



AUDIT GUIDELINES SECURITIES LENDING

August 16, 2002

The Audit Guidelines (the "guidelines") are intended to provide members of the Securities Industry Association ("SIA"), Internal Auditors Division with information for the purpose of developing or improving their approach towards auditing certain functions or products typically conducted by a registered broker-dealer. These guidelines do not represent a comprehensive list of all work steps or procedures that can be followed during the course of an audit and do not purport to be the official position or approach of any one group or organization, including SIA or any of its divisions or affiliates. Neither SIA, nor any of its divisions or affiliates, assumes any liability for errors or omissions resulting from the execution of any work steps within these guidelines or any other procedures derived from the reader's interpretation of such guidelines. In using these guidelines, member firms should consider the nature and context of their business and related risks to their organization and tailor the work steps accordingly. Internal auditors should always utilize professional judgment in determining appropriate work steps when executing an audit.



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I. INTRODUCTION TO SECURITIES LENDING

General Background

The internal Audit Guidelines for Securities Lending (also referred to as securities borrowing/lending) is a tool designed to facilitate the internal auditors' determination and assessment of the potential risks inherent in a securities lending business and the related controls which an organization may use to manage, monitor, and evaluate those risks. Also included are possible work steps that the Internal Auditor may perform to assess the effectiveness of controls and processes used in the monitoring of a firm's Securities Lending function. Although the guidelines were designed to evaluate the risks of a U.S. broker/dealer and its affiliate security dealers, many of the principles underlying the guidelines are also applicable to other financial services entities (e.g., investment managers, banks, and other custodians).

Broker/dealers borrow securities for various reasons, such as to effect delivery of short sales, to cover fails-to-deliver, and to satisfy segregation (possession or control) deficits. Securities borrowing and lending is critical to maintaining liquidity in the market place.

Both broker/dealers and institutions lend securities. Institutional investors are motivated to lend securities as a means of reducing funding costs. Custodian banks are natural holders of clients' inventory so they engage in securities lending on behalf of their custodial clients, including pension plans (securities lending is permitted by ERISA regulations), insurance companies, university endowment funds, mutual funds, and other clients. When custodian banks and other institutions are lending securities they may be acting either in a principal capacity or as agent. In a security lending transaction it is important to understand the legal capacity of the parties to the transaction in order to properly assess the ultimate credit risk.

Lending by broker/dealers is an effective cash management tool. Broker/dealers lend firm inventory as well as eligible margin securities as a means of generating inexpensive financing. Some broker/dealers operate a conduit or finder business. Under this arrangement, the broker/dealer borrows securities in order to re-lend them to another broker/dealer, thus allowing the broker/dealer to earn a spread on the transaction. In a conduit business, the intermediary acts as principal on each side of the loan and borrow. A finder typically functions in the capacity of agent on each side of the transaction. Intermediaries and finders typically earn a spread on the rebate rates between the two sides of the transaction.

When securities are lent, collateral is made available to the lender. Cash constitutes the major share of collateral held for U.S.-based accounts. The typical ratio of securities borrowed to collateral is plus or minus 102%. This ratio will vary depending upon the availability and volatility of the securities being borrowed. The lender has use of the collateral throughout the life of the loan. Upon agreement of the lender, non-cash collateral may be acceptable. When the borrower deposits cash it receives a fee, known as a rebate, on the amount that was exchanged for the securities. The rebate rate is negotiated between the lender and the borrower. Usually the rate negotiated is somewhat lower than the broker call rate available from a bank. The most influential factors in determining the rebate rate is the availability of the securities being borrowed and the need for cash. The less available the security, the lower the rate. In some cases the lack of availability could result in a negative rebate rate for which the lender receives rebate income. The amount of the rebate is calculated daily and paid periodically (e.g., monthly) over the life of the loan.

Process

The borrower locates a source for the securities to be borrowed, either directly or through an intermediary or finder. The borrower delivers collateral (cash, money markets or other cash equivalents) and the lender delivers the securities. This delivery occurs with same-day settlement. The borrower and lender record the transactions on their respective general ledgers and stock records. In accordance with Generally Accepted Accounting Principals, securities borrowed are recorded as a receivable and securities loaned are recorded as a payable. Over the life of the loan, the lender retains rights of beneficial ownership and the securities are marked to market. Under certain conditions, as specified in the loan agreement, substitutions may be allowed for non-cash collateral securing the borrow. The lender unwinds the transaction by issuing a loan recall to the borrower. The loan recall settles according to market settlement schedules, currently T+3 for corporate securities and municipal bonds. Conversely, the borrower may unwind the transaction by returning the securities to the lender when no longer needed. If recalled securities are not returned by the borrower, the lender can institute a buy-in procedure.

For the most part, firms participating in securities borrowing and lending transactions utilize the services of an industry wide service bureau (e.g., Loanet) to process the transactions. The service bureau offers a range of services, which can include complete processing, contract comparison and rebate billing and collection. For a further description of the process, refer to the Securities Lending Flowchart on page 17.

Regulation

For securities borrowing and lending transactions, broker/dealers are subject to rules and regulations of both the Securities and Exchange Commission (SEC) and Federal Reserve Bank (FRB).

The FRB's Regulation T ("Reg T") sets forth criteria representing "permitted purposes" for borrowing securities. Reg T stipulates, "without regard to the other provisions of this part, a creditor (broker/dealer) may borrow or lend securities in the case of short sales, failure to receive securities required to be delivered, or other similar situations." A broker/dealer may not borrow securities merely to enable it or another broker to have the securities on hand or to anticipate some need that may or may not arise in the future. A borrower, however, who reasonably anticipates a short sale may borrow securities up to one standard settlement cycle in advance of the trade date.

Reg T also dictates what asset classes may be used as collateral in a securities lending transaction. A broker/dealer may pledge the following asset types as collateral:

- Cash (any freely convertible currency)
- Money market instruments such as bankers acceptances, certificates of deposit, and money market mutual fund shares
- U.S. Treasury or agency securities such as FNMA's or FHLMC's
- Reg T margin-eligible foreign sovereign debt
- Irrevocable letters of credit that are insured by the FDIC or a foreign bank approved by the FRB.

Regulation

The customer protection rule, SEC Rule 15c3-3, pertaining to possession or control of customer securities, contains specific wording that relates to the contents of a written securities lending agreement that must accompany any securities lending transaction. An industry wide Standard Master Securities Loan Agreement, issued by the Bond Market Association is utilized for this purpose. Rule 15c3-3 also specifies the requirement to reduce securities to possession or control and describes the treatment of securities loaned and borrowed in the calculation of the customer reserve requirements.

The SEC's Net Capital Rule, 15c3-1, sets forth the treatment of securities lending transactions in the computation of net capital.

SEC Rule 17a-3 requires specific stock record treatment and documentation of securities lending transactions and Rule 17a-13 requires quarterly verification of stock loan and borrow positions.

The NYSE's Deliveries Against Short Sales regulation (440.C) requires that a broker/dealer make a "diligent effort" to borrow the necessary securities in order to avoid a fail to deliver against a short sale.

The NASD's Mandatory Close Out for Short Sales (Rule 11830), requires that a short sale of designated securities for a customer or for a member's own account must be delivered no later than the tenth business day following the settlement date. If delivery is not made, the member must close out the sale for cash or guaranteed delivery.

A security lending transaction is not protected by SIPC (Securities Investor Protection Corporation). The collateral delivered to the lender may be the only recourse in the event that the broker/dealer fails to return the securities.

Risks

The securities borrowing and lending business can be a rich source of revenue for all participants, i.e., broker/dealers, custodians and institutional clients. However, there are a number of risks that must be identified and managed as part of this business.

Counter-party or credit risk is the possibility that the counter-party reneges on the agreement, by not returning the securities or by defaulting on the return of the collateral. Counter-party risk often materializes as a result of the financial failure of a counter-party.

Risks

Operational risk may be present in the form of unauthorized activity or where there is a discrepancy in the loan details or underlying documentation as understood by the borrower and the lender. The lender retains rights of beneficial ownership. Therefore, dividend payments and corporate action activity must be properly accounted for. Contract comparison, especially through an industry wide service bureau such as Loanet, is a necessity. (Other service bureaus utilized by institutions include DML and Global Plus – both Sungard companies).

Settlement risk exists, especially on loan recalls, where the US market has an average fail rate of 30%. When a loan is recalled, if the security is not returned, there is the risk of a failure or buy-in.

Financial (accounting) risk is present to the extent that stock lending transactions are not recorded accurately or timely. Securities lending subsidiary records should be reconciled to the general ledger to ensure complete and accurate recording of transactions. In addition, profit and loss from securities lending activity should be calculated on a periodic basis.

Pricing or market risk exists as the price of the securities lent or securities put up as collateral change in price. For example, if the loan was initiated with a ratio of 102 % of the market value of securities given as collateral, and the price of the securities increases or decreases, more securities or more collateral may have to be put up to prevent undue exposure for either the borrower or lender. A daily mark-to-market procedure should be required, using an agreed upon pricing service to establish a standard mark. Once again, this is commonly performed through a service bureau, with the exposed counter-party exercising discretionary authority over the issuance of the mark. In some limited cases, particularly when securities have a limited market, obtaining daily accurate pricing information can be a concern.

Audit Guidelines

The following guidelines are presented primarily from the perspective of an organization that is conducting a securities lending business. It is important to note that these guidelines are not an exhaustive set of procedures that the auditor needs to follow during all audits of Securities Lending. To best evaluate securities lending activities at a specific firm, judgment should be exercised when determining the procedures to be performed and the sequence of performing those procedures.

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II A. AUDIT GUIDELINES

This guideline is intended to provide members of the Securities Industry Association, Internal Auditors Division with information for the purpose of developing or improving internal audit programs. The information is designed to provide guidance to member firms in the preparation of procedures tailored to the specific needs of their individual environment. Internal auditors should always use professional judgment in determining appropriate worksteps to complete specific audit steps.

The footnote in the “Risks to be Managed” section of the following tables is a cross-reference to the “Securities Lending Process Diagram” included on page 17. This reference is included for informational purposes and can be used to determine the potential areas of the securities lending process that may be affected.

Credit/Counter-party (see note)

<i>Risks to be Managed</i>	<i>Types of Controls to Manage or Eliminate Risks</i>	<i>Potential Audit Work Step</i>
<ul style="list-style-type: none"> • Credit policies and procedures are not adequate to manage the credit risk inherent from securities lending activities, exposing the firm to potential financial loss arising from counter party failure. <p>(1,2,3)</p>	<ul style="list-style-type: none"> • Someone independent from stock loan sales or operations functions (e.g., Credit Committee) is responsible for establishing credit policies and monitoring adherence to those policies. Approval of counter parties is documented. • Appropriate credit limits are established for each counter-party approved for stock lending business. • Concentration limits (by issuer) are set for securities lending to avoid excessive exposure to any single issuer securities. • Counterparties are subjected to an initial credit review and to periodic reviews thereafter. A process exists to monitor, report, age and approve instances where reviews are not completed within prescribed timeframes. 	<ul style="list-style-type: none"> • Determine that an independent authority is responsible for approving (e.g. Credit Committee) and monitoring (e.g. Credit Department) counter-party credit and concentration limits. • Review Credit Committee minutes to verify that limits have been approved. • Ascertain that limits are established only after a review of the counter-party’s financial condition has been completed. • Ascertain that guidelines used to establish and approve credit and concentration limits are adequate. • Select a sample of counterparties. Review their respective credit files to determine that appropriate documents (e.g., financial statements, SEC filings, press releases) are included to support the credit limit. • Verify that credit reviews are up to date.

Credit/Counter-party *(see note)*

<i>Risks to be Managed</i>	<i>Types of Controls to Manage or Eliminate Risks</i>	<i>Potential Audit Work Step</i>
	<ul style="list-style-type: none"> • When finders are utilized for securities lending, the finders are subjected to appropriate due diligence to ensure that finders meet established criteria concerning reputation and financial stability. • Counter-parties are required to provide signed stock loan/borrow agreements in conformity with the industry's Standard Master Securities Loan Agreement issued by the Bond Market Association (Annex I provides requirements for disclosure of the underlying principals when one party is acting as agent). • Executed stock loan agreements are maintained and secured by someone independent of stock loan sales. Procedures exist to identify and follow up on instances where an executed agreement has not been received. • Exceptions to credit limits are reported to and reviewed by someone independent of stock loan sales and operations functions. • Metric reports are in place to identify trouble or stressed accounts (e.g., high rate of violations). 	<ul style="list-style-type: none"> • Determine that finders are subjected to adequate levels of due diligence. • Ascertain that signed securities lending agreements conforming to industry standards are on file and that appropriate follow up is performed on unexecuted agreements. • Review procedures for monitoring adherence with approved credit limits. Verify that someone independent of stock loan functions reviews credit limit exceptions. • Obtain credit and concentration limit exception reports and investigate any significant exceptions. • Review exception reports over a selected period of time and investigate any identified exception trends (e.g. same counter-party, same security, same salesperson/trader, exceptions consistently just below the reporting threshold). • Review reports and processes in place to identify and monitor potential troubled accounts.

Note: For further guidance on credit/counter-party risk reference is made to the IAD Audit Guideline on Credit Risk, dated October 15, 2001.

Operational

<i>Risks to be Managed</i>	<i>Types of Controls to Manage or Eliminate Risks</i>	<i>Potential Audit Work Step</i>
<ul style="list-style-type: none"> Procedures and controls do not provide assurance that stock lending activity is: <ul style="list-style-type: none"> - Authorized and necessary; - Processed accurately and timely; - Properly adjusted to ensure collection of dividends, interest and other corporate actions. <p>(4,5,6,7,11)</p>	<ul style="list-style-type: none"> Approved credit limits can only be input or changed by personnel independent of stock loan sales and operations functions. Exception reports identify any counter-party that does not have an approved credit limit, indicating possible unauthorized lending or borrowing activity. Daily activity and balances are reconciled between stock loan subsidiary records, DTC and service bureau records. A person independent from the individual performing the reconciliations reviews reconciliations. Stock loan positions are automatically updated to reflect corporate actions. Differences are aged and followed up for resolution. 	<ul style="list-style-type: none"> Determine that individuals responsible for maintaining counter-party credit limits (e.g. Credit Department) are independent from stock loan sales and operations functions. Review stock lending activity and verify that all counterparties have been properly authorized. Review and test procedures for recording and balancing securities lending activity. <ul style="list-style-type: none"> ♦ Test the accuracy and balancing of the firm's records to DTC. ♦ Test the accuracy and balancing of the firm's records to service bureau records. ♦ Verify that a daily comparison of all contracts is performed and is accurate. ♦ Determine that an independent person reviews reconciliations. Select a sample of stock loan positions outstanding over a corporate action and dividend payment date. Verify that positions and prices are properly adjusted to give effect to the corporate action and that dividends due on securities loaned are collected.

Settlement

<i>Risks to be Managed</i>	<i>Types of Controls to Manage or Eliminate Risks</i>	<i>Potential Audit Work Step</i>
<ul style="list-style-type: none"> • Stock loan recalls are not issued timely and accurately and securities are not returned in accordance with instructions. <p>(12,13)</p>	<ul style="list-style-type: none"> • Daily reports are generated of securities that must be recalled. • Stock loan recalls and returns are processed timely and accurately. 	<ul style="list-style-type: none"> • Test the procedures for issuing stock loan recalls and determine that recalls are processed properly. <ul style="list-style-type: none"> ◆ Select a sample of stock loan positions that must be closed. Verify that recall notices were issued and that securities were returned within the required timeframe. ◆ Where securities have not been returned, verify that buy – in procedures have been instituted.

Financial

<i>Risks to be Managed</i>	<i>Types of Controls to Manage or Eliminate Risks</i>	<i>Potential Audit Work Step</i>
<ul style="list-style-type: none"> Stock loan rebates are not calculated correctly or not collected from counter-parties when due. <p>(10)</p>	<ul style="list-style-type: none"> Rebates are calculated automatically and procedures provide for accurate and timely collection/payment. Stock loan rebates receivable are aged and appropriate action is taken to collect amounts due. 	<ul style="list-style-type: none"> Review and test the procedures for billing, collecting and paying rebates. Rebates may be processed automatically through a stock loan service bureau such as Loanet or manually for transactions executed broker to broker. <ul style="list-style-type: none"> Verify the calculation and the proper recording of rebate amounts. Review rebate rates to ascertain that they conform to established parameters and are reasonable (see also Management Reports section). Review the stock loan rebate receivable aging and obtain explanations for uncollected amounts. Determine that personnel independent of stock loan functions process rebate checks.
<ul style="list-style-type: none"> General ledger accounts do not: <ul style="list-style-type: none"> - Accurately reflect balances from securities lending activity; - Correctly indicate profit and loss from securities lending. <p>(11)</p>	<ul style="list-style-type: none"> Borrow and loan subsidiary records are reconciled to the general ledger. Profit and loss for stock lending activity is calculated and reviewed periodically. Financial results of stock lending activity are periodically compared to budget/forecast amounts. 	<ul style="list-style-type: none"> Verify that loan and borrow transactions are reconciled to the general ledger. Review and test the accuracy of the reconciliation. Review and test the accuracy of the profit and loss calculation for the securities lending business. Obtain explanations for variances between actual results and budgeted results.

Market

<i>Risks to be Managed</i>	<i>Types of Controls to Manage or Eliminate Risks</i>	<i>Potential Audit Work Step</i>
<ul style="list-style-type: none"> The market value of collateral is not sufficient to satisfy stock loan contract rights and/or obligations, creating exposure in the event of counter-party default. <p>(8,9)</p>	<ul style="list-style-type: none"> Stock loan positions are marked to the market daily and collateral amounts adjusted accordingly. Price exception reports detailing potentially stale or incorrect collateral prices are reviewed by an independent party. Policy, procedures and the Security Lending Agreement clearly specify at what amount marks are not issued because they are considered insignificant. Mark to market exposure is reported to and reviewed by personnel independent of stock loan functions. 	<ul style="list-style-type: none"> Review and test procedures for marking stock loan/borrow positions to market. Verify that marks are calculated timely and accurately. <ul style="list-style-type: none"> Review procedures for verifying the accuracy of collateral market prices. Verify that price overrides are authorized and supportable. Select a sample of positions and verify prices used against independent pricing services. Determine that marks are issued and collected in accordance with firm policy. Ascertain that sufficient collateral (e.g., 102%) is received and maintained on stock loan transactions. Review and test accuracy of reports of mark to market exposure.

Regulatory

<i>Risks to be Managed</i>	<i>Types of Controls to Manage or Eliminate Risks</i>	<i>Potential Audit Work Step</i>
<ul style="list-style-type: none"> Procedures do not ensure compliance with all applicable rules and regulations. <p>(Entire flow)</p>	<ul style="list-style-type: none"> Over-borrow reports are produced detailing securities borrowed positions without a related short sale, fail or other similar position. Reports are generated of securities to be borrowed or recalled in order to comply with the possession or control requirements of SEC Rule 15c3-3 ((b) and (d)). Procedures exist to ensure that securities loaned and borrowed amounts are properly calculated and included in the reserve formula under SEC Rule 15c3-3 (Exhibit A items 3 and 11) and the net capital computation under SEC Rule 15c3-1 (paragraphs (c)(1), (2)(iv)(B) and (G)). Amounts calculated for the reserve formula and net capital are prepared or reviewed by personnel independent of stock loan. Stock Loan Department approval is required prior to execution of short sales. Personnel independent from stock loan functions verify positions (SEC Rule 17a-13) through confirmation with counter parties. Procedures provide for compliance with SEC Rules 17a-3 and 4 (Keeping and Preservation of Records). 	<ul style="list-style-type: none"> Review over-borrow reports and investigate borrow positions with no apparent permitted purpose. Review and test procedures for compliance with the possession and control requirements of SEC Rule 15c3-3. <ul style="list-style-type: none"> Review reports of borrowing/recall requirements. Verify that appropriate amounts of securities are borrowed/recalled on a timely basis. Test the calculation of the amounts included in the reserve formula and the net capital calculation related to securities lending activity. Ascertain that someone independent of securities lending functions has reviewed the amounts calculated. Review and test procedures for obtaining stock loan approval for short sales. Ensure that approval is documented. Review results of quarterly verification procedures. Ascertain that individuals independent from stock loan functions perform the quarterly verification procedures. Ensure that record maintenance and retention meets the requirements of SEC Rules 17a-3 and 4.

Management and Expense Reports

<i>Risks to be Managed</i>	<i>Types of Controls to Manage or Eliminate Risks</i>	<i>Potential Audit Work Step</i>
<ul style="list-style-type: none"> • Reports generated do not provide management with accurate, relevant or timely information to enable them to effectively manage risks. (Entire flow) 	<ul style="list-style-type: none"> • The following are examples of reports that may be provided to management concerning securities lending activities: <ul style="list-style-type: none"> - Analysis of activity by customer (balances, profitability, etc.). - Mark to market exposure (issued and unissued marks). - Concentration (by counterparty, by security relative to outstanding shares) of securities on loan. - Aged stock loan receivables and payables. - Net capital charges. - Errors, suspense and out of balance amounts. - Non-standard rebate rates (identify rebate rates outside of established parameters) - Credit limit exceptions - Dividend/interest exposure 	<ul style="list-style-type: none"> • Ascertain that management is being provided with all the information needed in order to effectively supervise securities lending activities. • Review and test the accuracy, completeness and timeliness of management reports.
<ul style="list-style-type: none"> • Expenses of stock loan personnel are inappropriate, excessive or otherwise do not conform to firm policy. (Entire flow) 	<ul style="list-style-type: none"> • Policy and procedures specify requirements relative to reimbursable expenses. • Expense reports are reviewed and approved by management. 	<ul style="list-style-type: none"> • Review expense reports for securities lending personnel to determine that expenditures are reasonable, in compliance with established policy and are approved. • Analyze overall out of pocket expenses for reasonability in light of the level of business. • Review expense reports to ascertain if there is an unreasonable or inappropriate concentration of expenses to a third party.

Technology

<i>Risks to be Managed</i>	<i>Types of Controls to Manage or Eliminate Risks</i>	<i>Potential Audit Work Step</i>
<ul style="list-style-type: none"> Inappropriate users are able to view and manipulate data housed within the securities lending system. (Entire flow) 	<ul style="list-style-type: none"> Programmed controls over access to the securities lending system. Access to the functionality within the securities lending system is commensurate with job responsibility. Access violations are reviewed and acted upon on a regular basis. 	<ul style="list-style-type: none"> Determine and test that systems have adequate access security controls. Obtain reports of users who have access to the system and verify that their access is appropriate. Understand which users are authorized to adjust data and assess the propriety of such authority. Review audit logs and assess the monitoring process over time. Perform a representative sample and ensure that violations have been reported to management.
<ul style="list-style-type: none"> Users cannot change securities lending system programs. (Entire flow) 	<ul style="list-style-type: none"> Programmed controls automatically log system changes. An enacted process and approval hierarchy has been developed for system changes. 	<ul style="list-style-type: none"> Verify that program changes are made through a change process that ensures that changes to credit limits and related calculations are properly authorized tested and approved.
<ul style="list-style-type: none"> A disaster occurs which in some way disrupts routine operations. (Entire flow) 	<ul style="list-style-type: none"> Business continuity and disaster recovery plans exist and are approved by senior management. Data backup and restoration process exists and is defined. 	<ul style="list-style-type: none"> Ensure the existence of a Business Continuity Plan (BCP) and determine how the plan has been validated for practicality and effectiveness.

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II B. SEGREGATION OF DUTIES CHECKLIST

Introduction

Adequate segregation of duties reduces the likelihood that errors (intentional or unintentional) will not be prevented and remain undetected. The basic idea underlying segregation of duties is that no one employee or group of employees should be in a position both to perpetrate and to conceal errors or irregularities in the normal course of their duties. Additionally, errors may occur due to inadequate supervision of employee activity. In general, the principal incompatible duties to be segregated are: authorization, custody of assets, and recording or reporting of transactions. In addition, the risk management function as well as other oversight functions (Controllers, Compliance, Legal, Credit) should be separated from the functions that are originating risk itself and the processing of a transaction.

A practical method for using this checklist is to:

1. List the names of individuals responsible for particular functions.
2. Review the checklist for individuals whose names are listed more than once.
3. Make a determination whether that represents a potential lack of segregation of duties.
4. Consider whether individuals are performing incompatible duties.

Once an individual is identified as performing incompatible duties, all duties performed by that individual should be challenged as to whether the effectiveness of those duties is reduced or eliminated by the lack of segregation of duties identified. Larger organizations may find it sufficient to list only the department performing each of these duties or functional job titles, rather than the names of individuals. Those companies could then evaluate whether any departments were performing incompatible duties.

Keep in mind that not all instances where an individual performs more than one function represent a lack of segregation of duties. In addition, it is important to remember that there is a possibility of a lack of segregation of duties within the same category. Consequently, completion of this checklist is intended to highlight potentially conflicting duties, not to be the only method of identifying all such conflicting duties. The segregation of duties checklist is located on the following page.

SEGREGATION OF DUTIES CHECKLIST

Credit Limit Application and Approval

Who approves new counterparties?

Who establishes the assessment of credit worthiness?

Who determines credit limits?

Who approves credit limits?

Who monitors and investigates counterparties?

Who has access to credit-related data files and programs?

Who determines securities lending credit risk management policy?

Booking and Accounting of transactions

Who executes transactions?

Who maintains books and records concerning securities lending transactions?

Who reconciles front office records to accounting office records?

Valuation

Who values positions?

Who reconciles position values to independent pricing source?

Who reviews and approves the position valuation reconciliation?

Regulatory Review

Who monitors and ensures compliance with regulatory requirements?

Who obtains and maintains the necessary credit limit and collateral documents?

Monitoring

Who is responsible for monitoring collateral and reconciling with custodian statement?

Who monitors positions against credit risk limits?

Who reviews and approves instances where credit limits have been exceeded?

Who monitors securities lending position exposure?

Who reviews and approves securities lending personnel expense reports?

Confirmation of Trades

Who is responsible for sending periodic statements for collateral?

Who is responsible for handling and documenting credit inquiries from counterparties?

Who receives inward and outward confirmations/statements?

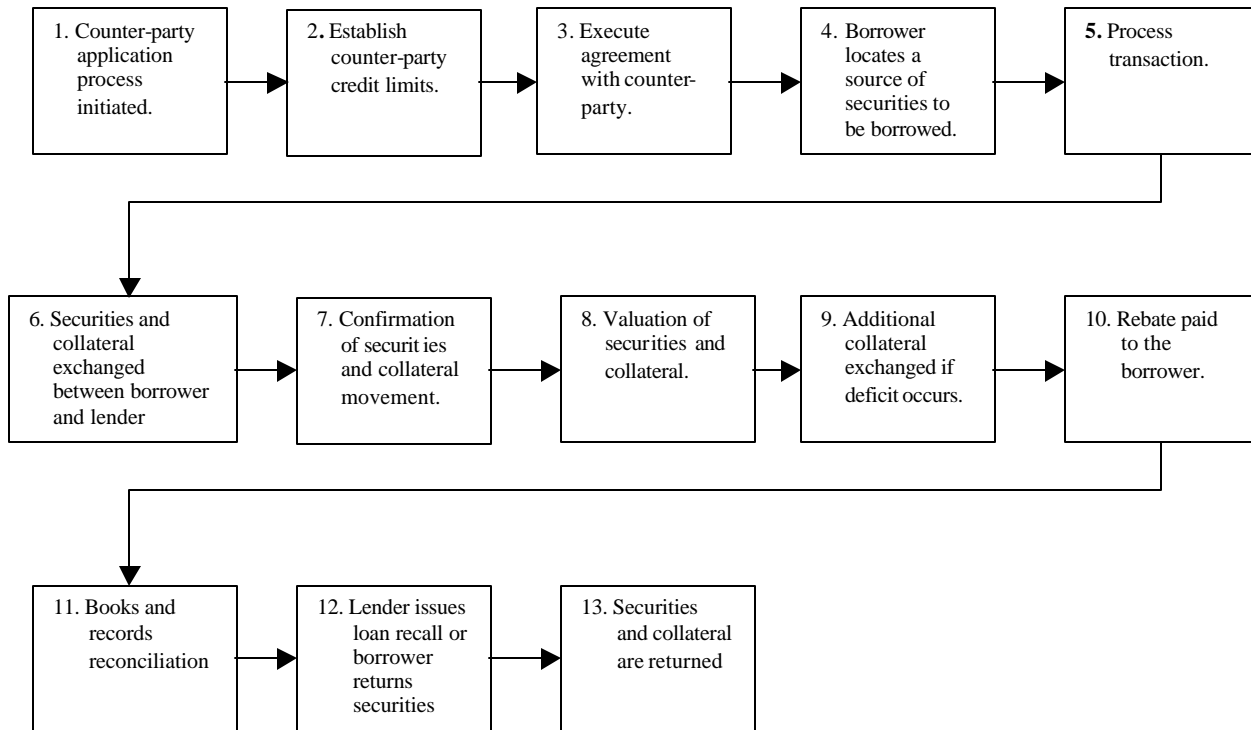
Who is responsible for quarterly verification procedures under SEC Rule 17a-13?



III. SECURITIES BORROWING AND LENDING FLOWCHART

The following flowchart illustrates the typical securities borrowing and lending transaction cycle. Definitions for the individual process steps are included below. Such definitions are numbered in order to cross-reference with the appropriate process steps.

Securities Borrowing and Lending Diagram Flowchart



Definition of Process Steps

1. Counter-party application process initiated – Open account for counter-party according to the existing procedures in the organization. Securities lending area applies for a counter-party credit line for securities borrowing and lending transactions with required documentation, including all lending agreements.
2. Review/approve counter-party credit limits established by credit department
3. Establish terms with counter-party and complete documentation that is required by the firm's credit policy
4. The borrower locates a source for the securities to be borrowed, either directly or through an intermediary or finder.
5. Transaction entry into the firm's books and records system. If an outside service bureau is also used (e.g., Loanet, DML, etc.), proper care should be taken to make sure that consistent information is used internally and externally.

6. Securities and collateral movement are exchanged between the borrower and the lender. The borrower delivers collateral and the lender delivers securities. This delivery occurs with same-day settlement.
7. Confirmation of securities and collateral movement with the counter-party.
8. Valuation of securities and collateral -over the life of the loan, securities must be marked to market related to contract amounts on a daily basis. The pricing source to be used for marking positions should be agreed upon with the counter-party so that both sides to the transaction are using the same price to perform their marks.
9. Collateral maintenance- additional collateral collected if after the mark to market process is completed a deficit has occurred. Policies on deficit thresholds should be established and adhered to in order to effectively manage counter-party exposure.
10. A rebate is paid to the borrower usually on a monthly basis or some other mutually agreed-upon schedule.
11. Books and records reconciliation should include balancing positions among the stock record report, reports from the depository or custodial agents, reports from service bureaus such as Loanet and DML, as well as reconciliation between the front office and back offices.
12. The lender initiates a loan recall, resulting in the return of the securities and collateral. The loan recall settles according to the target market's regular-way settlement schedules, currently T+3 for corporate securities in the U.S. market.
13. Securities and collateral are returned. If the securities are not returned by the T+3 settlement deadline, the loan becomes a fail and the lender will initiate a buy-in process. A buy-in notice is sent notifying the borrower that the securities will be bought in the open market at the borrower's expense (market value exceeds collateral). This notification can be done in conjunction with the recall process.

The Audit Guidelines (the “guidelines”) are intended to provide members of the Securities Industry Association (“SIA”) Internal Auditors Division with information for the purpose of developing or improving their approach towards auditing certain functions or products typically conducted by a registered broker-dealer. These guidelines do not represent a comprehensive list of all work steps or procedures that can be followed during the course of an audit and do not purport to be the official position or approach of any one group or organization, including the SIA or any of its divisions or affiliates. Neither the SIA, nor any of its divisions or affiliates, assumes any liability for errors or omissions resulting from the execution of any work steps within these guidelines or any other procedures derived from the reader's interpretation of such guidelines. In using these guidelines, member firms should consider the nature and context of their business and related risks to their organization and tailor the work steps accordingly. Internal auditors should always utilize professional judgment in determining appropriate work steps when executing an audit.