U.S. Securities and Exchange Commission

Office of Inspector General

Office of Audits

The SEC's Office of Broker-Dealer Finances Provides Effective Oversight, But Opportunities To Improve Efficiency Exist

February 26, 2020
Report No. 559

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OFFICE OF INSPECTOR GENERAL

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

M E M O R A N D U M

February 26, 2020

TO: Brett Redfearn, Director, Division of Trading and Markets

FROM: Carl W. Hoecker, Inspector General

SUBJECT: *The SEC's Office of Broker-Dealer Finances Provides Effective Oversight, But Opportunities to Improve Efficiency Exist*, Report No. 559

Attached is the Office of Inspector General (OIG) final report detailing the results of our evaluation of the Division of Trading and Markets' (TM) Office of Broker-Dealer Finances (OBDF). The report contains three recommendations that should help improve OBDF operations.

On January 30, 2020, we provided management with a draft of our report for review and comment. In its February 21, 2020, response, management concurred with our recommendations. We have included management's response as Appendix III in the final report.

Within the next 45 days, please provide the OIG with a written corrective action plan that addresses the recommendations. The corrective action plan should include information such as the responsible official/point of contact, timeframe for completing required actions, and milestones identifying how TM will address the recommendations.

We appreciate the courtesies and cooperation extended to us during the evaluation. If you have questions, please contact me or Rebecca L. Sharek, Deputy Inspector General for Audits, Evaluations, and Special Projects.

Attachment

cc: Jay Clayton, Chairman
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Executive Summary

The SEC's Office of Broker-Dealer Finances Provides Effective Oversight, But Opportunities To Improve Efficiency Exist
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Why We Did This Evaluation

The U.S. Securities and Exchange Commission (SEC or Commission) prescribes broker-dealer net capital and risk assessment reporting requirements through various rules overseen by the Division of Trading and Markets' (TM) Office of Broker-Dealer Finances (OBDF). The largest broker-dealer firms can apply for and use an alternative net capital calculation for computing capital, if approved. Additionally, over-the-counter derivatives dealers can apply for and use value-at-risk and other statistical models to calculate capital once approved. OBDF monitors approved firms' monthly, quarterly, and annual filings and meets regularly with the firms' senior risk management staff. As of January 2020, there were five approved alternative net capital broker-dealer firms and three approved over-the-counter derivatives dealers. There were also 280 broker-dealers subject to risk assessment and material affiliate requirements.

We conducted this evaluation to assess the efficiency and effectiveness of TM's OBDF. Specifically, we sought to determine whether OBDF (1) provides effective oversight of broker-dealer compliance with capital and risk reporting requirements, in accordance with applicable rules and guidance, and (2) ensures efficient use of Government resources to help achieve organizational goals and objectives.

What We Recommended

We made three recommendations to address areas that can improve OBDF's oversight and efficiency, including recommendations to update its inspection policies and finalize needed rule updates and strategic plans. Management concurred with the recommendations, which will be closed upon completion and verification of corrective action. This report contains non-public information about the SEC's broker-dealer oversight program. We redacted the non-public information to create this public version.

What We Found

We found that OBDF effectively monitors broker-dealer compliance with net capital and risk assessment rules and reporting requirements. Specifically, OBDF's sub-offices support its mission, and each sub-office has written policies and procedures with detailed processes that align with the organization's oversight requirements. Based on our review and testing of each sub-office's key processes and controls for oversight activities, we found that OBDF's processes were effective for overseeing broker-dealer net capital and risk reporting.

However, clarifications are needed in OBDF's Office of Broker-Dealer Inspections sub-office to reflect current practices and requirements. Specifically, certain updates to the Office of Broker-Dealer Inspections' written policies and procedures could strengthen controls over the inspection program, thereby improving efficiency.

(b) (5) [redacted]

Finally, we obtained reasonable assurance of OBDF's efficient use of Government resources and we did not identify waste. However, we were unable to link OBDF's programs and resources to its goals and objectives because of the lack of a unified, office-wide strategy. Also, OBDF did not make use of strategic planning, and did not have a formal succession plan. TM has drafted a strategic plan that includes goals for OBDF but, according to the TM Managing Executive, the final plan has been delayed because of the extensive rulemaking agenda. We reviewed TM's draft strategic plan and we discussed OBDF's strategic and succession planning with OBDF senior management who confirmed that, while there have been planning discussions, formal plans have not been established.

For additional information, contact the Office of Inspector General at (202) 551-6061 or http://www.sec.gov/oig.

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ABBREVIATIONS

ANC	Alternative Net Capital
EDGAR	Electronic Data Gathering, Analysis, and Retrieval
Exchange Act or Act	Securities Exchange Act of 1934
FOCUS	Financial and Operational Combined Uniform Single
GAO	U.S. Government Accountability Office
OBDF	Office of Broker-Dealer Finances
OBDI	Office of Broker-Dealer Inspections
OFR	Office of Financial Responsibility
OIG	Office of Inspector General
OQRA	Office of Quantitative Risk Analysis
OTCDD	over-the-counter derivatives dealer
RSBD	Risk Supervised Broker-Dealer Program
SEC or agency	U.S. Securities and Exchange Commission
SIPC	Securities Investor Protection Corporation
TM	Division of Trading and Markets

Background and Objective

Background

The Securities Exchange Act of 1934 (Exchange Act or Act) governs the way in which the nation's securities markets and its brokers and dealers operate.[1] Among other things, the Act defines a "broker" as any person engaged in the business of effecting transactions in securities for the account of others, and a "dealer" as any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise.[2] Over the years, high-profile collapses of large broker-dealers and apparent shortfalls in customer assets highlighted the need for financial firms and regulators to ensure customer assets are appropriately protected and made readily available to customers whenever they may be needed. Most broker-dealers must register with the U.S. Securities and Exchange Commission (SEC, agency, or Commission) and join a self-regulatory organization, which assists the SEC in regulating the activities of broker-dealers.

To help ensure fair, orderly, and efficient markets, and to help provide for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of broker-dealers, the SEC established, among other things, broker-dealer financial responsibility requirements (defined by 17 C.F.R. § 240.3a40-1, *Designation of Financial Responsibility Rules*), including requirements related to net capital and risk assessment reporting. In addition, broker-dealers that hold customer funds or have regulatory capital equal to or greater than $20 million are required to file with the SEC quarterly and annual risk assessments. Firms must also maintain and preserve information regarding those affiliates, subsidiaries, and holding companies whose business activities are reasonably likely to have a material impact on the broker-dealer's financial and operating condition (referred to as "material affiliates"). Also, among other requirements, broker-dealers must:

- maintain minimum amounts of liquid assets, or net capital, to promptly satisfy customer claims if the broker-dealer goes out of business;
- take certain steps to safeguard customer funds and securities; and
- make and preserve accurate books and records, including organizational charts, written policies and procedures, and consolidated balance sheets and income statements.

[1] 15 U.S.C. §§ 78a-78qq, as amended.

[2] 15 U.S.C. §§ 78c(a)(4)(A) and (a)(5)(A) (Definitions and Application).

Broker-dealers can apply for and, if approved, use an alternative net capital (ANC) calculation for computing capital.[3] In addition, registered dealers active in the over-the-counter derivatives markets (referred to as over-the-counter derivatives dealers [OTCDDs]) can apply for and, if approved, use value-at-risk and other statistical models to calculate capital.[4] The SEC's Division of Trading and Markets' (TM) Office of Broker-Dealer Finances (OBDF) reviews the applications with assistance from other divisions and offices as well as the Financial Industry Regulatory Authority and, based on the review, the Commission's Office of the Secretary approves the use of alternative methods for calculating capital. Once the SEC approves firms' use of such alternative methods, the firms must submit to the agency monthly, quarterly, and annual filings and meet with SEC staff regularly.

As of January 2020, there were five broker-dealers and three OTCDDs subject to the conditions of Appendix E and F of Rule 15c3-1 and approved by the SEC to use alternative approaches to computing net capital.[5] There were also 280 broker-dealers subject to risk assessment and material affiliate requirements. OBDF monitors these broker-dealers' compliance with the financial responsibility rules further described in Appendix II.

OBDF Responsibilities and Organizational Structure. As shown in Figure 1, OBDF consists of the following five sub-offices:

1. *Risk Supervised Broker-Dealer Program (RSBD).* RSBD monitors broker-dealers that use alternative methods to compute net capital and OTCDDs that use alternative methods, including value-at-risk modeling to compute capital charges for market and credit risk. RSBD oversees the firms' internal risk management control systems and modeled risk deductions to net capital, and the minimum risk management system standards for broker-dealers required for credit default swap portfolio margining. RSBD staff meets regularly with firms' senior risk management staff.

2. *Office of Quantitative Risk Analysis (OQRA).* Based on certain qualitative and quantitative standards, OQRA reviews the market and credit risk models used by broker-dealers and OTCDDs seeking approval to use alternative methods for calculating capital. OQRA also monitors nonmaterial changes and reviews material changes to firms' approved market and credit risk models, and meets regularly with the

[3] As a condition of approval, applicants must maintain an "early warning" level of at least $5 billion in tentative net capital, minimum levels of at least $1 billion in tentative net capital, and at least $500 million in net capital.

[4] Over-the-counter derivative instruments are financial management tools employed by many corporations, financial institutions, governmental entities, and other end-users. OTCDDs that wish to use value-at-risk and other statistical models to calculate capital charges for market risk and to take alternative charges for credit risk must, like ANC firms, file an application with and obtain authorization from the SEC.

[5] The ANC firms are Citigroup Global Markets, Inc.; Goldman, Sachs & Co.; J.P. Morgan Securities LLC; BofA Securities, Inc.; and Morgan Stanley & Co. The OTCDD firms are Credit Suisse Capital, LLC; Goldman Sachs Financial Markets, LP; and Nomura Global Financial Products, Inc. According to agency officials, as of January 2020, three active OTCDD applications were in various stages of review.

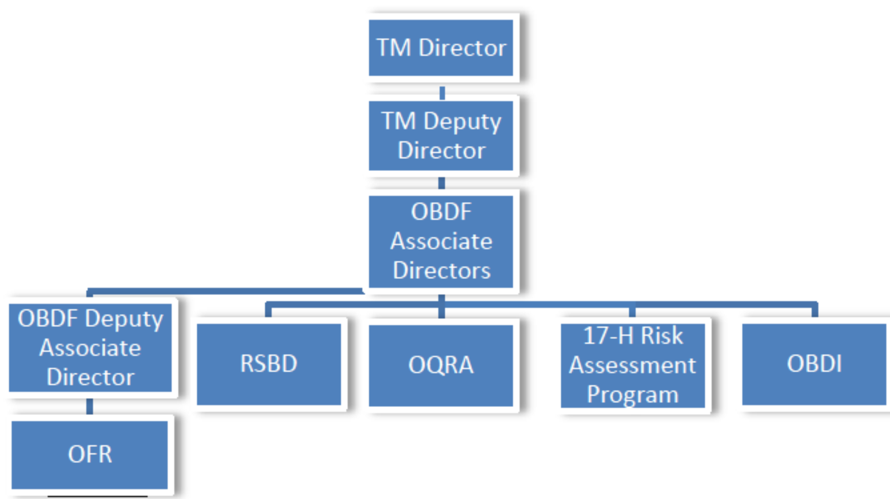
firms' senior quantitative modeling staff. In addition, OQRA offers technical and quantitative support to other SEC divisions and offices, as needed.

3. *Office of Financial Responsibility (OFR).* OFR is responsible for the legal aspects of administering the SEC's broker-dealer financial responsibility requirements, including drafting proposed and final rule releases, exemption orders, no-action letters, and briefing memoranda regarding related rules and providing guidance to internal and external parties on the requirements. OFR also oversees the SEC's self-regulatory organization margin rules and the Securities Investor Protection Corporation (SIPC).

4. *17-H Risk Assessment Program.* The 17-H Risk Assessment Program reviews the filings of the 280 (as of January 2020) broker-dealers subject to the SEC's risk assessment rules[6] (referred to as the 17-H rules) and the firms' material affiliates to assess the risks to the broker-dealers, including the risk of serious financial difficulty that may stem from affiliated entities or holding companies. Staff analyze financial dependencies, unregulated business activities, and other significant events that could adversely affect these broker-dealers, their customers, and the financial markets. Staff perform risk-based reviews each year based on several factors, including number of customer accounts, balance sheet size, and regulatory net capital.

5. *Office of Broker-Dealer Inspections (OBDI).* OBDI conducts targeted cross-firm inspections of each broker-dealer and OTCDD approved to use alternative methods to compute net capital. Specifically, OBDI reviews, compares, and contrasts each firm's risk management practices and framework for addressing market, credit, liquidity, legal, and operational risks. OBDI presents its inspections results to each firm and shares the results internally to assist OBDF with its oversight functions.

Figure 1. OBDF Organizational Chart



Source: OIG generated based on information obtained from the SEC's intranet site.

[6] As previously discussed, these are broker-dealers that hold customer funds or have regulatory capital equal to or greater than $20 million.

OBDF regulates approximately 3,700 broker-dealers with total assets of approximately $4.6 trillion. These broker-dealers have approximately 143 million public customer accounts. To accomplish its mission of monitoring broker-dealer compliance with the financial responsibility rules, OBDF received an appropriation of about $12.9 million in fiscal year 2019, which covered salaries and benefits for 46 full time equivalents.

Results of Prior Reviews. The SEC Office of Inspector General (OIG) reviewed the SEC's oversight of Bear Stearns and related entities and, in September 2008, issued Report No. 446-A[7] and Report No. 446-B.[8] These reports addressed the SEC's Consolidated Supervised Entity Program—created in 2004 as a way for global investment bank conglomerates that lack a supervisor under law to voluntarily submit to regulation—and the 17-H Risk Assessment Program, respectively.

Report No. 446-A identified numerous shortcomings in the Consolidated Supervised Entity Program. In Report No. 446-B, which followed up on a 2002 OIG audit,[9] the OIG determined that TM had not fulfilled its obligations in accordance with the underlying purpose of the 17-H Risk Assessment Program in several respects. The OIG also found that the majority of filers submitted paper documents and that TM was slow to encourage electronic filing.

Objective

Our overall objective was to assess the efficiency and effectiveness of TM's OBDF. Specifically, we determined whether OBDF (1) provides effective oversight of broker-dealer compliance with capital and risk reporting requirements, in accordance with applicable rules and guidance; and (2) ensures efficient use of Government resources to help achieve organizational goals and objectives.

To address our objectives, among other work performed, we (1) met with representatives from each OBDF sub-office; (2) reviewed applicable Federal laws, rules, and regulations and OBDF policies and procedures; (3) assessed TM's fiscal year 2018 risk and control matrix and management assurance statement; (4) obtained access to OBDF systems and shared drives; (5) compiled and tested key OBDF processes; (6) obtained and reviewed examples of OBDF program documentation, including evidence of OBDF's broker-dealer monitoring, inspection, and model review; and (7) obtained and reviewed results of prior OBDF organizational studies performed by consultants. Our assessment of OBDF's use of Government resources did not

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[7] U.S. Securities and Exchange Commission, Office of Inspector General, *SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program* (September 25, 2008, Report No. 446-A).

[8] U.S. Securities and Exchange Commission, Office of Inspector General, *SEC's Oversight of Bear Stearns and Related Entities: Broker-Dealer Risk Assessment Program* (September 25, 2008, Report No. 446-B).

[9] U.S. Securities and Exchange Commission, Office of Inspector General, *Broker-Dealer Risk Assessment Program* (August 13, 2002, Report No. 354).

include certain expenses such as travel and purchase card usage. However, we considered certain TM contract costs related to the intake and review of paper filings.

Appendix I includes additional information about our objectives, scope, and methodology; our review of internal controls; and prior coverage.

Results

Finding 1. OBDF Has Processes To Monitor Broker-Dealer Compliance With Net Capital and Risk Assessment Rules and Reporting Requirements, But Certain Updates Are Needed

OBDF effectively monitors broker-dealer compliance with net capital and risk assessment rules and reporting requirements. Specifically, OBDF's sub-offices support its mission and each has written policies and procedures with detailed processes that align with the organization's oversight requirements. Based on our review and testing, we found that OBDF's processes were effective for overseeing broker-dealer net capital and risk reporting. However, OBDI's policies lacked record retention and supervisory review requirements and should be updated.

As previously discussed, OBDF administers the SEC's ANC and OTCDD programs, performs quantitative risk analyses, monitors broker-dealers' compliance with risk assessment reporting requirements, and conducts broker-dealer inspections. During the period we reviewed, OBDF's sub-offices—RSBD, OQRA, OFR, the 17-H Risk Assessment Program, and OBDI—provided effective oversight of broker-dealer compliance with net capital and risk assessment rules and reporting requirements. In addition, organizational processes aligned with OBDF's oversight responsibilities. We reviewed the written policies, procedures, and other guidance established by each OBDF sub-office. We also tested each sub-office's key processes and controls, and assessed evidence of the following:

- RSBD's (1) review of applications to use ANC calculations and value-at-risk and other statistical models; (2) review of approved broker-dealers' and OTCDDs' required filings; (3) recurring meetings with approved broker-dealers and OTCDDs; (4) issue tracking and escalation practices; and (5) internal meetings and agency coordination.

- OQRA's (1) review of market and credit risk models used by broker-dealers and OTCDDs seeking approval to use alternative methods for calculating capital; (2) review of firms' material changes to approved models; and (3) technical and quantitative support provided to other SEC divisions and offices.

- OFR's (1) reviews of requests for broker-dealer exemption and other requests related to control locations, annual audit waivers, changes in net capital ratio requirements, Financial and Operational Combined Uniform Single (FOCUS) Report extensions and exemptions, and prepayment of subordinated debt; and

(2) processes for overseeing SIPC in accordance with the Securities Investor Protection Act of 1970.[10]

- The 17-H Risk Assessment Program's (1) intake and review of broker-dealer filings; (2) review of broker-dealers selected for annual reviews; (3) meetings with broker-dealers related to the 17-H rules; and (4) internal reporting.

- OBDI's inspection documentation, including (1) scope memoranda; (2) work plans; (3) document requests; (4) firm and internal presentations; and (5) inspection reports.

Appendix I provides additional detail on our scope and methodology for reviewing OBDF's sub-offices.

Overall, we found that each sub-office's processes aligned with established oversight requirements and that OBDF effectively monitored broker-dealers' compliance with net capital and risk assessment rules and reporting requirements during the periods we reviewed. However, certain updates are needed in OBDI to reflect current practices and requirements. Specifically, OBDI's written policies and procedures lacked record retention requirements and did not provide supervisory review procedures for inspection work products, such as inspection presentations or inspection reports. Although we were able to locate and review documents supporting OBDI inspections, clarifying OBDI's record retention requirements (that is, what should be retained and where) and supervisory review processes could strengthen controls over the inspection program, thereby improving efficiency.

OBDI management explained that the group is relatively small, with only one supervisor, and detailed policies and procedures were unnecessary. Nonetheless, OBDI management reviewed its policies and procedures and, in October 2019, provided a draft of updated policies. OBDF senior management agreed with our observation and acknowledged the need for updates.

Recommendation, Management's Response, and Evaluation of Management's Response

To strengthen OBDF's broker-dealer inspection program, we recommend that OBDF senior management:

Recommendation 1: Complete its review of policies and procedures for inspecting broker-dealers and consider defining supervisory review and record retention requirements in the updated version.

[10] 15 U.S.C. §§ 78aaa-78lll, as amended.

Management's Response. Management concurred with the recommendation. The Division of Trading and Markets has updated its written policies and procedures for inspecting broker-dealers to include supervisory review procedures for inspection work products and record retention requirements. The Division's senior management has reviewed and approved the revised policies and procedures. Management's complete response is reprinted in Appendix III.

OIG's Evaluation of Management Response. Management's proposed actions are responsive; therefore, the recommendation is resolved and will be closed upon verification of the action taken.

Finding 2. Efforts to Require Electronic Filings and Update the 17-H Rules, If Completed, Could Improve OBDF's Efficiency, Decrease Costs, and Reduce the Reporting Burden on Broker-Dealers Who Pose Little Risk

(b) (5) [redacted] Specifically, SEC strategic goal 2.2 states that the SEC should "Identify, and take steps to address, existing SEC rules and approaches that are outdated," noting that it is important for the SEC to continually analyze and seek feedback from investors and others about where rules are, or are not, functioning as intended.[11]

The Government Paperwork Elimination Act requires Federal agencies to allow individuals or entities that deal with the agencies the option to submit information or transact with the agency electronically, when practicable, and to maintain records electronically, when practicable.[12] In addition, the E-Government Act of 2002 was enacted to enhance the management and promotion of electronic Government services and processes.[13] In 2002 and 2008, the OIG recommended (1) encouraging broker-dealers to file required documents electronically, thereby reducing paper filings; and (2) updating and/or finalizing the 17-H rules, which remain in a temporary state and have not been updated or made permanent since their issuance in 1992, despite significant changes in broker-dealer operations and resulting risks. OBDF senior management acknowledged the potential benefits of completing these updates and drafted the proposals further described below.

Proposal To Require Broker-Dealers To File Electronically. Under OBDF's 17-H Risk Assessment Program and the 17-H rules, broker-dealers may submit to the SEC required filings electronically or in paper format. Although the number of broker-dealers that file paper forms under the 17-H rules has declined since the OIG began reporting on this issue in 2002, paper filings are less efficient than electronic filings. We

[11] U.S. Securities and Exchange Commission, *SEC Strategic Plan, Fiscal Years 2018-2022*.

[12] P.L. 105-277, 112 Stat 2681-749 (October 21, 1998).

[13] P.L. 107-347, 116 Stat 2899 (December 17, 2002).

determined that, as of July 2019, 33 of the 281 broker-dealers subject to the 17-H rules at the time (or about 12 percent) were expected to file by paper. Paper filings require additional intake and review steps, including professional scanning services provided by a contractor.

We assessed a judgmental sample of 10 scanning requests from OBDF's 17-H Risk Assessment Program and found that, on average, it took (b) (7)(E) [redacted] from receipt of the paper filing to verification of the completed scan, which is then retained in OBDF's Broker-Dealer Monitor system.[14] Paper filings have a limited impact on OBDF and the 17-H Risk Assessment Program but have a greater effect on TM, because the division receives thousands of paper filings each year and relies on the support of contractors for the intake, review, and scanning of these paper filings, at added costs.[15]

In 2015, TM issued a no-action letter detailing how broker-dealers file annual reports with the Commission in paper form, but file them with the Financial Industry Regulatory Authority electronically.[16] The letter states that staff would not recommend enforcement action to the Commission if a broker-dealer or OTCDD files annual and supplemental reports electronically through the Commission's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system. In 2017, TM followed up with an updated no-action letter providing a simplified process for electronic filing in EDGAR.[17] These letters permit electronic filing of broker-dealer reports but do not necessarily encourage electronic filing or explain the benefits of electronic forms.

(b) (5) [redacted] and the Commission included the proposal to require electronic filing in its fall 2019 rulemaking agenda as a long-term action. Reducing the number of paper filings could improve the overall efficiency of OBDF's processes for intake and review of required filings, reduce added costs related to paper filings, and align with the SEC's stated strategic goals.

(b) (5) [redacted]

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[14] Despite this delay, OBDF established processes to ensure staff timely review paper filings.

[15] TM uses an administrative support services contractor to assist with the intake and review of paper filings, with an annual obligated value of $623,362. TM also uses a professional scanning services contractor to scan paper filings received. Those services totaled $296,592 for fiscal year 2018 and $177,866 for fiscal year 2019 through August 2019.

[16] *Electronic Filing of Broker-Dealer Annual Reports with the Securities and Exchange Commission* (December 21, 2015).

[17] *Simplified Process for Electronic Filing of Broker-Dealer Annual Reports with the Securities and Exchange Commission* (January 27, 2017).

(b) (5) [redacted]

(b) (5) [redacted]

Raising the capital threshold for reporting under the 17-H rules would benefit both OBDF and the broker-dealers. The 17-H Risk Assessment Program would receive fewer quarterly and annual 17-H filings, increasing the overall efficiency of the filing intake and review processes. Additionally, the increased capital threshold would align with the SEC's stated strategic goals by addressing outdated SEC rules and reduce the reporting burden on smaller broker-dealer firms that currently file Form 17-H quarterly and annually.

Recommendation, Management's Response, and Evaluation of Management's Response

To improve OBDF's overall efficiency, decrease costs, and reduce the reporting burden on broker-dealer firms who pose little risk and in accordance with SEC strategic goal 2.2, we recommend that OBDF senior management:

Recommendation 2: Finalize steps deemed feasible and prudent and, as necessary, (a) require broker-dealers to electronically file with the Commission annual reports and risk assessment reports, and (b) raise the capital threshold for reporting under the 17-H rules.

> **Management's Response.** Management concurred with the recommendation. The Division of Trading and Markets will continue to work with relevant offices to consider whether to recommend that the Commission revise its rules to require broker-dealers to file certain reports electronically instead of in paper. The Division will also consider whether to recommend that the Commission raise the capital threshold for reporting under the 17-H rules, last updated in 1992. Management's complete response is reprinted in Appendix III.

OIG's Evaluation of Management Response. Management's proposed actions are responsive; therefore, the recommendation is resolved and will be closed upon verification of the action taken.

Finding 3. OBDF Could Benefit From Formal Strategic and Succession Planning

We found that neither OBDF nor TM has a finalized, written strategic plan and that OBDF has not developed a formal succession plan. Although we obtained reasonable assurance of OBDF's efficient use of Government resources and we did not identify waste,[18] we were unable to link OBDF's programs and resources to its goals and objectives. TM has drafted a strategic plan that includes goals for OBDF but, according to the TM Managing Executive, the final plan has been delayed because of an extensive rulemaking agenda. We reviewed the draft TM strategic plan and discussed OBDF's strategic and succession planning with OBDF senior management who confirmed that, while there have been planning discussions, formal plans have not been established.

According to the Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government*, internal control helps an entity run its operations efficiently and effectively, and strategic planning is a component of internal control. Specifically, GAO's standards state the following:

- The entity determines its mission, sets a strategic plan, establishes entity objectives, and formulates plans to achieve its objectives.
- Management, with oversight by an oversight body, sets objectives to meet the entity's mission, strategic plan, and goals and requirements of applicable laws and regulations.
- Management sets objectives before designing an entity's internal control system and may include setting objectives as part of the strategic planning process.

Also, in an October 2019 report,[19] GAO identified best practices for succession planning, including developing succession plans aligned with strategic goals and analyzing current and future workforce gaps. The Office of Personnel Management's *Guidance on Establishing an Annual Leadership Talent Management and Succession Planning Process* defines "succession planning" as:

> . . . a proactive and systematic process where organizations identify those positions considered to be at the core of the organization—i.e., too critical to be left vacant or filled by any but the best qualified persons—and then

[18] As defined by the U.S. Government Accountability Office, "reasonable assurance" is a "high degree of confidence, but not absolute confidence", and "waste" is "the act of using or expending resources carelessly, extravagantly, or to no purpose." [U.S. Government Accountability Office, *Standards for Internal Control in the Federal Government* (GAO-14-704G, September 2014)].

[19] U.S. Government Accountability Office, *Department of Veterans Affairs: Improved Succession Planning Would Help Address Long-Standing Workforce Problems* (GAO-20-15, October 2019).

create a strategic plan to fill those positions with qualified and capable employees.

As shown in Figure 2, the Office of Personnel Management's guidance describes the succession planning process in five stages.

Figure 2. Succession Planning Process

Stage 1
- Determine future executive resources needs

Stage 2
- Evaluate current talent state

Stage 3
- Align talent to agency needs

Stage 4
- Finalize executive development plans

Stage 5
- Implement and update plans

Source: OIG-generated based on Office of Personnel Management guidance.

The prior consultant's reports resulting from the organizational alignment review of OBDF concluded that the office lacked a unified, office-wide strategy and did not make use of strategic planning. The reports also noted that OBDF did not have a formal succession plan. We found that although planning discussions have taken place, OBDF does not have a finalized, written strategic plan and has not developed a formal succession plan. Without such plans, we were unable to link OBDF's programs and resources to its or TM's organizational goals and objectives. Additionally, without performance goals and metrics, OBDF may limit efficiency and its ability to identify and assess areas that are performing well or need improvement.

Recommendation, Management's Response, and Evaluation of Management's Response

To ensure OBDF's programs and resources are aligned with organizational goals and objectives, we recommend that OBDF senior management:

Recommendation 3: Finalize efforts to develop or support the development of plans that coherently link the organization's programs and resources, including its future executive resource and other workforce needs, to organizational goals and objectives.

Management's Response. Management concurred with the recommendation. The Commission's Office of Human Resources initiated a succession planning process on a Commission-wide basis last year. As part of that process and to determine potential future executive resource needs, the Division of Trading and Markets evaluated the staff of the Office of Broker-Dealer Finances and other Division offices. The Division also undertook an evaluation of the current talent state within its offices. With respect to strategic planning, the Division of Trading and Markets will work to finalize a strategic plan for the Office of Broker-Dealer Finances in fiscal year 2020. Management's complete response is reprinted in Appendix III.

OIG's Evaluation of Management Response. Management's proposed actions are responsive; therefore, the recommendation is resolved and will be closed upon verification of the action taken.

Appendix I. Scope and Methodology

We conducted this evaluation from June 2019 through February 2020 in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation* (2012). Those standards require that we plan and perform the evaluation to obtain sufficient, competent, and relevant evidence to provide a reasonable basis for our findings, conclusions, and recommendations based on our evaluation objective. We believe that the evidence obtained provides a reasonable basis for our findings, conclusions, and recommendations based on our evaluation objective.

Scope and Objective. The evaluation covered OBDF operations and activities between 2012 and 2019. The overall objective was to assess the efficiency and effectiveness of TM's OBDF. Specifically, we sought to determine whether OBDF (1) provides effective oversight of broker-dealer compliance with capital and risk reporting requirements, in accordance with applicable rules and guidance; and (2) ensures efficient use of Government resources to help achieve organizational goals and objectives.

Methodology. We conducted fieldwork at the SEC's Headquarters in Washington, DC. To assess OBDF and determine whether it provided effective oversight, we:

- interviewed TM management, as well as OBDF management and staff;
- reviewed applicable Federal laws, regulations, and guidance, and OBDF policies and procedures;
- compiled key OBDF processes by sub-office and tested processes (detailed below);
- performed walkthroughs of OBDF systems and shared drives; and
- reviewed the 2016 and 2018 results of OBDF organizational studies performed by consultants.

We tested each sub-office's key processes and controls for oversight activities that, unless otherwise stated, generally occurred between 2012 and 2019. Specifically, we assessed evidence of the following:

<u>RSBD</u>

- Applications of all firms that applied to participate in the ANC and OTCDD programs between 2012 and 2019.
- Review of approved broker-dealer and OTCDD filings such as FOCUS reports, graphs reflecting daily intra-month value-at-risk by business line, back-testing

reports, management risk reports, annual audited financials, and accountants' reports on 15c3-4 compliance.

- Internal monthly ANC coordination meetings, as well as evidence of reoccurring meetings with participating firms.

- Project lists, monthly status reports, and filing inventory checklists to verify OBDF's tracking and escalation of issues that may arise, as well as tracking and retention of pertinent documents.

<u>OQRA</u>

- Monitoring of material and non-material model changes for ANC broker-dealers between 2014 and 2019.

- Internal and external correspondence supporting OQRA's review of market and credit risk model changes, including requests for additional information and model review methodologies.

- Quantitative model review support for internal SEC offices such as TM's Office of Clearance and Settlement.

<u>OFR</u>

- Checklists associated with reviews of requests for broker-dealer exemptions and requests related to control locations, annual audit waivers, changes in net capital ratio requirements, FOCUS extensions and exemptions, and prepayment of subordinated debt.

- SIPC oversight documents that OFR reviewed in accordance with the Securities Investor Protection Act of 1970, including proposed bylaws changes, proposed rule changes, monthly and annual reports, and inspection reports.

- Action memos, review requests, phone logs, project lists, and draft orders and other memoranda.

<u>17-H Risk Assessment Program</u>

- 17-H Broker-Dealer Monitor system reports, including the 17-H broker-dealer list, filings list, broker-dealer financials report, customer-carrying and clearing report, 17-H events list, and 17-H meetings list.

- 17-H filings monitor lists to determine whether, between 2017 and 2019, OBDF monitored for compliance with the reporting requirements of the 17-H rules (during this period, only two filings were delinquent).

- 17-H paper filing scanning logs, from which we selected and tested a judgmental sample of 10 scanning requests.

OBDI

- Inspection work plans, scope memoranda, information and document requests, and meeting documents for inspections performed between 2016 and 2019, including the internal audit inspection, the model risk management inspection, and the liquidity stress test inspection.

- Firm presentations, internal presentations, and inspection reports for the internal audit inspection.

Internal Controls. To assess internal controls relative to our objectives, we reviewed TM's Management Assurance Statement and Risk Control Matrix for fiscal year 2018. TM indicated in its Management Assurance Statement that no control deficiencies have been identified. However, the Management Assurance Statement did not specifically address OBDF or OBDF's control activities. As a result, as described in this report, we reviewed each OBDF sub-office's policies and procedures, and assessed whether each process and control activity aligned with identified criteria and with the sub-office's oversight requirements for broker-dealer capital and risk reporting. Though our testing of OBDF sub-offices did not identify processes that were not aligned with oversight responsibilities, as discussed in Finding 1, we noted that OBDI's written policies and procedures did not include supervisory review processes and inspection record retention policies, which we believe to be a best practice. Also, as discussed in Finding 2, efforts to reduce the number of paper filings and raise existing filing thresholds would improve the efficiency of OBDF internal processes and align with SEC strategic goals. As reported in Finding 3, we were unable to link OBDF's programs and resources to its or TM's organizational goals and objectives. Without performance goals and metrics, OBDF may limit efficiency and its ability to identify and assess areas that are performing well or need improvement. TM and OBDF are working on strategic and succession plans to address this concern. Our recommendations, if implemented, should address these deficiencies.

Computer-Processed Data. We did not rely significantly on computer-processed data to address our objectives. Therefore, we did not test system controls for the reliability of any computer-processed data. [20]

Prior Coverage. Since 2002, the SEC OIG and GAO have issued the following four reports of particular relevance to this evaluation:

SEC OIG:

- *Broker-Dealer Risk Assessment Program* Audit No. 354 (August 13, 2002).

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[20] GAO-20-283G*, Assessing Data Reliability*, published on December 16, 2019, supersedes GAO-09-680G, *Assessing the Reliability of Computer-Processed Data* (July 2009). However, our evaluation was initiated prior to the release of this revised guidance; therefore, we used the guidance in place at the start of our evaluation.

- *SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program* Report No. 446-A (September 25, 2008).

- *SEC's Oversight of Bear Stearns and Related Entities: Broker-Dealer Risk Assessment Program* Report No. 446-B (September 25, 2008).

GAO:

- *Financial Market Regulation – Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration* (GAO-07-154; March 15, 2007).

These reports can be accessed at: https://www.sec.gov/oig (SEC OIG) and https://www.gao.gov (GAO).

Appendix II. Net Capital and Risk Assessment Rules

To ensure fair, orderly, and efficient markets, the SEC established, among other things, 20 rules promulgated under the Exchange Act and overseen by OBDF that require broker-dealers to maintain financial and risk assessment records, compute and report certain net capital calculations, and follow other financial requirements. Some of the key rules overseen by OBDF are as follows:

- *Rule 15c3-1e Deductions for Market and Credit Risk for Certain Brokers or Dealers.*[21] Appendix E sets forth a program that allows a broker or dealer to use an alternative approach to computing net capital deductions, subject to the conditions described in §§ 240.15c3-1e and 240.15c3-1g, including supervision of the broker's or dealer's ultimate holding company under the program. A broker or dealer may apply to the Commission for authorization to compute deductions for market risk pursuant to Appendix E in lieu of computing deductions pursuant to §§240.15c3-1(c)(2)(vi) and (c)(2)(vii).

- *Rule 15c3-1f Optional Market and Credit Risk Requirements for OTC Derivatives Dealers.*[22] OTCDDs may apply to the Commission for authorization to compute capital charges for market and credit risk pursuant to this Appendix F in lieu of computing securities haircuts pursuant to § 240.15c3-1(c)(2)(vi). OTCDDs shall provide a description of all statistical models used for pricing over-the-counter derivative instruments and for computing value-at-risk, a description of the applicant's controls over those models, and a statement regarding whether the firm has developed its own internal value-at-risk models.

- *Rule 15c3-*4 *Internal Risk Management Control Systems for OTC Derivatives Dealers*.[23] An OTCDD shall establish, document, and maintain a system of internal risk management controls to assist it in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.

- *Rule 17h-1T Risk Assessment Recordkeeping Requirements for Associated Persons of Brokers and Dealers*.[24] Every broker or dealer registered with the Commission pursuant to Section 15 of the Exchange Act, and every municipal securities dealer registered pursuant to Section 15B of the Act for which the Commission is the appropriate regulatory agency, unless exempt pursuant to

[21] 17 C.F.R. § 240.15c3-1e.

[22] 17 C.F.R. § 240.15c3-1f.

[23] 17 C.F.R. § 240.15c3-4.

[24] 17 C.F.R. § 240.17h-1T.

paragraph (d) of this rule, shall maintain and preserve information such as organizational charts, written policies, procedures, and other documentation outlined in the rule.

- *Rule 17h-2T Risk Assessment Reporting Requirements for Brokers and Dealers*.[25] Every broker or dealer registered with the Commission pursuant to Section 15 of the Exchange Act, and every municipal securities dealer registered pursuant to Section 15B of the Act for which the Commission is the appropriate regulatory agency, unless exempt pursuant to paragraph (b) of this rule, shall file a Form 17-H within 60 calendar days after the end of each fiscal quarter. The Form 17-H for the fourth fiscal quarter shall be filed within 60 calendar days of the end of the fiscal year. The cumulative year-end financial statements required by section 240.17h-1T may be filed separately within 105 calendar days of the end of the fiscal year.

[25] 17 C.F.R. § 240.17h-2T.

Appendix III. Management Comments

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

DIVISION OF
TRADING AND MARKETS

MEMORANDUM

TO: Rebecca L. Sharek
Deputy Inspector General for Audits, Evaluations, and Special Projects
Office of the Inspector General

FROM: Brett W. Redfearn
Director, Division of Trading and Markets

DATE: February 21, 2020

RE: Division of Trading and Markets' Response to the Office of Inspector General's Report, *The SEC's Office of Broker-Dealer Finances Provides Effective Oversight, But Opportunities to Improve Efficiency Exist*

The Division of Trading and Markets ("Division") submits this memorandum in response to the Office of the Inspector General's ("OIG") draft report entitled *The SEC's Office of Broker-Dealer Finances Provides Effective Oversight, But Opportunities to Improve Efficiency Exist*.

The Division appreciates the OIG's findings that: (1) the Office of Broker-Dealer Finances ("OBDF") effectively monitors broker-dealer compliance with net capital and risk assessment rules and reporting requirements; (2) OBDF's sub-offices support its mission and each has written policies and procedures with detailed processes that align with the organization's oversight requirements; and (3) OBDF's processes were effective for overseeing broker-dealer net capital and risk reporting.

We welcome the OIG's findings and will take steps to address them. Our response to the findings is below.

Recommendation 1: *Complete its review of policies and procedures for inspecting broker-dealers and consider defining supervisory review and record retention requirements in the updated version.*

The Division concurs with this recommendation. The Division has updated its written policies and procedures for inspecting broker-dealers to include supervisory review procedures for inspection work products and record retention requirements. The Division's senior management has reviewed and approved the revised policies and procedures.

Recommendation 2: *Finalize steps deemed feasible and prudent and, as necessary, (a) require broker-dealers to electronically file with the Commission annual reports and risk assessment reports, and (b) raise the capital threshold for reporting under the 17-H rules.*

The Division concurs with this recommendation. The Division will continue to work with relevant offices to consider whether to recommend that the Commission revise its rules to require broker-dealers to file certain reports electronically instead of in paper. The Division will also consider whether to recommend that the Commission raise the capital threshold for reporting under the 17-H rules, last updated in 1992.

Recommendation 3: *Finalize efforts to develop or support the development of plans that coherently link the organization's programs and resources, including its future executive resource and other workforce needs, to organizational goals and objectives.*

The Division concurs with the recommendation. The Commission's Office of Human Resources ("OHR") initiated a succession planning process on a Commission-wide basis last year. As part of that process, the Division evaluated the staff of OBDF and other Division offices to determine the potential future executive resource needs. The Division also undertook an evaluation of the current talent state within its offices. The Division is committed to completing, implementing and updating its succession planning so that it conforms to GAO best practices and OPM guidance. With respect to strategic planning, the Division will work to finalize a strategic plan for OBDF in FY 2020.

We appreciate the opportunity to review and comment on the Report. Please contact Michael Macchiaroli, Associate Director, or Tom McGowan, Associate Director, if you have any questions.

Major Contributors to the Report

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To Report Fraud, Waste, or Abuse, Please Contact:

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Telephone: 1-833-SEC-OIG1 (833-732-6441)

Address: U.S. Securities and Exchange Commission
Office of Inspector General
100 F Street, N.E.
Washington, DC 20549

Comments and Suggestions

If you wish to comment on the quality or usefulness of this report or suggest ideas for future audits, evaluations, or reviews, please send an e-mail to OIG Audit Planning at AUDplanning@sec.gov. Comments and requests can also be mailed to the attention of the Deputy Inspector General for Audits, Evaluations, and Special Projects at the address listed above.