

BD Regulatory Audits

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I. INTRODUCTION^{1/}

The handling of regulatory examinations is an important part of the duties and responsibilities of many compliance professionals. In today's regulatory climate, where the SEC and the SROs are placing increased scrutiny on firms' activities, it is critical for compliance officers to understand the regulatory examination process and the key issues relating to such inspections. This outline discusses several key topics in an effort to provide information concerning regulatory examinations and to furnish practical guidance on the handling of such inspections. Specifically, the outline covers the following topics: (1) background information regarding the regulatory exam process; (2) practical guidance for handling an inspection; (3) special issues regarding regulatory examinations; (4) NASD sweep exams; and (5) current examination priorities.

II. REGULATORY EXAMINATIONS

A. Types of Examinations

1. Routine examinations are the most common examination type and generally follow a set schedule and procedures. These examinations regularly involve an inspection of a firm's financial, operational and sales practice compliance.

2. Cause examinations are typically triggered by events that would require firms to file Forms U-4, U-5, NYSE RE-3 and NASD 3070. For example, a regulator may initiate a cause examination as a result of a customer complaint or series of complaints regarding a broker or a particular type of investment (e.g., annuities or brokered CDs). Cause examinations may also result from arbitration referrals, surveillance triggers or referrals from other securities regulators.

3. Sweep or special examinations typically involve a large number of firms that are scrutinized relating to a specific industry issue. Recent examples of sweep examinations include those relating to mutual fund breakpoints and sales practices, information barriers, hedge funds and the role and activities of Compliance Departments. (See Section V below for a more detailed discussion of NASD sweeps.)

^{1/} This outline was drafted by Ben A. Indek, a partner of Morgan, Lewis & Bockius LLP. Sections II, III and IV are edited and enhanced versions of outlines developed by a number of individuals for use in connection with past Securities Industry Association Compliance and Legal Division and NSCP seminars. Mr. Indek is greatly indebted to the work of those persons and wishes to acknowledge their efforts.

B. Pre-Examination Work by a Regulator

1. Prior to the commencement of any regulatory examination, SEC and SRO examiners spend considerable time and effort gathering and reviewing available data regarding the firm to be inspected. This process includes obtaining information from within the SEC or SRO (including information relating to customer complaints, prior disciplinary history, litigation, statistical data, etc.) and requesting information and records from the firm.

2. This process is intended to gain an understanding of the firm, its registered persons and business activities and to focus the inspection.

C. Initial Communication By a Regulator

1. Notice

a. SEC and SRO rules do not require that notice be given in advance of an examination. Yet, notice is generally provided for routine examinations in order to facilitate advance production of requested material and an overall orderly examination. Cause and sweep examinations typically involve little or no notice. Often times, however, the SEC and SROs will publicly hint at or actively announce impending sweeps.

2. Benefits of Notice

a. Documents can be located and organized in advance.

b. Supervisors and compliance personnel can be prepared for anticipated questions.

c. Individual schedules can be rearranged.

d. Firms can reduce the time that examiners are on site with good preparation.

e. Firms can focus their attention on the examination at hand rather than responding to requests for documents or information.

3. Benefits of No Notice

a. Regulators believe that the integrity of the information provided by a firm is enhanced when it is produced by a firm with little or no notice.

b. Where a firm is able to effectively and efficiently respond to a surprise examination, it further supports the notion that the firm has good systems and controls in place.

D. Notifications of Requested Material/Information

1. Documents that are typically requested for routine examinations are limited to a specified period of time and are usually standard in nature. Requests for internal

audit reports, branch examination reports, records regarding internal disciplinary actions and other related materials raise issues that should be addressed with the staff.

E. Staffing and Coordination by Regulators

1. SEC examinations are coordinated by the Commission's Office of Compliance, Inspections and Examinations. These examinations may be conducted by Staff from regional offices, district offices, or the SEC's principal office in Washington, D.C.

2. NYSE examinations are staffed from the Division of Member Firm Regulation located in New York City.

3. NASD examiners from its district offices conduct examinations. Typically, but not always, examiners conduct inspections within their respective districts.

4. Efforts have been made to coordinate examinations. On November 30, 1995 the SEC released a Memorandum of Understanding signed by the SEC, the examining SROs and NASAA "to promote cooperation and coordination among the examining authorities as well as to eliminate unnecessary and burdensome duplication in the examination process." Dual NASD and NYSE members may request a coordinated examination be conducted by those regulators.

5. With the increasing vitality of state regulators and the effectiveness of the SEC's long-awaited books and records rule in May 2003, state regulators currently play an important role in broker-dealer examinations.

F. The Duration of Regulatory Examinations

The duration of routine examinations varies based on the size of a firm and the number of examiners dedicated to the project. For large firms, routine examinations may take six months or longer to complete. (Of course, much of that time will be spent off-site analyzing materials and following-up on open issues.) Firms should keep in mind, however, that the more effort they put into producing requested material on a timely basis, and the more effort that is made to making sure that the examiner(s) understand the firm's business and methods of operation, the less time the regulators are likely to spend completing the examination.

G. Status Reports

1. Generally, firm representatives involved in the examination process shy away from asking the regulators for interim status reports. Firms are concerned that by asking too many questions, the regulators may become overly suspicious. Yet, a reasonable and timely request for interim status reports may enable a firm to promptly respond to an issue that is troubling an examiner. A firm might then be in a position to explain or clarify certain information before it becomes part of the exit interview.

2. Whether the examiners will provide interim information or findings depends on the individual involved and the ability of each firm to establish an appropriate rapport with the examiners.

H. Results of a Regulatory Examination/The Exit Interview

1. It is customary at most of the SROs to hold an exit interview at the conclusion of a routine examination. To a great extent, this meeting has become a formality where the staff recites the alleged violations they intend to report in their letter.

2. Firms should view the exit interview the same way they view status reports. In other words, every opportunity should be taken to demonstrate to the examiners the firm's commitment to the compliance function and to advocate its position with respect to each of the preliminary findings.

3. Who attends the exit interview from the firm's standpoint should be considered carefully. When a firm sends senior representatives to this meeting, it demonstrates respect and concern for the examination process.

4. Regulatory examinations typically conclude with the delivery of a report to the firm identifying the results of the inspection. Such reports require a response by the firm.

5. Upon the completion of an examination, regulators may close the matter without action, provide a deficiency letter to a firm or refer the matter to enforcement for a follow-up investigation.

III. PRACTICAL GUIDANCE FOR HANDLING REGULATORY EXAMINATIONS

A. Steps to Take Before the On-Site Portion of the Exam Begins

1. Notify senior management, compliance and legal of an upcoming examination. Review the examination notice and request and identify and notify parties responsible for responding to the request. Discuss with the examiners before they arrive any requests that are unclear or potentially over-broad.

2. Designate a knowledgeable, cooperative and personable employee to be the primary interface with the examiners during the examination. Advise other personnel of the upcoming examination, and who the primary interface will be. Suggest that all communications with the examiners be handled by the primary interface.

a. A senior Compliance Department employee is ideal, but each firm should carefully identify the “right person.”

3. Organize and have ready for inspection the documents requested by the regulator. Have personnel available for the first meeting.

4. Set aside space in each of the firm’s offices visited by the examiners enabling them to work more efficiently to conclude their examination. Also, removing the examiners to their own designated space will minimize the disruption of normal business activity.

5. If possible, ask the examiners in advance what resources they will need from you (e.g., computer, printer, telephone, etc.).

B. Actions to Take During the Exam

1. Educate the examiner about the nature of the firm’s business activities, philosophy, and organizational structure. It is critical to make sure that the firm and the examiner(s) are “speaking the same language.”

2. Encourage communication between firm representatives and examiners to gauge the examiner’s progress and impressions.

3. Firms should cooperate and accommodate all reasonable requests by producing and reviewing requested documents as quickly as possible. Firms will not gain points by making the staff sit idly waiting for documents. In addition, the longer the examiners wait, the more time they have to come up with additional document requests.

a. While cooperative, firms should not give unfettered access to records or allow regulators to roam through files. Ask examiners to communicate all requests through the primary interface. Examiners should not ask administrative staff or other personnel for information.

b. SEC Rule 17a-4(l) requires firms to make and keep current, separately for each office, certain books and records relating to the office. Where a firm does not maintain the records at an office, the firm may choose to produce the records “promptly” at the request of the regulator. The term “promptly” is not defined in the rule. According to the SEC, requests for records should generally be filled on the day the request is made. The SEC has informed the industry that, “valid reasons for delays in producing the requested records do not include the need to send the records to the firm’s compliance office for review prior to providing the records.”

c. Particular care should be taken to withhold any record that is privileged or otherwise protected from disclosure, but be certain any information withheld is actually privileged. Just because a document may be labeled “privileged” or “confidential” does not make it so.

d. Copies of any records provided to a regulator should be maintained by the firm and appropriately labeled to maintain the confidential nature of such materials. Make sure to replace originals in the file from which they were obtained.

4. Where a firm is advised of a problem or concern perceived by a regulator during the course of an examination, the firm should consider taking prompt remedial steps to address the issue prior to the conclusion of the inspection.

5. Prior to the examiners leaving the premises, attempt to locate any missing documents requested during the inspection and provide such materials to the staff.

6. Where disagreements have occurred during the course of an examination, the firm should make clear their position on any such issue prior to the conclusion of the on-site portion of the inspection. If there is strong disagreement on an issue, consider the appropriateness of contacting the examiner's supervisor for discussion before the issue is identified as a finding.

C. Responding to the Examination Report

1. Firms should consider the following in connection with the examination report:

- a. Promptly review the report with senior executives.
- b. Continue to take remedial actions to address any identified concerns or begin the process with respect to issues raised only in the report.
- c. Draft and be prepared to provide revised procedures that address any identified concerns.
- d. Draft and circulate a detailed response.
- e. Include responses to all items identified in the report.

IV. SPECIAL ISSUES DURING REGULATORY EXAMINATIONS

A. Internal Audit Reports

1. SROs generally take the position that internal audit and other internal investigative reports will not be requested on a routine basis, but will be required to be produced when special circumstances dictate.

2. Attorney-Client Privilege

- a. Requires a "communication" between the client and the attorney.
- b. The privilege may extend to agents of the attorney, but only under certain limited circumstances.

c. This privilege would generally not apply to internal audit reports prepared by non-attorneys.

3. Self-Evaluative Privilege

a. The theory behind this privilege is to promote the public interest in encouraging institutional self-policing by protecting internal investigative reports of corporate wrongdoing. Criteria that must apply: (1) the information to be protected must result from critical self-analysis, (2) the free flow of this category of information must advance the public interest, (3) the absence of confidentiality would discourage the free flow of the information in question.

b. Courts have construed the application of this privilege narrowly and inconsistently.

4. Considerations when responding to a regulatory request for internal audit reports.

a. Authority of request.

b. Nature of documents requested.

c. Alternative arrangements to provide information.

B. Employee Interviews

1. SRO rules and regulations arguably permit examiners to conduct employee interviews during the course of an examination.

2. SEC provisions do not permit examiners to require an employee to submit to an interview during the course of an examination.

a. Upon arriving at the firm, SEC examiners distribute a copy of SEC Form 1661 entitled "Supplemental Information for Regulated Entities Directed to Supply Information Other Than Pursuant to a Commission Subpoena." The Form describes the obligation to provide "mandatory" information pertaining to books and records requirements contained within Sections 17(a) and (b) of the Securities Exchange Act of 1934, among other provisions. Failure to provide "mandatory" information may result in criminal, civil or other sanctions. Information outside the scope of the "mandatory" information is voluntary.

3. If an examiner insists on conducting an employee interview, firms and their employees arguably have the right to be represented by counsel or other representatives during interviews conducted by examiners. Potential collateral consequences and/or a potential disciplinary action may require that firms and individuals be afforded the opportunity to seek advice of counsel prior to responding to requests for interviews from an examiner. This is particularly true if the area of inquiry is anticipated to proceed to enforcement or involves privileged information.

4. Firms should maintain strict control over the examiner's access to firm employees. A senior compliance employee or other qualified person should be assigned the task of serving as the liaison for the examiner. In the branch, the branch manager or operations manager should be assigned that task. The examiner should be informed that all requests for information and documentation be directed to the appointed liaison. Should an examiner seek to interview a firm employee, the firm should insist on being given sufficient notice so it may discuss the issue with the employee and allow the employee to decide if he or she wishes to seek advice of counsel.

5. Firms should insist that examiners do not interview brokers concerning pending complaints and arbitration proceedings. Such inquiries should be directed to the liaison assigned to respond to inquiries from the examiner. Attorney-client privileged communications may have taken place between the employee and counsel. The employee and the firm may be deemed to have waived the privilege if the employee responds to question asked by the examiner.

V. NASD SWEEPS

In October 2004, the NASD's Mary Schapiro described the NASD's sweep process at length at the Fall conference. The following information is taken from that presentation.

A. Background

1. NASD defines a sweep as a method used to obtain information and conduct examinations and investigations concerning systemic issues that are common to the entire industry or a certain segment.
2. NASD is using them more frequently in sales practice and related areas than in the past.
3. NASD has indicated that it carefully selects those firms included in a sweep.

B. The Market Regulation Department Sweep Process

1. Identification of a sweep topic.
2. Preparation, review and approval of staff action plan.
3. Delivery of specialized training to examiners.
4. Development of special exam tools, templates and request letters
5. Selection of firms
 - a. Based upon various factors, including level and type of activity, complaints, regulatory history and prior exam findings.
 - b. Attempt to include variety of broker-dealers (based upon size and structure)
6. Commencement of initial exams.
7. Incorporation of information from first exams into final plan.
8. Deployment of examiners to conduct the sweeps.
9. Report to sweep leadership.
10. Findings used to determine regulatory response.

C. Staff Commitments to Firms

1. NASD will track and approve centrally; different offices will not conduct the same or competing sweeps.
2. Close attention will be given to selection of firms included in a sweep in an effort to minimize the affect of multiple sweeps on a firm.
3. NASD will coordinate with the SEC, NYSE and other securities regulators to eliminate duplication and the burdens of such redundancies.
4. NASD will communicate with firms to assure that requested information is necessary, response dates are fair and reasonable and technology is used to facilitate production.
5. These commitments made with caveat that investor protection and the integrity of the market are paramount concerns.

D. NASD Sweeps

1. NASD had active 30 sweeps (independently and with SEC and NYSE) as of October 2004. These included:
 - a. Mutual fund share classes
 - b. 529 Plans
 - c. Broker dealer securities self-offerings
 - d. Structured products
 - e. Variable annuities
 - f. Fee based accounts
 - g. Fairness opinions

E. Additional Sweeps Since October 2004

1. Gifts and gratuities
2. SEC Section 31 fees

VI. THE SEC EXAM PROGRAM

On October 13, 2004 Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations, gave a speech entitled "An Update on the SEC's Examination Program." The speech makes the following key points:

1. The SEC's exam program philosophy is to be more proactive and to identify high risk conduct and take steps to end or mitigate the activity before it becomes too severe or systemic.
2. The SEC is implementing its philosophy by:
 - a. Risk based targeting – the staff is trying to identify high risk areas and launch target exams.
 - b. Identify and remedy problems – the SEC is taking a targeted approach to identify problems.
 - c. Fostering strong compliance practices – the staff is issuing public reports to foster communication about compliance practices and internal controls.

VII. SEC OCIE REFERRALS TO ENFORCEMENT

A. Factors considered in determining whether OCIE refers exam findings to the Division of Enforcement.

In her October 13, 2004 remarks, Lori Richards identified 10 criteria that are used in considering whether OCIE refers an exam's findings to the Division of Enforcement. These factors are:

1. Did fraud occur?
2. Were investors hurt?
3. If no fraud occurred, is the conduct ongoing, repetitive, systemic or severe?
4. Did the firm tell OCIE about conduct and remedy it?
5. Is the conduct the type the SEC or other regulators should address?
6. Is the conduct in a "message" area?
7. Did the firm profit?
8. Did the firm act with intent?
9. Is the firm a recidivist?

10. Were the firm's WSPs inadequate?

VIII. CURRENT SEC AND SRO EXAMINATION PRIORITIES

A. The following areas have been identified as SEC examination priorities for 2005:^{2/}

1. Sales Practices (including those relating to suitability, variable annuities and mutual funds);
2. Supervision;
3. Trading on Exchange Floors and by Market Makers;
4. Best Execution;
5. Internal Controls;
6. Net Capital and Customer Reserve Computations;
7. Fixed Income Mark-Ups;
8. Anti-Money Laundering;
9. Information Security;
10. Sales to Military Personnel;

B. NYSE exam priorities for 2005 include:^{3/}

1. AML;
2. Non-managed Fee-Based Accounts;
3. Electronic Communications;
4. Regulation SP;
5. Internal Controls;
6. Supervision of Electronic Devices;

^{2/} This areas were identified by John Walsh of OCIE at an April 2005 SIA Compliance and Legal Division seminar.

^{3/} These areas were identified by Michael Ruffino of NYSE Member Firm Regulation and discussed at a November 2004 SIA Compliance and Legal Division seminar.

7. Structured Products;
8. Retailization of Hedge Funds;
9. Outsourcing; and
10. Mutual Funds and Annuities.