



# NATIONAL EXAM PROGRAM

OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

## Examination Priorities for 2014<sup>1</sup>

January 9, 2014

### I. Introduction

The National Examination Program (“NEP”) is publishing its 2014 examination priorities to communicate with investors and registrants about areas that the staff perceives to have heightened risk and to support the Securities and Exchange Commission (“SEC”) mission to protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation.

These examination priorities areas were selected collaboratively by senior staff from the NEP’s twelve offices, as well as by 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 SEC,
- Information gathered through examinations conducted by the NEP and other regulators,
- Communications with other U.S. and international regulators and agencies,
- Comments and tips received directly from investors and registrants,
- Data maintained in third party databases,
- Interactions with registrants, industry groups, and service providers outside of examinations, and
- Industry and media publications.

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 program areas: (i) investment advisers and investment companies (“IA-IC”), (ii) broker-dealers (“B-D”), (iii) exchanges and self-regulatory organizations (“SROs”, and collectively, “market oversight”), and (iv) clearing and transfer agents (“CA” and “TA”).

This description of NEP priorities is not exhaustive. While the NEP expects to allocate significant resources throughout 2014 to the examination of the issues described below, the NEP will conduct additional examinations in 2014 focused on risks, issues, and policy matters that are not discussed here. These additional examinations may result from market developments, new information learned from

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<sup>1</sup> The views expressed herein are those of the staff of the Office of Compliance Inspections and Examinations, in coordination with other SEC staff including the Divisions of Trading and Markets, Enforcement, and Investment Management. The Commission has expressed no view on its contents. This document was prepared by the SEC staff and is not legal advice.

examinations or other sources, and coordination with other regulators. Similarly, the NEP may focus its resources on a subset of the risks and issues identified here.

## II. NEP-Wide Initiatives

The most significant initiatives across the entire NEP include:

**Fraud Detection and Prevention.** Our Nation’s capital markets are built on trust. Scams, theft, unfair advantage, and other fraudulent conduct erode that trust and adversely affect investors and the efficient functioning of our markets.<sup>2</sup> As part of its risk-based approach to targeting registrants and business practices, the NEP will continue to utilize and to enhance its quantitative and qualitative tools and techniques to seek to identify market participants engaged in fraudulent or unethical behavior.<sup>3</sup>

**Corporate Governance, Conflicts of Interest, and Enterprise Risk Management.** The NEP will continue to meet with senior management and boards of entities registered with the SEC, including their affiliates where appropriate, to discuss how each firm identifies and mitigates conflicts of interest and legal, compliance, financial, and operational risks. This initiative is designed to: (i) evaluate firms’ control environment and “tone at the top,” (ii) understand firms’ approach to conflict and risk management, and (iii) initiate a dialogue on key risks and regulatory requirements.

**Technology.** The capital markets are experiencing a decades-long revolution in technology, and the increasing complexity, interconnectedness, and speed fostered by technology continues to challenge market participants and regulators. The NEP will continue to examine governance and supervision of information technology systems, operational capability, market access, information security, and preparedness to respond to sudden malfunctions and system outages.<sup>4</sup>

**Dual Registrants.** The convergence among broker-dealer and investment adviser representative activity continues to be a significant risk. For example, representatives of dual registrants, *i.e.*, registrants that are both broker-dealers and investment advisers, and affiliated advisers and broker-dealers may influence whether a customer establishes a brokerage or investment advisory account. This influence

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<sup>2</sup> Examples of fraud cases brought or adjudicated in FY 2013 based on SEC exam referrals include, among many others, In re J.S. Oliver Capital Management (Aug. 30, 2013); SEC v. OM Investment Management LLC (Sept. 27, 2013); SEC v. Advanced Equity Partners, LLC (Sept. 26, 2013), SEC v. Bethancourt (May 7, 2013), In re Johnny Clifton (July 12, 2013); SEC v. Wilson (Nov. 15, 2012); In re Riad (Dec. 19, 2012); and In re Fiduciary Asset management, LLC, Dec. 19, 2012).

<sup>3</sup> The resources that the NEP has expanded in 2013 include its Quantitative Analytics Unit, a team of specialists with post-graduate degrees in fields such as computer science and mathematics that is able to evaluate risks in the algorithms, models, and software of the most sophisticated investment firms, as well as the NEP’s Risk Analysis Examination initiative, which examines clearing firms and large broker-dealers by downloading and analyzing all transactions cleared by a firm over a period of several years.

<sup>4</sup> For example, in 2013, the NEP issued a risk alert and a joint public report, with the Commodity Futures Trading Commission and the Financial Industry Regulatory Authority, on business continuity and disaster recovery planning for financial service firms impacted by Hurricane Sandy. *See* Risk Alert on SEC Examinations of Business Continuity Plans of Certain Advisers Following Operational Disruptions Caused by Weather-Related Events Last Year (Aug. 27, 2013), available at <http://www.sec.gov/about/offices/ocie/business-continuity-plans-risk-alert.pdf>, and Joint Review of the Business Continuity and Disaster Recovery Planning of Firms (Aug. 16, 2013), available at <http://www.sec.gov/about/offices/ocie/jointobservations-bcps08072013.pdf>.

may create a risk that customers are placed in an inappropriate account type that increases revenue to the firm and may not provide a corresponding benefit to the customer. The NEP will continue to examine the significant risks to investors of migration and other conflicts this business model presents. The NEP will also continue to examine the impact to investors of the different supervisory structures and legal standards of conduct that govern the provision of brokerage and investment advisory services.

**New Laws and Regulation.** The staff will review general solicitation practices and verification of accredited investor status under newly adopted Rule 506(c) under the Securities Act of 1933 to the extent conducted by a regulated entity; generally will review, monitor, and analyze the use of Rule 506(c); and will evaluate due diligence conducted by broker-dealers and investment advisers for such offerings. As regulatory requirements for crowdfunding offerings and entities become effective, the NEP also expects to examine industry developments and compliance with such new rules.

The staff also will be conducting reviews to assess compliance with the recently adopted rules by municipal advisors. Similarly, in the event that rules are in place regarding security-based swaps dealers and other registered entities created or impacted by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), the staff expects to allocate resources to conduct reviews of those registrants, as well as customer margin and operational practices resulting from centralized clearing for various security-based swap products.

**Retirement Vehicles and Rollovers.** During changes in employment or when entering retirement, investors are left with multiple options as to treatment of their retirement plan assets held at their former employer. Investment advisers and broker-dealers may have incentives to recommend that the assets be placed with an IRA or other alternative offered by a financial services firm. The staff will undertake several initiatives, including:

- (a) examining the sales practices of investment advisers targeting retirement-age workers to roll over their employer-sponsored 401(k) plan into higher cost investments, including whether advisers are misrepresenting their credentials or the benefits and features of individual retirement account (“IRA”) plans or other alternatives, and
- (b) examining broker-dealers and investment advisers for possible improper or misleading marketing and advertising, conflicts, suitability, churning, and the use of potentially misleading professional designations when recommending the movement of assets from a retirement plan to an IRA rollover account in connection with a customer’s or client’s change of employment.

### **III. Program Area-Specific Initiatives**

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

“Core risks” are those risk areas that are common to the business model utilized by a particular category of registrant and that have existed for a sustained period and are likely to continue for the foreseeable future. Certain of these core risks have been selected as focus areas in 2014 because of their significance in recently conducted examinations.

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

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

Across all of the program areas, 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. Exam scopes will vary from registrant to registrant, depending on the registrant’s business activity and the risk associated with such activity. Nevertheless, across each program, certain issues predominate. In addition to the specific risks unique to each registrant, the staff will consider the focus areas described below when scoping and conducting examinations in 2014.

#### **INVESTMENT ADVISER/INVESTMENT COMPANY 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 \$55 trillion for investors.

##### **➤ Core Risks.**

**Safety of Assets and Custody.** If the markets run on trust, then few things are more important than the safekeeping of clients’ assets. Yet, the NEP continues to observe non-compliance with Rule 206(4)-2 under the Advisers Act (“Custody Rule”). In March, 2013, the NEP published a Risk Alert, sharing observations regarding the most common issues of non-compliance.<sup>5</sup> Given the importance of this requirement for a fiduciary, the staff will continue to test compliance with the Custody Rule and confirm the existence of assets through a risk-based asset verification process. Examiners will pay particular attention to those instances where advisers fail to realize they have custody and therefore fail to comply with requirements of the Custody Rule.

**Conflicts of Interest Inherent in Certain Investment Adviser Business Models.**<sup>6</sup> Over time, the staff has observed instances of non-compliance with the federal securities laws very often arise in situations where there are unaddressed conflicts of interest. Registrants engage in activity that puts their own interests ahead of their clients in contravention of their fiduciary duty and existing laws, rules, and

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<sup>5</sup> Significant Deficiencies Involving Adviser Custody and Safety of Client Assets (March 4, 2013), *available at* <http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf>. Cases brought in this area in 2013 arising out of exam referrals include In re GW & Wade, LLC (Oct. 28, 2013), In re Further Lane Asset Management, LLC (Oct. 28, 2013); In re Knelman Asset Management Group, LLC (Oct. 28, 2013); and SEC v. OM Investment Management LLC (Sept. 27, 2013).

<sup>6</sup> Cases brought in 2013 related to conflicts in the adviser business model include In re Goelzer Investment Management (July 31, 2013) (best execution); In re Manarin Investment Counsel, Ltd. (Oct. 2, 2013) (best execution); In re Parallax Investments, LLC (Nov. 26, 2013) (principal transactions); In re Equitas Capital Advisors, LLC (Oct. 23, 2013)(compliance); In re Gisclair (Oct. 23, 2013)(compliance); In re Stastney (Sept. 18, 2013)(principal transaction); and In re J.S. Oliver Capital Management (Aug. 30, 2013)(cherry-picking, soft dollars).

regulations. Yet, they too often do not perceive or properly mitigate the conflict. The staff will therefore conduct examinations focused on conflicts of interest inherent in the business model, including:

- Compensation arrangements for the adviser, with a particular focus on undisclosed compensation arrangements and their effect on recommendations made to clients,
- The allocation of investment opportunities,
- Controls and disclosure associated with side-by-side management of performance-based and purely asset-based fee accounts,
- Risk controls and disclosure, particularly for illiquid investments and leveraged investment products and strategies, and
- Higher risk products or strategies targeted to retail (and especially retired or elderly) investors.

**Marketing/Performance.**<sup>7</sup> The staff will review the accuracy and completeness of advisers' claims about their investment objectives and performance. For example, the staff will review and test hypothetical and back-tested performance, the use and disclosure of composite performance figures, performance record keeping, and compliance oversight of marketing. The staff also expects to review marketing efforts arising out of newly effective rules adopted under the Jumpstart Our Business Startups ("JOBS") Act.

➤ **New and Emerging Issues and Initiatives.**

**Never-Before Examined Advisers.** This initiative will address advisers that have never been examined and are not part of the Presence Exam initiative (referenced below). The staff will utilize a number of strategies to conduct focused, risk-based examinations of the adviser population that has been registered for more than three years but has not yet been examined by the NEP.

**Wrap Fee Programs.** The staff will assess whether advisers are fulfilling their fiduciary and contractual obligations to clients and will review the processes in place for monitoring wrap fee programs recommended to advisory clients, related conflicts of interest, best execution, trading away from the sponsor, and disclosures.

**Quantitative Trading Models.** The staff will examine investment advisers with substantial reliance on quantitative portfolio management and trading strategies and assess, among other things, whether these firms have adopted and implemented compliance policies and procedures tailored to the performance and maintenance of their proprietary models, including such procedures as (i) evaluating if any models are used to manipulate the markets, (ii) reasonably review or test the models and their output over time, (iii) maintaining proper documentation within required books and records, and (iv) maintaining a current inventory of all firm-wide proprietary models.

**Presence Exams.** The staff will continue the 2012 initiative to examine a significant percentage of the advisers registered since the effective date of Section 402 of the Dodd-Frank Act. The five key focus areas of these examinations are marketing, portfolio management, conflicts of interest, safety of client assets, and valuation. The vast majority of these new registrants are advisers to hedge funds and private

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<sup>7</sup> Cases in 2013 concerning marketing and performance that arose out of SEC exam referrals include *In re Modern Portfolio Management, Inc.* (Oct. 23, 2013).

equity funds that were not registered or regulated by the SEC prior to the Dodd-Frank Act, and have never been examined by the SEC. The staff will also continue to prioritize examinations of private fund advisers where the staff's analytics indicate higher risks to investors, or where there are indicia of fraud, broker-dealer status concerns, or other serious wrongdoing.<sup>8</sup>

**Payments for Distribution in Guise.** The staff will continue its review of the 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. The staff will assess whether such payments are, in fact, payments for distribution and preferential treatment.

**Fixed Income Investment Companies.** The staff will monitor the risks associated with a changing interest rate environment and the impact this may have on bond funds and related disclosures of risks to investors.

➤ **Policy Topics.**

**Money Market Funds.**<sup>9</sup> NEP staff will continue targeting some examinations at money market funds, focusing particularly on how they have managed any potential stress events and working with Division of Investment Management staff to examine particular money market funds that exhibit outlier behavior in some respect.

**“Alternative” Investment Companies.** The staff will continue its assessment of funds offering “alternative” investment strategies, with a particular focus on: (i) leverage, liquidity and valuation policies and practices; (ii) the staffing, funding, and empowerment of boards, compliance personnel, and back-offices; and (iii) the manner in which such funds are marketed to investors. The staff will additionally review the representations and recommendations made regarding the suitability of such investments.

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<sup>8</sup> As of September 30, 2013, over 200 presence exams had been completed and the Presence Exam initiative was on pace to meet its goal of touching 25 per cent of advisers newly registered with the SEC under the Dodd-Frank Act within two years. Examination teams from every regional office have participated in the Presence Exam initiative. Exam teams have identified multiple issues in each of the five focus areas mentioned above. Presence examinations have contributed to several developments in 2013, including

- (a) guidance from the Division of Investment Management that resulted from information about the application of the Advisers Act custody rule to non-transferable stock certificates held by audited pooled investment vehicles. The guidance states that the Staff would not object if an adviser to a pooled investment vehicle does not maintain non-transferable stock certificates or “certificated” LLC interests obtained in a private placement with its custodian if certain conditions are met. See <http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf>; and
- (b) a speech by an official in the Division of Trading and Markets cautioning private fund advisers on broker-dealer registration issues identified in several examinations. “A Few Observations in the Private Fund Space,” Remarks by David W. Blass (April 5, 2013), available at <http://www.sec.gov/News/Speech/Detail/Speech/1365171515178>.

<sup>9</sup> Cases brought in 2013 involving money-market fund operations include Ambassador Capital Management, LLC (Nov. 26, 2013).

**Securities Lending Arrangements.** The staff will examine securities lending arrangements to determine whether they comply with exemptive orders and evaluate consistency with relevant no-action letters.

## **BROKER-DEALER EXAM PROGRAM**

The Broker-Dealer (“B-D”) Program manages the SEC’s examination program for nearly 4,500 registered broker-dealers with approximately 113 million customer accounts, over 160,000 branch offices, and over 630,000 registered representatives. The B-D Program also coordinates closely with the Financial Industry Regulatory Authority (“FINRA”), other SRO’s and state regulators to share information from examinations, compare priorities, and maximize examination coverage.

### ➤ **Core Risks.**

**Sales Practices/Fraud.**<sup>10</sup> The B-D Program will conduct examinations to detect and to prevent fraud and other violations in connection with sales practices to retail investors, including:

- Affinity fraud targeting seniors or other groups,
- Micro-cap fraud and pump and dump schemes,
- Unsuitable recommendations of higher yield and complex products (e.g., leveraged ETFs and structured products), as well as the adequacy of due diligence, and
- Unregistered entities engaged in the sale or promotion of unregistered offerings or other unusual capital raising activities.

**Supervision.**<sup>11</sup> The staff will focus on broker-dealers’ supervision of: (i) independent contractors and financial advisors in “remote” locations and large branch offices, (ii) registered representatives with significant disciplinary histories, and (iii) private securities transactions. All three factors present challenges to the ability of the broker-dealer to supervise with a view to preventing securities law violations.

**Trading.**<sup>12</sup> The staff will focus on market access controls related to, among other things, erroneous orders; the use of technology with a focus on algorithmic and high frequency trading; information leakage and cyber security; market manipulation involving practices such as marking the close, parking, fraudulent stimulation of demand (spoofing), and excessive markups and markdowns. The staff will

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<sup>10</sup> SEC cases brought or adjudicated in 2013 included *In re Clifton* (July 12, 2013) (oil and gas leases) and *In re Advanced Equity* (Sept. 26, 2013) (sale of unregistered stock to senior citizens). In addition, a case brought in 2012 involving a broker-dealer registered representative who misappropriated funds from a 94-year old retiree, among other charges, resulted in a recent four year prison sentence in a parallel criminal matter. See *SEC v. Rothman* (Sept. 24, 2012), “Judge Sentences Bucks County Investment Advisor to Four years for Embezzlement Scheme,” available at [http://www.justice.gov/usao/pae/News/2013/November/rothman\\_release.htm](http://www.justice.gov/usao/pae/News/2013/November/rothman_release.htm) (Nov. 14, 2013). See also Investor Bulletin: Affinity Fraud, by the SEC Office of Investor Advocacy and Education available at <http://investor.gov/news-alerts/affinity-fraud>.

<sup>11</sup> SEC cases brought in 2013 involving allegations of failure to supervise independent contractors, financial adviser or registered representatives include *In re Saviano* (Sept. 6, 2013) and *In re Hernandez*, (Sept. 24, 2013).

<sup>12</sup> SEC cases regarding significant trading issues brought in 2013 included *In re Knight Capital Americas LLC* (Oct. 16, 2013) and *SEC v. Bethancourt* (May 7, 2013).

also examine for abuses of the bona-fide market making exception to Regulation SHO, and will examine relationships between broker-dealers and Alternative Trading Systems (“ATs”).

**Internal Controls.** The staff will assess the standing, authority, and effectiveness of key control functions; including liquidity, credit, and market risk management practices; internal audit; valuation practices; and compliance.

**Financial Responsibility.** In addition, the staff will review for compliance with the customer protection and the net capital rules<sup>13</sup> with a focus on assets collateralizing large concentrated customer debit balances and the liquidity of firm inventory. For those firms computing net capital pursuant to Appendices E and F of the net capital rule<sup>14</sup> and its associated modeling requirements, the staff will review data integrity and test the approval process for any changes in such models.

**AML.** The staff will review clearing and introducing firms to assess anti-money laundering (“AML”) programs. The staff will also conduct examinations of the AML programs of proprietary trading firms that allow customers direct access to the markets from higher risk jurisdictions.

➤ **New and Emerging Issues and Initiatives.**

**Exchange Act Rule 15c3-5 (“Market Access Rule”).** Among other issues, the staff will examine whether firms are appropriately applying the Market Access Rule (effective July 14, 2011) to their proprietary trading, as well as the adequacy of books and records maintained by broker-dealers that provide market access through master/subaccount arrangements.<sup>15</sup>

**Suitability of Variable Annuity Buybacks.** Some current holders of variable products have guaranteed income benefits and death benefits that have substantially increased in value due to current market conditions. Recent news articles have suggested that insurance companies are offering to repurchase the products. If the customer accepts the offer, the customer may need to purchase a new variable product with less favorable terms. The staff will examine whether registered representatives are recommending that customers accept the buyback terms and, if so, whether such recommendations are suitable and what types of disclosure are made to the customer.

**Fixed Income Market.** The staff will focus on a number of issues, including the structure of the market and its effect on the quality of executions and, in particular, the use of filters by market participants to control what is displayed by fixed income ATs. The staff will evaluate factors that may impact the quality of execution in the fixed income market, including market structure and the use of ATs. For example, ATs interfaces may impact the range of quotations displayed to market participants.

**MARKET OVERSIGHT EXAM PROGRAM**

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<sup>13</sup> Rules 15c3-3 and 15c3-1 under the Securities Exchange Act of 1934 (“Exchange Act”).

<sup>14</sup> Rule 15c3-3e under the Exchange Act.

<sup>15</sup> See National Exam Risk Alert, Master/Sub-Accounts (Sept. 29, 2011), available at <http://www.sec.gov/about/offices/ocie/riskalert-mastersubaccounts.pdf>.



OCIE's Office of Market Oversight is responsible for examining certain SROs and exchanges 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 2014 will include the following priorities:

**Oversight of FINRA.** The staff will continue to review the examination areas outlined in Section 964 of the Dodd-Frank Act and other program areas.

**Exchange Examinations.** The staff will conduct risk targeted exams focused on areas of perceived control weakness at the exchanges. In addition, the staff will continue its review of order types by focusing on the options exchanges. The staff will also continue to follow up on business continuity planning at the exchanges.

**New Registrants.** The staff, in coordination with the Division of Trading and Markets, will conduct pre-launch reviews of new exchange applicants to determine whether each applicant is organized and has the capacity to carry out its responsibilities as an SRO by enforcing its members' compliance with the federal securities laws and rules and the exchange's own rules. The staff will also review exchanges undergoing ownership changes to assess their continued compliance with applicable laws and rules. In addition, the staff expects to allocate resources to begin examining security-based swap execution facilities if the SEC adopts final rules requiring their registration.

**Section 31 Fee Examinations.** The staff will conduct its annual review of controls and policies and procedures to ensure accurate reporting and payment of Section 31 fees.

#### **CLEARANCE AND SETTLEMENT EXAM PROGRAM**

The Clearance and Settlement Program currently consists of two registrant types and associated exam programs: Clearing Agencies and Transfer Agents.<sup>16</sup>

##### **A. Clearing Agencies**

The Clearance and Settlement Program currently has responsibility for annually examining four clearing agencies designated as systemically important by the Financial Stability Oversight Council under the Dodd-Frank Act. It currently also has oversight responsibility for two other clearing agencies, and has assisted in examinations of two clearing agencies for which the CFTC is the primary supervisory agency. For 2014, the staff anticipates that it will focus on the following areas:

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<sup>16</sup> Security-based Swap Data Repositories ("SDRs") will be incorporated into the Clearance and Settlement Program once these entities are required to register with the SEC pursuant to regulations enacted under the Dodd-Frank Act. In the event that further rulemaking occurs during 2014 affecting SDRs, NEP staff will review draft rules to provide the examination perspective.

**Annual Exams Mandated by the Dodd-Frank Act.** The Dodd-Frank Act requires all systemically designated clearing agencies to be examined annually by their primary supervisory agency. The SEC is the primary supervisory agency for:

- Depository Trust Company (“DTC”),
- National Securities Clearing Corporation (“NSCC”),
- Fixed Income Clearing Corporation (“FICC”), and
- Options Clearing Corporation (“OCC”).

Areas for review will be determined through a risk-based approach, incorporating new rules and standards, and in collaboration with the Division of Trading and Markets and other regulators, as applicable.

**Other Examinations.** The staff will continue to utilize a risk based approach to examine clearing agencies. With the adoption of Exchange Act Rule 17Ad-22, the staff will focus on the clearing agencies’ compliance with this Rule.

**New Registrants.** The staff, in coordination with the Division of Trading and Markets, will conduct pre-launch reviews of new clearing agency applicants to determine whether each applicant is organized and has the capacity to carry out its responsibilities as an SRO by complying with the federal securities laws and rules as well as their own rules and by enforcing compliance by its members of the clearing agency’s own rules. In addition, the staff expects to allocate resources to begin examining security-based swap data repositories if the SEC adopts final rules requiring their registration.

## **B. Transfer Agents<sup>17</sup>**

The Transfer Agent Program has examination authority for approximately 450 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 276 million shareholder accounts for approximately 1.5 million issuers (including equity, debt, and mutual fund securities) as reported for the end of 2012. In addition to core transfer agent services (defined below), certain transfer agents may provide paying agent services, which reported at the end of 2012 distributing over \$2.15 trillion in shareholder dividends and interest payments.

**Transfer Agent Core Activities.** Most, if not all, transfer agents engage in three core activities: the timely turnaround 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). The staff will examine compliance and controls in these critical core activities.

### **Other Areas of Focus:**

- Transfer agents that service microcap securities and private offerings,
- Policies and procedures adopted by transfer agents for handling and transferring certificates damaged by Hurricane Sandy and for Letters of Indemnity received from the DTC, and

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<sup>17</sup> Cases filed or adjudicated in 2013 involving transfer agent issues include *In re Securities Transfer, Inc.* (July 23, 2013) and *In re Korem* (July 26, 2013).

- Transfer agents that provide “third party” administration (services similar to transfer agent recordkeeping functions but performed for parties other than the issuer of a Section 12 security, such as retirement plans). Among other things, the staff will evaluate whether entities that provide these services are appropriately registered or exempt from broker-dealer registration.

**Direct Registration System.** Transfer agents that are registered Fast Automated Transfer Program agents with DTC, may offer security holders an option to maintain their ownership on the books of the issuer. The Direct Registration System provides registered owners with the option of holding their assets on the books and records of the transfer agent in book-entry form. As this ownership method becomes more popular (as opposed to street-name or certificate ownership), the staff will review transfer agents’ policies and procedures around order taking, recordkeeping, and clearing relationships.

**Business Continuity and Disaster Recovery Plans.** The staff will review the adequacy of transfer agents’ business continuity and disaster recovery plans based on the size and scope of their business models.