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SECURITIES INDUSTRY ASSOCIATION
SIA

Audit Guideline #25

# Reorganization Department

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SECURITIES INDUSTRY ASSOCIATION
INTERNAL AUDITORS DIVISION
AUDIT GUIDELINES COMMITTEE

**REORGANIZATION DEPARTMENT**
**AUDIT GUIDELINE**

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## I. BACKGROUND

*General Overview*

In the 1980s and 1990s, corporate reorganization activity has flourished as company after company acquires another, retires debt, splits its stock, refinances its capital, or calls its debt securities. A reorganization may be defined as a change in a corporation's outstanding debt or equity securities. The basic types of reorganizations are:

- Tender Offer — An offer to purchase outstanding shares of a security at a specified price. This differs from an "Invitation to Tender" which is a purchase offer whereby shareholders specify the offering price at which they elect to tender their assets.
- Redemption — The liquidation of a debt issue on or before the maturity date. As specified in the indenture (and articles of incorporation), securities may be "called" prior to the maturity date on a full or partial basis
- Conversion — The exchange of equity or debt for a different class of equity or debt. Conversion privileges generally have an expiration date for callable securities.
- Stock Split — The division of the outstanding shares of a corporation into a greater number of shares as authorized by the board of directors and approved by stockholders. In a two-for-one split, shareholders would be entitled to two shares for each share owned.
- Reverse Split — The reduction of the outstanding shares of a corporation (i.e., division into a lesser number of shares).
- Merger — A plan initiated when two or more companies elect to combine their assets and liabilities to form one company.
- Legal Transfer — A transaction that requires documentation other than the standard stock or bond power to validate the transfer of a stock certificate from a seller to a buyer i.e., securities registered to a corporation or a deceased person.
- Liquidation — Cash distribution(s) to stockholders in proportion to and in order of ownership preference made after the remaining assets of the liquidating corporation have been converted to cash and its creditors paid.
- Proxy — Written "power of attorney" given by share-holders of a corporation authorizing a specific vote on their behalf at corporate meetings.
- Rights Offering — A shareholder's entitlement to purchase anadditional interest in the issuing company indirect proportion to the number of shares owned. Holders of rights may: (1) sell/trade the rights, (2) exercise the right to purchase at the specified price, or (3) allow the rights to expire
- Exchange/Acquisition Offer — An offer made by a corporation to exchange one or more Issues of its securities for another. In a takeover attempt, an acquiring company may offer its own shares in exchange for the company being acquired.
- Warrant — An entitlement to purchase additional shares of a security at a predetermined price during a specified time period. Warrants are similar to rights but are generally issued for longer terms. They are offered as part of a Unit (see below) to make the security more attractive to investors.
- Unit — A combination of two or more securities. Holders may elect to split or combine the component securities (e.g. bond or stock and warrants).
- Put Bond — Allows the holder to "put" the bond for early Feature redemption at intervals specified in the bond indenture.

Reorganizations may be classified as Voluntary or Mandatory. Voluntary offers have set deadlines (i.e., they expire) while mandatory activities can be described as perpetual. Listed below are the major categories of offers:

| Voluntary | Mandatory |
|---|---|
| Tenders | Splits/Reverse Splits |
| Exchanges | Stock Mergers |
| Conversions | Cash Mergers |
| Rights/Subscriptions | Redemptions (Maturities/Calls) |
| Warrants | Name Changes |
| Put Bonds | Liquidation Distributions |
| Invit. to Tender | Defeasances |
| Unit Trusts | Class Actions |

The Reorganization Department within Operations is generally composed of several key units: Announcements, Securities Processing, Redemptions, Mandatories and Voluntaries. In addition, many firms have an International unit which processes reorganizations in foreign securities.

*Announcement/Information Unit* — This section is responsible for gathering critical information on actual or proposed changes in the capital structure of corporations. Such data may be obtained from a variety of industry publications (e.g. Wall Street Journal), specialized services (e.g. J.J. Kenny Bond Service), paying agents, depositories, custodian banks, or directly from the corporation initiating the change. Once the required information is obtained, it must be summarized and transmitted to the affected clients, branch offices, and home office locations. Generally, announcement information is maintained on an automated database.

*Securities Processing Unit* — This section is responsible for the management and control of security inventory by Reorg personnel relating to the substitution of the original holdings for those outlined by the offer. When a capital change is announced, the Reorg Dept assumes control over all cashiering functions for the affected security(ies). Shortly after the capital change expires, Reorg will contact the paying agent to determine if the funds and/or securities are available. Upon receipt, the check and/or securities are then deposited to a processing account. Finally, entries are recorded to credit customers with the required substitutions.

*Redemptions Unit* — This section is responsible for obtaining funds in exchange for debt instruments held by a securities firm for its customers. Redemption issues may be classified as maturing debt or partially/ fully called bonds.

In the case of partial calls, the issuing company will select certificates representing the number of shares/bonds being called. The Reorg Dept must then determine if any securities the firm holds appear on the list of called certificates provided by the issuer.

Physical certificates that have been called are submitted to the redemption agent. In the case of partially called securities held at depositories, the depository will advise the Reorg Dept of the number of certificates to be redeemed on behalf of the firm (aka "allocation"). Reorg will then conduct an impartial lottery to determine which of the firm's customers will be subject to early redemption. The lottery results are reflected by bookkeeping entries which remove the old position in the customer's account and replace it with the "called" one. Funds are collected from the redemption agents and depositories. On the redemption date, entries reflecting delivery of the called security for the specified redemption amount(s) are processed to the client's account.

*Mandatory Unit* — This section is responsible for processing of capital changes in which participation is mandatory, i.e., shareholders must "exchange" their holdings for cash and/or new securities. Reorg must notify the clients/branch network and process the exchange to all accounts reflecting the affected security. Since such exchanges are open-ended, any shares received by the firm in the future must be routed to Reorg for exchange on an individual account basis.

*Voluntary Unit* — This section processes changes in the capital structure of corporations where a firm's customers must elect to participate within a stated period of time. Therefore, shareholders should receive notification of the capital change and, if necessary, a prospectus or offering circular. If the client opts to participate, instructions must be given to the Account Executives prior to expiration date. Generally, firms will establish a deadline of one business day prior to the expiration date for accepting orders from the branch network. Upon receipt of the customer's instructions, Reorg can advise the depository to exchange, tender, convert, etc., the securities being held on behalf of the client.

The following processing steps are typically performed for reorganizations:

1. Instructions are generated to all inventory holding locations within the firm to request that the affected securities be directed to the Reorganization Department for routing to a depository prior to the established cutoff date. Reorg would control the conversion and deal directly with the agent and/or the depository.
2. If securities are held at a depository, Reorg will advise the depository to make deposits directly with the paying/transfer agent. A Depository Instruction form and Letter of Transmittal (L/T) will be issued.
3. All incoming securities from the other holding locations are prepared for presentation to the designated paying agent. The securities are

made negotiable and an L/T completed.

4. Securities which were physically held by the firm are forwarded to the agent. The agent will provide the firm with a receipt known as a "Window Ticket."
5. All exchange information is recorded and maintained in an "agent" file which serves as a control mechanism for the physical inventories presented to the agent until the offer is completed.
6. Upon receipt of the newly issued securities or cash proceeds from the paying agent, the "agent" file is closed and entries created to reflect the reorg into the records of the firm.
7. The old security position is removed from the firm's records and new securities are routed to the proper box locations. The firm's and the customer's records are updated to reflect the new positions.

*Source* — NYIF: Securities Operations, A Guide to Operations and Information Systems in the Securities Industry, Michael T. Reddy

## II. AUDIT OBJECTIVES

The magnitude of funds and securities flowing through the Reorganization Department warrants a periodic risk assessment and evaluation of the adequacy of internal controls by the Audit Department. Time-critical functions (e.g. processing of expiring offers) should be a principal area of focus since significant exposure could result from the firm's failure to act in a timely and accurate fashion.

*The global objective of a review of the Reorganization area is to ascertain that internal controls are adequate and properly functioning to ensure efficient/effective operations and compliance with applicable regulations and firm policy. Controls, as implemented by area management, should ensure that:*

*Collection/Dissemination of Reorg Data*

- Announcement information is collected, reviewed, validated, and communicated (to clients, the retail network, and affected Home Office areas) in a timely, complete, and accurate manner.
- Where applicable, reorganization material (e.g. prospectus) is disseminated to affected clients in a timely fashion.

[Note: Generally, this function is performed by the Proxy Unit.]

- The securities database is properly updated to reflect reorganization activity.

*Instructions Processing*

- Incoming instructions on voluntary offers are properly validated, documented, and tracked prior to submission to depositories and agents. Controls should prevent the use of customer securities to participate in expiring offers without valid client instruction.
- Outgoing instructions as to the disposition of reorg monies and securities are properly documented and communicated to depositories/ agents in an accurate and timely manner.

*Securities/Checks Processing*

- On Site: Physical certificates and checks are processed in a secured, controlled environment.
- In Transit: Securities shipments to the agent are transmitted via overnight carrier, properly insured, contain all required documentation (e.g., L/T), and are submitted to the agent in a timely manner. In addition, the anticipated receipt of securities in transit from branches should be monitored.
- Securities at the agent are periodically confirmed in compliance with possession & control requirements.
- For restricted stock, the proper legal documents have been obtained prior to transfer.

*Transactional Processing and Accounting*

- Treatment of accounts is impartial, i.e., customers do not receive preferential treatment (e.g. call lotteries are random and include all accounts, accounts requesting early redemption of putable securities are properly "queued," etc.).
- Funds disbursements are properly reviewed and authorized.
- Monetary transactions are recorded to accounts in a timely and accurate manner. Differences should be identified and resolved in a timely manner.
- The Stock Record accurately reflects the movement of securities to/from accounts. Differences should be identified and resolved in a timely manner.
- Receivables and payables are reconciled daily and closely monitored by managerial personnel.
- Trading activities are properly authorized and limited to business-related transactions (e.g. sale of cash-in-lieu positions).

- Error and suspense account activity is properly identified, reported, and monitored to ensure the timely resolution of items.
- Client proxies are mailed in a timely manner.

*Systems/Contingency Planning*

- Systems are operating as designed.
- Systems are protected from unauthorized access and misuse of hardware/software:
  - — Systems are adequately tested and documented.
  - — Change controls are in place.
  - — Data security and access controls are in place.
- Systems have sufficient capacity to accommodate increased volume.
- Disaster recovery plans have been developed, documented, tested, and communicated to all relevant personnel. Procedures are in place to update contingency plans as needed.
- Year 2000 Issues have been addressed .

*Regulatory Compliance*

- The Firm is in compliance with all applicable rules and regulations, examples of which are outlined below:

SEC Rules 15c3-3 (Customer Reserve Rule) & 15c3-1 (The Net Capital Computation) require reporting of various aged position and money balances. Refer to SIA Guidelines for the aforementioned rules.

SEC Rule 17a-13 requires that the firm: (a) physically examine and count all securities held, (b) account for all securities in transfer, in transit, pledged, loaned, borrowed, deposited, failed to receive/deliver ... subject to the firm's control but not in its physical possession, and (c) verify the aforementioned securities that have been in said status for longer than 30 (calendar) days.

SEC Rule 10b-4 prohibits short tendering of securities or the use of borrowed stock to respond to a tender offer. An investor may only participate in a tender offer with stock long in his account.

NYSE Rule 180 states that the deliverer is responsible for any failure to deliver securities on or after settlement date (resulting in a loss by the receiver due to a pending corporate action). An NSCC liability letter should be sent one day before the last day of the expiration and/or protect period when a fail to receive exists (over the expiration period). This is related to: (a) Section 59(j) in the NASD's Uniform Practice Code which addresses fails to deliver and liability notice procedures, (b) the NSCC Division's Rules and Procedures relating to liability notices, and (c) the Draft of the S.I.A. Broker-to-Broker Stock Loan Agreement regarding the recall of loaned securities by presenting a liability letter which supersedes the loan.

NASD Rules of Fair Practice Article III, Section 27 requires that operations be properly supervised.

Statutory law requires that customer-related abandoned property such as credit monies and long securities be escheated to the various states after a specified time period has elapsed - usually three years for brokerage firms.

NYSE Rule 240: "In cases where members ... on the last day for subscription have more rights to subscribe than they or their customers appear to be entitled to in accordance with the records of the members ..., the excess amount of rights shall be sold in the best available market and the proceeds of such sales shall be held subject to the claims of the persons entitled to such rights to subscribe."

Called Securities: NYSE Rule 217: "Securities which are called for redemption shall not be a delivery on and after the first date when the serial numbers of the stock certificates or bonds drawn for redemption become available ... except when an entire issue is called ...."

NYSE Rule 273: "Reclamation, by reason of the fact that the called security was delivered, which was not a delivery under the provisions of Rule 217/218, may be made without limit of time and such security may be returned to the party who held it at the time such security ceased to be a delivery." See the NASD's Uniform Practice Code Section 57 for related language.

MSRB Rules G-12(e) and G-15(c) on deliveries of called securities: "provide that a certificate for which notice of partial call has been published does not constitute good delivery unless it was identified as called at the time of trade. The rules also provide that, if a notice of call affecting an entire issue has been published on or prior to the trade date, called securities do not constitute good delivery unless identified as such at the time of trade." MSRB Rule G-17: "The Board recognizes that lottery systems are a proper method of allocating the results of a partial call. Principles of fair dealing require that all such lotteries treat dealer and customer accounts alike."

*Safeguarding of Physical Assets*

- Physical assets are properly safeguarded, i.e., adequate measures have been taken to prevent/ deter theft.

## III. RISKS

The risks associated with reorganization activity may be categorized as follows:

*Announcements Processing*

- Inaccurate or incomplete announcement information is disseminated to the field.
- Reorg material(s) on expiring offers is not properly distributed to affected shareholder accounts (generally a Proxy function).
- Reorg information is not disseminated on a timely basis.

Since all reorganization processing is based on announcement information, it is imperative that the announcement data be recorded in the system/files and disseminated to the appropriate parties in a complete, accurate, and timely fashion. A firm could be subject to significant monetary exposure for missed announcements, untimely communication of announcements, or dissemination of inaccurate information.

*Instructions Processing*

- Client instructions on voluntary offers are not properly recorded or not properly submitted to depositories and agents to ensure anticipation in expiring deals.
- Customer securities are used to participate in offerings (particularly those which are in-the-money) without valid instructions from clients.

Failure to properly process client instructions could also expose a firm to material losses. For example, if client instructions to tender stock for cash are not executed, a firm would be subject to market risk since it would have to sell the client's stock in the open market and use the proceeds to pay the offering price to the client. The firm may realize a loss for the difference between the sale proceeds and the offering price.

*Securities/Checks Processing*

- Physical securities are not subject to adequate safeguards, both on site and in transit from branches or to/from agents.
- At agent securities are not properly confirmed, i.e., verified in accordance with regulations and internal policy/procedure.
- Incoming checks from agents are not properly safeguarded.

The processing of physical securities/monetary instruments is inherently riskier than the processing of externally held positions. Certificates and checks must be adequately safeguarded both on site and in transit to prevent losses from theft.

*Transactional Processing and Accounting*

- Funds disbursements via wire/check are not properly authorized or do not represent valid payables.
- Funds and securities transactions are not recorded in an accurate, complete and timely manner.
- Differences are not minimized and breaks are not identified, reported, & resolved on a timely basis.
- Reconciliation and monitoring of receivable & payable balances are not properly performed.
- Suspense and error account activity is not properly identified, reported, and resolved.
- Trades are not properly authorized and/or do not arise from business-related activities.

The business impact of failure to properly process and record transactions is multifaceted:

- The books and records of the firm would be inaccurate resulting in a potentially material misstatement of reorg-related balances in financial statements and regulatory reports.
- Client/firm assets could be misappropriated resulting in financial loss. The firm could be exposed to further financial loss from costs associated with remedial actions (e.g. researching and correcting errors), litigation, and regulatory fines/censure relating to failure to properly maintain its accounting records or for failure to properly supervise its operations.

*Systems and Contingency Planning*

- Systems are not operating as intended.
- Hardware/software can be accessed by unauthorized personnel with the ability to corrupt, destroy or misuse data.
- In the event of systems failure, critical data cannot be accessed on a timely basis (i.e., alternative procedures are not in place).
- System capacity cannot accommodate increased processing volume.
- Business recovery plans are inadequate, untested, or not properly communicated to relevant personnel.

Since most firms have highly automated reorganization operations, it is imperative that systems and data be safeguarded. In general, the aforementioned reorg functions (e.g. Announcements Processing, Instructions Processing, etc.) are automated processes which require strong system controls. Refer to these sections for risks associated with control weaknesses in automated as well as manual processes.

*Regulatory Compliance*

- Regulatory requirements are not satisfied due to: (1) failure to properly identify and interpret such requirements and/or (2) unintentional or willful failure to adhere to such requirements.

In the current regulatory environment, failure to comply can result in severe regulatory censure.

*Safeguarding of Physical Assets (Firm-related)*

- Physical assets (e.g. furniture, machines, supplies, etc.) are not properly safeguarded. Firm assets could be stolen/destroyed resulting in financial loss and potential disruption of business.

## IV. CONTROL POINTS

*Global Perspective* — From an overall perspective, there are fundamental control elements which should be present:

- Processing should be automated to enhance the efficiency and effectiveness of operations. Systematic processing is significantly less prone to error.
- Workflows should be systematically managed (i.e., use of a Process Management system in which the flow of work between individuals and departments is systematically controlled).
- Alternate procedures (e.g. maintain manual files in expiration date order) should be developed to facilitate the monitoring and processing of time-critical activity in the event of system failure.
- Timely management and supervisory review/ approval should be required for all critical functions. Management reports should properly highlight time-sensitive activity, aged balances, and discrepancies. Procedures should be in place to identify, research, and resolve discrepancies on a timely basis.
- Custody, accounting, and control/reporting functions should be adequately segregated.
- Timely reconciliations and independent verifications (e.g. counts, confirmations, etc.) should be performed.

*Detailed Perspective* — Typical controls which serve to minimize the risks in reorganization processing are detailed below:

*Announcements*

- Use of automated reporting services and depository feeds to help ensure that the population of current announcements is complete. Information may also be obtained from verbal notifications, review of written material, and use of in-house databases (e.g. to identify maturing issues). Procedures for the timely revision/updating of existing announcements should also be in place.
- Verification and approval of announcement data:
  - — A comparison of multiple information feeds should be performed to identify and correct discrepancies. Other exception reports (e.g. illogical or missing data) should also be developed.
  - — System input should be subject to supervisory review/approval. Client material detailing the terms of the reorganization should be reviewed and approved prior to mailing via Proxy.
  - — See Systems/Contingency Planning below for additional controls.
- Electronic dissemination of data to the field i.e., retail network and home office.
- Establishment of procedures to insure timely receipt and subsequent distribution of reorg material on expiring deals.

*Instructions*

- Use of systems which permit direct retail input and operational tracking of instructions. The system should generate a “confirmation” at the branch.
- Validation of client positions v. instructions to ensure that clients are long the security(ies). The status of each client’s position should be closely monitored up to the cutoff date to ensure that clients are not overtendering (except for securities in transit when a protect period is applicable).
- Supervisory review of expiring deals and follow-up with branches (e.g. accounts which have not indicated whether they wish to participate). This is especially important for “valuable” offerings.
- Balancing of activity (e.g. instructions received v. issued to agents and depositories).

*Securities/Check Processing*

- Segregation of custody, accounting, and control/reporting functions to maintain checks and balances (see Transaction Processing & Accounting below).
- Establishment of a physically secured processing and custodial environment (e.g. overnight storage of certificates in a vault).

- Verification of physical securities (e.g. periodic, surprise counts by an independent area). Differences should be identified, reported, and resolved in a timely manner.
- Use of insured, overnight carriers for timely delivery of securities.
- Filming of incoming & outgoing checks and securities.
- Use of anticipation reports to monitor securities in transit.
- Automation of the tracking and aging of “at agent” activity.
- Confirmations of “at agent” positions by an independent control & reporting area.
- Timely managerial/supervisory review and approval of critical functions.

Note: Generally, coupon validation and processing are handled by areas outside of the Reorganization Department (e.g. Custody and Dividends).

*Transaction Processing & Accounting*

- Automation of processing (e.g. transmission of instructions/funds to depositories, recording of securities movements, recording of payments and payouts, processing of bond lotteries, etc.).
- Daily reconciliation of all departmental accounts.
- Timely management/supervisory review and approval of critical functions.
- Management should review activity/exception reports (e.g. breaks, open balances, aged balances, suspense & error account activity, etc.) in a timely manner and ensure that the appropriate follow-up action has been taken to resolve discrepancies.
- Management authorization of journal adjustments, disbursements and trading activity.
- Notifications to clients/branches for selected processing (e.g. called bonds).

*Systems and Contingency Planning*

- Use of system edit checks to prevent and/or detect input of illogical or invalid data. Mandatory fields may also be utilized to ensure input of required data.
- Restriction of system access to properly authorized personnel.
- Adequate documentation of systems.
- Use of program change controls to ensure that changes are properly authorized and thoroughly tested prior to implementation into production.
- Use of a “process manager” system to automate the workflow within and between departments.
- Development, testing and communication of business recovery plans.

*Regulatory Compliance*

- Automation of the reporting process, where possible.
- Assignment of reporting responsibilities to a non-processing area.
- Verification of reports by an independent compliance area.

*Physical Assets*

- Establishment of a physically secured environment to prevent theft/destruction of firm assets.

*Other*

- Development of a comprehensive procedures manual which is updated as needed.
- Use of formal and on-the-job training methods.

*Management Reporting*

- Development of a weekly operation report to monitor overall reorganization, custody, transfer and proxy business.

## V. AUDIT PROCEDURES

*I. Accounting (Global)*

The initial step in a Reorg audit program should be a full review of accounting. “Clean” accounts are generally indicative of well-controlled operations. Therefore, activity/balances should be examined for the following:

- Aging of Balances — For all processing, suspense & error accounts:
  a. Obtain bookkeeping reports (or management reports) for account balances.
  b. Prepare an aging schedule.
  c. Analyze activity to identify any significant, adverse trends.
  *****
  a. Select a sample of aged balances, focusing on high-dollar items.
  b. Determine reason for aging of each open item. Document any exception conditions.
- Suspense Accounts — Refer to SIA Guidelines for Suspense Accounts.
  a. Develop audit software to summarize suspense turnaround (i.e., how long it takes to resolve an item) within a given period.

b. Analyze activity to identify any significant, adverse trends.

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a. Using the bookkeeping reports, select a sample of material suspense items.

b. Verify that each item is valid, i.e., meets criteria for classification as a suspense item.

c. Verify that each item was identified/ recorded to the established suspense account(s) in a timely manner.

d. Verify that each item was resolved in an accurate, complete, and timely manner.

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a. For a predetermined period, analyze activity in the account(s) for any unusual trends (e.g. large number of suspense items relative to processing volume, items involving the same customer account, same securities, etc.).

- Error Accounts

a. Using the bookkeeping reports, select a sample of material errors.

b. Verify that each item was identified/ booked to the established error account(s) in a timely manner.

c. Verify that each item was resolved in an accurate, complete, and timely manner. Immediate market action should be taken for all errors. Note that aged items should only represent positions with an illiquid market.

d. Verify that errors are properly documented (for material items).

e. Verify that corrective actions were reviewed/approved by management (e.g. sign error story and order ticket) and that remedial measures to prevent recurrence have been taken, where necessary.

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a. For a predetermined period, analyze activity in the account(s) for any unusual or adverse trends such as a large number of errors relative to processing volume, material gains and losses, recurrence of the same type of error, errors involving the same processor, etc.

- General

a. Review departmental job descriptions and manning runs. Verify that there is adequate segregation of duties between custodial, accounting, and reporting functions.

b. Obtain a listing of all departmental accounts. Verify that each account has been assigned to a individual responsible for daily reconciliations. Verify that such reconciliations are properly performed/ documented and are periodically reviewed by management.

c. Determine that procedures are in place for:

* Management review/approval of accounting entries prior to processing (e.g. focus on manual adjustments, entries between internal accounts, entries to refresh dates).

* Timely identification/correction of illogical balances (e.g. credit balance in expense account) or illogical activity (e.g. long position in location account).

* Timely identification/monitoring of inactive or obsolete accounts for possible closure.

* Management review/approval over the establishment, classification/coding, and termination of departmental accounts.

*II. Announcements (Global)*

a. Review the overall procedures for the collection and loading of announcement information.

b. Verify that essential vendor/depository feeds are being utilized. Verify that use of automated feeds is adequately supplemented by manual review procedures for hardcopy material (e.g. Wall Street Journal).

c. Verify that comparisons of data input are being systematically performed to identify data mismatches.

d. Verify that system reports are being generated/ utilized to identify illogical data.

*III. Processing of Voluntary Reorganizations*

Select a sample of various types of voluntary reorganization offerings. Obtain the deal folder and perform the following audit procedures:

- Announcements

a. Review source documentation for the terms of each offering.

b. Verify that the announcement data were processed (loaded/updated/disseminated) in an accurate, complete, and timely manner.

c. Verify that announcements were formally reviewed/approved by management in a timely fashion.

d. Verify that the securities database was properly updated to reflect the reorganization status of the security(ies).

- Instructions

a. Verify that incoming instructions were processed in a timely manner.

b. Verify that customers were not permitted to overtender (e.g. customer should be "trade date" long the security except where securities are in transit and guarantee of delivery has been made in the applicable protect period).

c. Verify that outgoing instructions (a#ceptances) and securities/payments to depository/agent were processed in a timely fashion. There should be monitoring of expiring deals (e.g. expiration calendar).

d. Verify that incoming (customer) instruction totals reconcile to outgoing instruction totals.

Note: Certain firms may monitor and follow-up on customer responses, particularly on "in-the-money" deals.

- Processing

a. Verify that participating accounts were accurately credited/debited (for funds) and received/delivered (for securities) relating to the reorg offer. This may include a review of cash-in-lieu payments relating to fractional shares.

b. Determine reason for any untimely transfers of funds and securities to/from depositories and paying agents.

c. Verify that entries were processed in a timely manner.

d. Verify that funds disbursements were properly authorized, supported by documentation, and processed in accordance with internal policy.

e. Verify that processing was formally reviewed/approved by management in a timely fashion.

f. Obtain the bookkeeping report of offering activity. Review for any quantity/money residual balances resulting from difference(s) between payouts and receipts. Determine reason for difference(s). Verify that difference was properly resolved.

g. Verify that all required documentation has been retained in the files.

Note: In the event that securities are unavailable to fill customer instructions due to fails-to-receives and/or stock loans, a liability letter should be issued to the appropriate entity in a timely manner.

All "streetside" entries should be booked in a timely manner versus a Reorg processing account (i.e., not versus a customer account).

*IV. Putable Securities*

Obtain a listing of issues eligible for voluntary early redemption (e.g. collateralized mortgage obligations). Select a sample of issues with customer put requests and review files as follows:

- Request Processing

a. Verify that all put requests were properly documented and processed in an accurate (i.e., first-in-first-out basis with the exception of decedent accounts) and timely manner (i.e., within the allowable window period).

b. Verify that any withdrawal requests were processed in an accurate, complete, and timely manner.

c. Verify that overtendering is monitored on a timely basis and that appropriate follow-up action is taken to resolve exception items (e.g. process withdrawal of put request where underlying position has been sold).

d. Review periodic reconciliations of depository and Firm positions marked for early redemption. Obtain explanations for differences. Verify that appropriate follow-up action is taken, where needed.

- Payment Processing

a. For depository-eligible items in the sample above, obtain the most recent depository report of accounts selected for payment. Verify that the accounts selected for DTC payment were properly credited for principal and interest.

b. Verify that the Stock Record was properly adjusted for the partial/full paydown of principal.

*V. Securities/Check Processing*

- Physical Inventory Accounts

a. Conduct a surprise count of the contents of location ("box") accounts, comparing physical counts to position inventory reports. Obtain explanations for differences. Verify that appropriate follow-up action is taken, where needed.

b. Verify that positions are recorded to the correct location account (e.g. mandatory issues are booked to the mandatory box).

c. Review security over physical certificates for adequacy.

- Aging of Positions

a. Using position inventory reports, select a sample of aged positions in location accounts. Determine reason for aging of items. Verify that appropriate follow-up action is taken, where needed.

b. Review position inventory reports for adverse trends such as a large number of aged positions, illogicals, etc..

- Accounting Entries

a. Develop an audit software report of location account entries (short and long sides) within a predetermined period.

b. Review entries for propriety (e.g. positions which are out- of- balance should not be booked to a non-location account to avoid detection).

- Branch In Transit Items

a. Obtain reports of items in transit from branches.

b. Select a sample of aged items.

c. Research items to determine cause of aging.

d. Verify that appropriate follow-up action is taken, where needed.

- At Agent Processing

Obtain a copy of the Detail Report of Positions at the Agent. Perform the following audit steps:

a. Select a sample of confirmed positions.

b. Obtain confirmation documentation.

c. Verify that the confirmation is valid: (1) original document (2) signed/stamped by agent, and (3) dated.

d. Compare information on the confirm to position records of the firm (date/ quantity). Obtain explanation of differences.

Note: Open items should be reconfirmed by an independent area.

*****

a. Select a sample of aged, unconfirmed positions.

b. Verify that the processor has taken all necessary steps to obtain the confirmation. Steps should be properly documented in the files.

*****

a. Verify that the report is accurately aging items and reflecting their status as confirmed or unconfirmed. [Note: The Auditor should verify that certain activities are not inappropriately "resetting the clock" (e.g., processing of "wash" entries or small-dollar entries which could make the age of an open item appear to be more current.]

b. Compare position totals on the at agent report to at agent location account totals. Obtain explanation of differences.

*****

a. Determine that procedures are in place to ensure that:

 * Securities sent out to the agent are received in a timely manner.

 * Securities are sent out with proper insurance via an appropriate overnight carrier.

*****

Refer to Aging of Balances Tests (e.g. analysis of aging schedule) in the Accounting section of Audit Procedures.

- Check Processing

a. Verify that incoming checks are properly recorded to customer/firm accounts and deposited.

b. Review security over checks for adequacy.

Refer to the following sections for related audit steps for Incoming and outgoing checks: (1) General Tests in the Accounting section for segregation of duties between Custodial and accounting functions and (2) Processing Tests In the Processing of Voluntary Reorganizations section for Funds disbursements.

*VI. Processing of Mandatory Reorganizations*

Select a sample of mandatory reorganizations (e.g. mergers, redemptions, full calls, liquidations, reverse splits, name changes, etc.).

- Announcements and Processing

 Refer to Announcements Tests and Processing Tests in the Processing of Voluntary Reorganizations section for related audit steps. Note that client instructions processing is not applicable.

- Calls

 In addition to the announcement and processing tests referenced above, the following audit procedures should be considered for calls:

— Lotteries

a. Review lottery procedures for compliance with regulatory criteria (e.g. randomness, proper inclusion/exclusion of accounts, correct date used to identify accounts eligible for lottery, etc.).

*****

a. Using the announcement files, select a sample of partial calls.

b. Compare internal lottery totals to DTC allocation amounts.

c. Determine that procedures are in place to generate a timely notice to the Custody area (e.g. "vault pull list") for called certificates.

[Note: Failure to properly "pull" called certificates will be detected by the Dividends Department in a subsequent interest period. A review of the Reorg error account should detect customer interest adjustments related to missed calls.]

Note: Prerefundings are similar to calls; however, replacement debt securities are received in lieu of cash.

- Maturities

In addition to the announcement and processing tests referenced above, the following audit procedures should be considered for maturities:

Verify that procedures are in place to:

a. Identify maturing issues in a timely manner. Bond redemptions should be expedited, i.e., sent to paying agents approximately ten business days prior to maturity to ensure timely collection of funds.

b. Identify and exclude defaulted issues from processing.

*VII. Regulatory Reporting*

a. Obtain the Reorganization regulatory reports and supporting documentation for the most recent month-end. This should include the 15c3-1 and 15c3-3 reporting categories.

b. Through review of regulations and discussions with the management of Regulatory Reporting, determine the applicable Reorg regulatory requirements.

c. Verify that all required Reorg categories have been included in the regulatory reports.

d. Verify that all calculations are accurate and are supported by adequate documentation as follows:

* Verify that system reporting logic is accurate (e.g. report criteria satisfy regulatory criteria such as aging of items).

* Where the system calculates the reportable amount per item, select a sample of line items and recompute the reportable amounts.

* Scan reports for obvious illogicals or pricing errors.

* Review manual adjustments to reported totals for accuracy and appropriateness.

*****

a. Trace and agree totals from supporting documentation to the Reorg regulatory reports.

b. Obtain a copy of the FOCUS report for the month-end. Trace and agree totals from the Reorg regulatory reporting detail to the FOCUS report. Review any adjustments made to the Reorg- related numbers for accuracy and appropriateness. *****

a. Obtain regulatory reports for a three-month period. Compare figures and identify any material variances. Through discussions with management, determine the reason for the variances. Note any exception conditions.

*VIII. Other*

- Escheatment

a. Review procedures for identification, segregation, and reporting of abandoned property, i.e., aged customer-related payables.

- Worthless/Expired Securities/Rights/Warrants

In many firms, the Reorganization Department is responsible for the Monitoring and processing of worthless securities, i.e., securities which Are defunct by virtue of the fact that the underlying issuer no longer Exists as a legal entity (e.g. corporate charter revoked) or securities Which have expired (e.g. expired rights). The Auditor should:

a. Verify that procedures are in place to:

  * Identify and validate/document the worthlessness of securities.

  * Transfer positions to an account for worthless securities.

  * Purge worthless positions from the Stock Record in a timely manner. This includes proper notification to clients.

*****

a. Obtain the bookkeeping report for the worthless securities account.

b. Verify that all positions in the account meet the criteria for classification as permanently worthless. Research/ document any exceptions.

c. Verify that there are adequate procedures in place to address recoveries, i.e., where securities which were previously worthless have recovered in value.

- Systems

a. Determine whether adequate System Development Life Cycle procedures are followed.

b. Verify that access to systems is limited to authorized individuals.

c. Verify that change management capabilities are limited to authorized personnel.

d. Review procedures and controls over software distribution, data ownership, firewalls, network control, copyright protection, etc.

- Contingency Planning

a. Review business recovery plans for adequacy.

b. Verify that plans have been tested and procedures are in place to update plans as needed.

- Physical Security

a. Review security over departmental assets (e.g. computers, reports, etc.) for adequacy.

- Management Reports

a. Obtain a copy of all management reports.

b. Verify that reports properly highlight items such as:

  * Time-sensitive activity
  * Aged balances
  * Material variances
  * Errors and related P&L
  * Unconfirmed items
  * Out-of-balances and breaks
  * Illogicals and data mismatches
  * Rejected items (e.g. securities sent to agent)
  * Corrections, adjustments and reversals
  * Entries to invalid ("no name") accounts

c. Verify that reports are produced/ distributed in a timely manner and are properly utilized by management.

- Regulatory Examinations

a. Review the results of recent regulatory examinations (e.g., annual Operations/ Financial examination performed by the NYSE) to determine if any reorganization-related findings were cited. Verify that any such findings have been properly addressed.

## VI. REFERENCE MATERIALS


Textbooks

- Michael T. Reddy, New York Institute of Finance: <u>Securities Operations, A Guide to Operations and Information Systems in the Securities Industry</u>, Second Edition, Prentice Hall, 1995.

Regulatory Guidelines

- The Municipal Securities Rulemaking Board Manual, Commerce Clearing House, 1995.
- The National Association of Securities Dealers Manual, Commerce Clearing House, 1995.
- The New York Stock Exchange Handbook, Commerce Clearing House, 1995.


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