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SEC Information memorandum from Lori Richards, Mary Ann Gadziala, and Office of Compliance Inspections and Examinations Re CSE Examination of Bear Stearns and Co Inc

Lori Richards

Mary Ann Gadziala

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**Information Memorandum
Non-Public**

To: Robert Colby, Deputy Director
Michael Macchiaroli, Associate Director
Matthew Eichner, Assistant Director
Division of Market Regulation

From: Lori A. Richards, Director
Mary Ann Gadziala, Associate Director
Office of Compliance Inspections and Examinations

Re: CSE Examination of Bear, Stearns & Co. Inc.

Date: November 4, 2005

Introduction

Staff from the Office of Compliance Inspections and Examinations (exam staff in headquarters and the Northeast Regional Office), herein referred to as "staff", conducted a risk management and internal-controls based examination of the consolidated organization (collectively referred to as "Bear Stearns" or the "firm"), including the registered broker-dealer, Bear, Stearns & Co. Inc. ("BS&Co."), its ultimate holding company, The Bear Stearns Companies Inc. ("TBSCI"), and various affiliates.¹ The examination was conducted in connection with BS&Co.'s application to use an alternative, risk-based method for calculating deductions from net capital for market and derivatives related credit risk and thereby, consenting to be supervised as a consolidated supervised entity ("CSE") pursuant to Rule 15c3-1 under the Securities Exchange Act of 1934 ("Exchange Act").

The examination focused on the following areas: internal audit; anti-money laundering controls; capital computations²; Sarbanes Oxley internal controls; and the firm's internal control systems for managing market, legal and compliance ("L&C"), credit, funding and liquidity, and operational risks, including business continuity planning. The staff conducted various tests of the firm's implementation of its procedures and their compliance with the requirements under Exchange Act Rule 15c3-4 focusing on the following businesses conducted within material affiliates: credit derivatives – primarily credit default swaps, fixed

¹ Approximately 24 individuals participated in the examination which was initiated with a document request letter to the firm dated August 8, 2005.

² The staff's review of the capital computations included the computation done at the holding company level as well as the combined capital computation at the broker-dealer level for BS&Co. and Bear Stearns Securities Corp. for the period of May 31, 2005.

income derivatives – primarily municipal and mortgage derivatives, residential whole loans, and commercial mortgages.³

The staff held an examination exit interview with the firm on October 26, 2005 to outline findings from the examination. This memorandum summarizes the examination findings that the staff deems most significant. Each finding is followed by the firm's initial verbal response (if provided) in italics. A comprehensive deficiency letter with all of the staff's findings is being prepared to be sent to the firm requesting formal responses to all the staff's findings. In addition, a comprehensive examination report is being finalized.

Significant Examination Findings

Internal Audit

The staff's review of the firm's Internal Audit Department ("IAD") noted the firm's policy of discarding certain audit workpapers 60 days after the issuance of the Audit Report. While IAD's procedures require that certain workpapers be maintained, the procedures also require that other supporting documents, such as the Potential Issues Log, general testing schedules, narratives describing procedures performed, and other underlying documents that evidence the review, testing, and potential findings of the audit, are to be discarded 60 days after the final Audit Report is issued. The firm noted that it does retain the underlying workpapers for SOX-related work and for audits that the firm's external auditor reviews. The staff found that the policy of discarding IAD audit supporting documents leaves no evidential support that IAD performed its planned audit work. The lack of workpapers also deprives IAD of a useful source of information in evaluating the need for and scope of future audits. In addition, the staff noted that low risk findings are not included in the final Audit Report, are not maintained by IAD in its workpapers, and are not tracked in the firm's tracking system for following up on audit findings. Although a finding may appear to be of low risk at the time of the audit, it could potentially become of increased significance to the firm at a later date. Due to a lack of supporting information, there is no way to ascertain the appropriateness of the audit team's determination that a finding was low risk. Additionally, when aggregated across audits, low risk findings may pose a larger risk to the firm than they may appear to pose as individual low risk findings.

Firm's Response: IAD noted that it is reconsidering the policy on document discarding, but that IAD is hesitant to change it, especially without specific guidance on what document retention would be sufficient.

Staff's Comment: The staff has consulted with the Division of Market Regulation ("DMR") on this issue. Both the DMR and the staff agree that an agreement must be reached with the firm prior to the approval of its CSE application regarding the retention of internal audit

³ These primary business activities are conducted in the following affiliates: Bear Stearns Credit Products Inc.; Bear Stearns Capital Markets Inc.; EMC Mortgage Corporation; and Bear Stearns Commercial Mortgage, Inc.

workpapers in order to document the extent of the work performed in conducting periodic reviews of the firm's risk management systems as required by Rule 15c3-4.

IAD's procedures appear to permit senior management of the business audited to have undue influence in the draft Audit Report and to require that approval of the Audit Report be obtained from auditee senior management before its issuance. The staff is concerned that such procedures appear to permit business personnel rather than the independent audit team to make a determination on findings.

Firm's Response: IAD asserted that the senior management's input in the process of audit report drafting is limited to confirming facts that the auditors include in the report. The firm also stated that it will revise the procedures to reflect the role that the senior management of the audited business has in the preparation of the Audit Report.

Market Risk Management

The staff's review noted that, unlike its other CSE peers, Bear Stearns does not have a Board or Committee level approved overall firmwide VaR limit for its aggregate businesses that is sub-allocated downstream to its individual business lines. Rather, Bear Stearns sets and manages its VaR limits at the business desk level. The staff's review also noted that certain business heads can establish new trading limits and approve existing limit breaches with their sole written approval without direct approval from Risk Management. Risk Management receives a copy of the limit approval memorandum after the limit has been established. The staff believes that establishing an overall firmwide VaR limit and requiring Risk Management approval in establishing trading limits and limit breaches would enhance and strengthen the Risk Management control function at Bear Stearns.

Firm's Response: To date Bear Stearns has not made it a priority to have a firmwide VaR limit. The firm generally takes a "bottom-up" approach to setting limits. "Bottom-up" is an approach which emphasizes knowledge of the details of the risk and scrutiny of it. Well justified risk-taking will be approved. The firm then evaluates the sum-total of the approved risks for overall acceptability.

At Bear Stearns, risk taking is evaluated first and foremost at the trading desk level. Bear Stearns doesn't tend to take big positions in the risk factors most common across all desks and thus doesn't often find itself with VaR spikes driven by everyone having the same position. When a risk measure does not tend to spike there is less need to set a limit on it to constrain the spikes. Desk-level exposures to the most ubiquitous risk factors (e.g. general level of interest rates) have typically been kept to a moderate level. As a result, the firm believes that its risk profile tends to be dominated by a diversity of risk factors. Firmwide VaR is measured daily and disseminated but has not exhibited sufficient magnitude or volatility to compel the firm to place a limit upon it.

The firm indicated that it would not be difficult to implement a firmwide VaR limit. However, the firm does not believe that the previous lack of this limit is indicative of any weakness in

its internal controls nor does it feel that the introduction of such a limit would add in a meaningful way to its control environment.

With regard to the limit approval process, the firm noted that Risk Management is currently a signatory to new limit approvals but they will modify their policy so that new limits are not officially approved until signed-off upon by Risk Management.

Staff's Comment: The staff believes that the firm's setting of a firmwide VaR limit would need to be accompanied by a thorough analysis approved at the Board or Committee level rather than simply setting a number.

The staff's review also noted the need for Bear Stearns to establish controls and written procedures related to the process of updating the VaR data inputs. The staff reviewed six data files within the Unix Database which serve as inputs into the RIO system and are utilized in calculating daily VaR. The staff noted the firm's failure to update on a timely basis two of six files which are used for sensitivities of corporate/credit spreads. The staff noted that the data inputs had gaps of several weeks and up to a month without the updated spread/sensitivity information although the firm's internal practice requires a weekly update. As a result, the firm's daily VaR amounts could be based on stale data at any point in time. Additionally, the staff noted the need for the firm to establish a periodic model review process as required by Exchange Act Rule 15c3-1(e)(d)(1)(ii).

Firm's Response: The firm will implement a "maintenance manual" for its RIO system which will identify a program of review and updates of key RIO models, assumptions and inputs.

The staff conducted various risk management reviews and tests of the daily risk management reports and systems. Discrepancies in the data contained in the firm's Market Risk Management reports disclosed the following:

- The staff's data integrity review of EMC Core loans revealed that the EMC whole loan feed into RIO, the firm's VaR calculation engine, did not properly include unsettled positions.
- A sample review of three mortgage derivative trades revealed that one trade with trade date July 6, 2005, was not processed by RIO, the firm's VaR engine, until approximately July 18, 2005. This timing delay was due to the fact that the desk trader was still programming a pricing model for the aforementioned trade in the Unix database, a trade entry system. The staff is concerned that a mortgage derivative trader has the ability to prevent new trades from flowing into RIO, thus causing an inaccurate VaR calculation.

Firm's Response: The firm is in the process of addressing the concerns raised by the staff. A new approach for EMC unsettled loans is under development and the firm is evaluating potential solutions to the concern that a trader has the ability to prevent trades from flowing into the VaR engine.

Legal & Compliance

In addition to a number of issues related to policies and procedures discussed below, the staff's review of the L&C area noted several weaknesses in the firm's L&C controls. L&C has not formally documented the identification or assessment of all applicable rules, laws, regulatory requirements and risks pertinent to the entire organization. The staff's review also noted that the firm failed to sufficiently document the identification, escalation and resolution of L&C issues as required by Rule 15c3-4 of the Exchange Act. The firm's written procedures generally state that matters should be escalated to the appropriate parties, but there is no specific escalation process. As a result, the firm failed to maintain an audit trail of issues identified and escalated from subordinates to L&C senior management. In addition, the firm's L&C monitoring and surveillance system is based on an informal process and does not have the capability to track issues or trends that develop over time. The staff also noted that the Compliance Department has undergone significant personnel changes which has left various areas of the Compliance Department understaffed and employees taking on multiple responsibilities.

Firm's Response: The firm's Senior Managing Director of Global Compliance has only been in her position since August 2005 and is in the process of reorganizing the Compliance Department in addition to implementing new processes where there are gaps. The firm plans on improving the surveillance process. The firm also responded to the staff's comments by stating that the firm is concerned about the potential of exposing the firm to legal risk by tracking legal issues. Additionally, the firm is concerned about privilege issues.

Staff's Comment: Based on the firm's response regarding their concern about the potential of exposing the firm to legal risk by tracking legal issues, the staff remains concerned about the extent to which the firm will establish, document, and maintain a system of internal risk management controls to assist it in managing the legal risks associated with its business activities as is required by Rule 15c3-4.

Capital Computations

The staff's review of the firm's capital computations noted that the firm's reconciliation process between the general ledger, the market risk and credit risk systems, and the capital calculator are currently in various stages of development. The staff noted the need to finalize the reconciliation process to ensure the completeness of the capital calculations going forward.

Firm's Response: The firm is in the process of enhancing its reconciliation process and expects to have it completed in the short-term.

Operations

The staff's review noted that reconciliation differences between the EMC front-office (i.e., MORT) to back-office (i.e., GOTS) trade blotters do not appear to be resolved in a timely manner. As of July 15, 2005 there was a total of 492 differences or "breaks", of which, 234 (48%) were aged greater than 100 days.

Firm's Response: The firm agrees that this is a concern and is researching this issue.

Funding and Liquidity

Bear Stearns' contingency funding plan does not consider realistic stress scenarios, contain projected weekly cash flow analyses, or require specific actions when liquidity falls below stated goals in a stress environment according to internal analyses. The addition of these components to the funding plan would improve the firm's internal risk management controls for liquidity risk which are required under Rule 15c3-4.

Firm's Response: The firm agreed to enhance its contingency funding plan.

Policies and Procedures

The reviews conducted by different examination teams consistently identified issues with regard to the firm's written policies and procedures. The staff's review noted that in a number of areas the firm's written procedures were newly created or updated during the staff's examination. As a result, the staff was unable to test compliance with these procedures. In some instances, the staff noted that the firm had written policies but lacked written procedures or that the procedures lacked specificity with regard to the various functions performed. In other instances the firm did not maintain any procedures surrounding the function that was reviewed. The firm's lack of procedures resulted in inconsistent actions taken by the firm. Highlighted below are a few examples noted by the staff regarding such issues:

- The firm's Market Risk Management function has a set of general policies but no procedures for its risk management functions. As a result, the firm has established limited policies addressing new trading limits, limit breaches, exceptions, limit reporting and all other risk management controls, but such policies lack specificity of the risk management procedures utilized.
- A review of the firm's price verification process revealed that existing policies lacked procedural controls to require trader level or portfolio level reviews based upon predetermined thresholds. Additionally, the policies failed to specify the Risk Management and Business Unit Controller responsibilities regarding price verification.

- A review of the firm's pricing model validation policy disclosed a lack of specificity as to the procedures to be utilized to address concerns raised during the validation process. The staff reviewed ten model review reports from early 2004 to early 2005. The review disclosed that in one instance an "initial analysis" cited concerns about outdated models but no recommendations for corrective actions were made. In addition, three reports recommended advanced pricing models be implemented, however, as of the time of the staff's review, the advanced models had not been implemented because the recommendation was not a high priority.
- A review of the inventory aging reports for the products reviewed by the staff noted the lack of policies and procedures for the aging of fixed income derivatives. As a result, the firm did not age fixed income derivatives. In addition, the procedures did not specify the timing of the distribution of the reports as the staff noted that Risk Management received an EMC Aged Report for the period ending May 31, 2005 on August 23, 2005, approximately 11 weeks aged.
- The firm lacks formalized policies and procedures regarding the middle office and operational controls in processing transactions.
- A review of the firm's unsigned confirmation backlog revealed that the firm used inconsistent practices in resolving outstanding unsigned confirmations. The Derivatives Documentation Handbook does not include guidelines defining the time frame within which the first follow-up attempt, and subsequent follow-up attempts, should be made with counterparties that have outstanding unsigned confirmations.
- With the exception of a limited contingency funding plan, the firm has not implemented written policies and procedures related to the funding and liquidity area.
- The firm has not yet fully developed comprehensive policies and procedures for its independent Operational Risk Management function, particularly with regard to the delineation of responsibilities and the process for collection and verification of events.
- The Derivatives Operations area does not have written procedures regarding how to resolve disputed margin calls or how to handle delinquent margin calls.

In addition to the lack of procedures, the staff also noted a number of instances where the firm failed to follow its own procedures. Examples of such instances include the following:

- The staff's review of the Credit Risk Management area noted that the firm failed to perform an annual review for all counterparty's limits and ratings on an annual basis as required by its written policies and procedures. The staff's review of the September 22, 2005 Clients to be Reviewed report revealed that 745 counterparties (of a total of approximately 9,500 counterparties) were overdue for a credit review. Of these, nine were overdue by greater than 90 days.

- The staff's review of twelve scorecards (which were utilized in the credit ratings process) found that the credit analyst did not record the rationale as required in five of the eleven instances when one or more category ratings differed from the scorecard's suggested rating.
- L&C failed to document its review for Qualified Institutional Buyer ("QIB") compliance for Leveraged Finance transactions.
- The firm failed to enforce its written procedures by not documenting all surveillance reviews conducted by the Control Group surveillance analysts. In particular, the firm failed to produce records that evidence the review of the Watch List for the duration the security remained on the Watch List.
- The firm failed to follow its written procedures regarding the escalation and documentation of surveillance review exceptions of mortgage securities transactions (specifically, ARMs transactions).

Firm's Response: In general, the firm accepted the staff's comments with regard to the need for additional or enhanced written policies and procedures and acknowledged the lapses noted by the staff.

The staff expects any updated procedures to be provided in response to the deficiency letter that will be sent to the firm and the staff will again review the policies and procedures to assess the firm's progress in strengthening this area during the next examination of the firm.

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