and monitored post-implementation.

Clearance and Settlement Exam Program

The Clearance and Settlement Program currently consists of two registrant types and associated exam programs: Transfer Agents and Clearing Agencies.¹

A. Transfer Agent Program

The Transfer Agent Program has examination authority for approximately 460 transfer agents consisting of both SEC-registered (approximately 75% of the transfer agent population) and bank-registered transfer agents. The full transfer agent population maintains over 306 million shareholder accounts for approximately 1.7 million issuers (including equity, debt, and mutual fund securities) as reported for the end of 2011. In addition to core transfer agent services (defined below), certain transfer agents may provide paying agent services, which reported at the end of 2011 distributing over \$1.8 trillion in shareholder dividends and interest payments.

➤ **Ongoing Risks.**

The staff anticipates that ongoing risks that will be focus areas for transfer agents in 2013 include:

Transfer Agent Core Activities. Most, if not all, transfer agents engage in three core activities: the timely turnaround (elapsed time it takes to process) of items and transfers (Exchange Act Rule 17Ad-2); accurate recordkeeping and associated retention (Exchange Act Rules 17Ad-6 and 17Ad-7); and safeguarding funds and securities (Exchange Act Rule 17Ad-12). Compliance with these core transfer agents' regulations are a general indication of the compliance environment of the transfer agent; therefore, the exam staff will focus on compliance and controls in these critical core activities.

Transfer Agent Safeguarding. Certain transfer agent services may heighten the risk of investor loss, such as paying agent activities located in non-bank registered transfer agents (which may involve the handling of millions of dollars of investor funds) and direct securities transactions in which a transfer agent accepts shareholder orders (*e.g.*, employee stock plans). In addition, transfer agents that offer purchase and sale services may increase the risk of engaging in unregistered broker-dealer or investment adviser activity if they offer, for example, investment advice. The staff will focus on whether transfer agents provide appropriate customer service without offering investment advice that would require the transfer agent to register as either a broker-dealer or an investment adviser.

Transfer Agent Recordkeeping and Retention. While recordkeeping and retention is a core activity for all transfer agents, certain events could elevate the potential risks surrounding these processes. The staff will review whether transfer agents have policies and procedures that include, for example: business continuity procedures related to facility or other business impediments; electronic storage, appropriate redundancy, and timely retrieval for the required regulatory periods; and third-party vendor access and security.

¹ Security-based Swap Data Repositories ("SDRs") will be incorporated into the Clearance and Settlement Program once these entities are required to register with the Commission pursuant to regulations enacted under the Dodd-Frank Act. In the event that further rulemaking occurs during 2013 affecting SDRs, NEP staff will review draft rules and standards to provide the examination perspective.

Transfer Agent Size, Volume, and Experience. The size of, volumes processed by, and experience of, a transfer agent may also indicate heightened risks. For example, a transfer agent with a staff of only one or two may have an enhanced risk profile caused by key person risk. Additionally, the risk potential may increase as transfer agents service more issuers or handle increased numbers of transfers. The staff has also observed that newly-registered transfer agents generally pose an increased risk, as they may not fully understand the requirements of applicable regulations.

➤ **New and Emerging Issues.**

The staff anticipates that new and emerging risks for the Transfer Agent Program in 2013 will include:

Microcap Securities and Private Offerings. Transfer agents that service microcap securities, especially those involved in private offerings, may be used to facilitate the unregistered offering of restricted securities by allowing securities transfers that could circumvent existing rules or enable fraudulent schemes. To help prevent the facilitation of these unlawful schemes, the staff will evaluate whether transfer agents have effectively implemented formal written policies and procedures for the appropriate removal of restrictions on microcap securities. As conflicts of interest increase the potential for this risk, the staff will review whether these policies and procedures include, for example, an understanding of roles of the other parties involved with the transactions (*e.g.*, attorneys, brokers, control persons, etc.), the identification of potential conflicts associated with those parties, as well as appropriate actions to be taken where conflicts may be identified.

Microcap securities and private offerings are also a priority for the B-D Program, as discussed above. The staff in both units will coordinate their activities.

Conflicts of Interest. Potential conflicts of interest may arise if the transfer agents' principals are owners of or affiliated with issuers, vendors, or others involved in the transfer agents' activities (*e.g.*, attorneys, brokers, etc.). The staff will examine whether transfer agents have implemented effective formal written policies and procedures to identify, disclose, where appropriate, and mitigate conflicts where those conflicts could lead to unlawful activities.

Hybrid Securities. As the securities industry evolves, new types of securities increase the risk that transfer agents' existing procedures and operations do not appropriately reflect the characteristics of these new securities. Some of the hybrid securities that combine characteristics of equity and debt securities include, for example, preferred shareholder classes, convertible securities, and equity warrants or options. The staff will review whether transfer agents have implemented effective formal written policies and procedures that reflect *all* types of securities serviced by the transfer agent (including those that are new or complex) and can demonstrate an in-depth understanding of the instructions required for transfers and/or conversions of those security types.

Outsourcing. Transfer agents, similar to other financial service firms, may outsource certain activities to other registered transfer agents or, depending on the activity, other types of financial intermediaries. In addition, larger transfer agents may establish "off-site" processing centers in out-of-state or non-US locations. The staff will examine whether transfer agents that outsource services have implemented effective formal written policies and procedures and appropriate contractual clauses (or service level agreements) that, for example, help monitor, ensure, and maintain the appropriate processing

environment for meeting their regulatory obligations and allow for timely and accurate production of books and records.

Third Party Administration. Some registered transfer agents provide services generally known as “third party” administration. “Third party” administration services are similar to transfer agent recordkeeping functions but are performed for parties other than the issuer of a Section 12 security, (e.g., a retirement plan). These recordkeeping activities are generally related to either a specific plan or performing services in conjunction with a mutual fund company and keeping plan members’ records at the omnibus level with the mutual funds’ transfer agents. As these third party administrators often accept and route plan-member orders, the staff will review whether these registrants have effectively implemented policies and procedures that evaluate their activities to help identify when the activities may require either broker-dealer or investment adviser registration. In connection with IA-IC examinations, the staff will also ask for information on third-party administrators, and may use this information to consider whether entities that provide these services are appropriately registered or exempt from registration.

➤ **Policy Topics.**

The Transfer Agent Program may review areas in order to understand better the practices of transfer agents, which will help examination staff in informing the drafting of new rules (e.g., potential rule writing by the Commission regarding the JOBS Act), or review the effects of any new regulation for transfer agents, if adopted, and associated compliance. Additionally, the policy divisions may request the examination staff to review practices related to pending or implemented industry initiatives (for example, dematerialization, proxy reform, and escheatment practices).

B. Clearing Agency Program

In July 2012, Depository Trust Company (“DTC”), National Securities Clearing Corporation (“NSCC”), Fixed Income Clearing Corporation (“FICC”), and Options Clearing Corporation (“OCC”) were designated as systemically important by the Financial Stability Oversight Council under the Dodd-Frank Act with the SEC as the primary supervisory agency. Additionally, CME Group (“CME”) and ICE Clear Credit were designated as systemically important with the CFTC as primary supervisory agency.

The Dodd-Frank Act requires all systemically designated clearing agencies to be examined annually by their primary supervisory agency. The staff will perform its first annual examination of DTC, NSCC, FICC, and OCC in 2013, in accordance with the requirements of the Dodd-Frank Act. It is anticipated that CFTC will request the staff to participate in its annual examination of CME and ICE Clear Credit. For the two non-designated clearing agencies, the staff will consider the level, nature, and timing of any examination activity based upon a risk approach.

For 2013, the staff anticipates that it will focus on the following areas:

Performance of Annual Exams Mandated by the Dodd-Frank Act. The performance of the required annual examination will utilize a risk-based approach to determine the policies, procedures, and associated internal controls to be reviewed and evaluated. This approach will incorporate, where appropriate, new rules and standards adopted; input as a result of collaboration and coordination with TM and other regulators (the Federal Reserve Board, the Federal Reserve Banks of New York and Chicago and the CFTC, where applicable); and experience with the clearing agencies through

monitoring and/or prior examination activities. The staff also will consider the requirements pursuant to Section 17A of the Exchange Act and the rules thereunder and where applicable the following factors defined by the Dodd-Frank Act:

- The nature of the operations and the risks borne by the designated clearing agency;
- The financial and operational risks presented by the designated clearing agency to financial institutions, critical markets, or the broader financial system;
- The resources and capabilities of the designated clearing agency to monitor and control such risks;
- The safety and soundness of the designated clearing agency; and
- The designated clearing agency's compliance with the Dodd-Frank Act and rules and orders prescribed under the Dodd-Frank Act.

Performance of Monitoring Activities. To the extent possible, regular interaction with designated clearing agencies, in addition to examination activities, is beneficial when considering the potential risks and factors defined by the Dodd-Frank Act. Such monitoring activities could include:

- Periodic discussions with the Board, Senior Management, the head of internal control functions (e.g., the General Auditor, Chief Risk Officer, and Chief Compliance Officer).
- Review of risk management reports (e.g., back and stress tests), internal audit reports, compliance reports, incident reports, new initiatives committee documentation, and other similar documentation, where applicable and periodically as issued.
- Participation in and/or review of information regarding meetings held by TM's Risk Monitoring group and the staff responsible for the Commission's Automation Review Policy Program.
- Collaboration and periodic information sharing with other regulators.

Informing Policy and Process. In the event that further rulemaking continues in 2013 affecting clearing agencies, the staff will review draft rules and standards to provide the examination perspective. Additionally, the staff will enhance / tailor the clearing agency exam procedures and processes, where appropriate during the fiscal year, to incorporate the new requirements and the consultation, where applicable, of TM and/or other regulators.