

## **IVA: BD Regulatory Audits: What You Need To Know**

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### **I. INTRODUCTION<sup>1/</sup>**

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; (5) SEC examination program developments; and (6) current SEC and NASD 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 to determine whether it is in compliance with applicable laws, rules and regulations.<sup>2</sup>

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 sales practices, information barriers, fairness opinions, hedge funds and the role and activities of Compliance Departments.

4. The SEC conducts "oversight" examinations of firms that have been recently inspected by an SRO. In an oversight examination, the SEC is evaluating a firm's compliance with relevant rules and the efficacy of the SRO's examination program.<sup>3</sup>

#### **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

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<sup>1/</sup> 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. This outline was prepared in August 2006.

<sup>2/</sup> The NASD recently posted various written materials and a webcast on its website relating to the routine examination process. The materials provide an overview of the NASD's examination program and practical guidance on preparing and handling inspections. See July 5, 2006 NASD Release "What to Expect: Preparing For an NASD Routine Examination."

<sup>3/</sup> For an excellent overview of the SEC and SRO examination process see Clifford Kirsch & Holly Smith's "SEC & SRO Inspections," Chapter 23, contained in Kirsch's "Broker-Dealer Regulation" published by PLI. Several of the practical suggestions noted in this outline came from this outstanding work.

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, extensive e-mail records 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.

a. More recently, according to the Securities Industry Association, OCIE, the NYSE and NASD are working together to reduce examination program duplication:

“NASD and NYSE have identified common areas that they will allocate when conducting routine inspections so that only one regulator will be responsible for reviewing that area at a particular firm. These areas include: anti-money laundering, research analysts, regulation SP, business continuity planning, regulation SHO, monitoring of registered representatives subject to statutory disqualification, continuing education, new supervisory controls rules, internal controls, and electronic communications. As both regulatory organizations are responsible for such rules, there may be times, such as with cause examinations or sweeps where both organizations are reviewing the referenced areas but with respect to different regulatory initiatives or scope.

NASD, NYSE and OCIE are working to create a database of statistical branch office information that will be utilized to determine possible on-site branch visits, and to warehouse information concerning actual on-site visits made by either OCIE, NASD or NYSE. This database is accessible by NASD, NYSE and OCIE, with the expectation that it will further reduce unnecessary duplication of, and improve the efficiency of, branch examinations. The senior staffs of OCIE, NYSE and NASD have suggested that they will make greater use of joint “first day” letters, so that when the examiners begin examinations at around the same time they will develop a common information request to the extent feasible, considering that the examination teams will be focused on distinct topics, rules, and regulations. The senior staffs are considering adopting a practice by which sweep examination requests will routinely include a query as to whether the recipient has received any other recent request for the same or substantially similar information, and an instruction to the recipient to immediately inform the regulator of such a request.”<sup>4</sup>

b. In 2005, the NYSE and NASD agreed to and conducted 65 coordinated examinations of dual member firms.

c. Recent coordination efforts include:

(i) SEC, SRO and state agreement to coordinate examinations of firms that hold “free lunch” seminars for senior citizens that may include high pressure sales practices.

(ii) NASD and NYSE coordination of firms’ options business with the public.

(iii) Inclusion of language in SEC, NASD and NYSE letters, commencing examinations asking firms to inform the staff about any duplicative efforts of the 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.

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<sup>4/</sup> This information is available on the web at <http://sia.com/regulatorycoordination>. See also Lori Richards, “Transparency in Regulatory Examinations,” NYSE Regulation Second Annual Securities Conference, June 20, 2006.

## **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. Review records from prior examinations to confirm that noted deficiencies have been addressed.<sup>5/</sup>

3. 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."

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

5. 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.

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<sup>5/</sup> See Kirsch & Smith at 23-4.

6. 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.

#### **D. Tracking Corrective Action Plans**

1. A firm should consider developing and implementing a written plan that identifies and tracks the remedial actions to be taken as a result of deficiencies identified by an SEC, SRO or state examination.
2. The plan could identify the issue, describe the remedial steps, assign responsibility and define timelines for the action items.
3. A firm should consider testing for adherence to any recently implemented policies, procedures or systems prior to the onset of the next examination to confirm that any deficiencies are not repeated.

### **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.

### **C. Cooperation**

1. On September 14, 2005, the NYSE issued an Information Memo 05-65 on cooperation. While the memo applies most directly to the obligations of those under NYSE investigation, the principles could also be applicable to Exchange MFR examinations. The memo sets out the Exchange’s views on three specific topics: (i) required cooperation; (ii) extraordinary cooperation; and (iii) credit for extraordinary cooperation. For purposes of this outline, it is appropriate to focus on the eight factors that are often considered by the NYSE’s Division of Enforcement in assessing a firm’s cooperation during an investigation. They are:

- a. Prompt, full disclosure coupled with thorough internal review.
- b. Candor with the Exchange.
- c. Waiver of attorney-client privilege.
- d. Breadth, depth and timeliness of remedial action.
- e. Response to investigative requests.
- f. Aiding the jurisdiction of the Exchange.
- g. Culture of compliance.
- h. Partnering with the Exchange to uncover wrongdoing.

## **V. NASD SWEEPS**

### **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.<sup>6</sup>

2. NASD is using them more frequently in sales practice and related areas than in the past.

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<sup>6/</sup> See remarks of Mary Schapiro at the October 2004 NASD Fall Conference. While the following is mainly drawn from these remarks that focused on Market Regulation Department sweeps, the concepts should apply to all NASD sweeps.

3. NASD has indicated that it carefully selects those firms included in a sweep.

## **B. The 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.

## **VI. THE SEC EXAM PROGRAM**

### **A. Background**

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.

## **B. 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?

## **C. Recent developments in SEC examinations<sup>7</sup>**

1. Before beginning any sweeps, OCIE is consulting with other SEC staff and the SROs. OCIE is also alerting the Commission to the commencement of a sweep.

2. OCIE is updating its examination brochure provided to firms at the beginning of an exam. The new brochure includes more information on the exam process.

3. OCIE's new policy is to advise firms of the status of examinations; where an exam is still ongoing for more than 120 days from the end of the fieldwork, the examiner will contact the firm and provide a status report, including the likely time until completion.

4. OCIE has established a telephone Examination Hotline where problems, complaints or concerns about examination (on an anonymous basis if a firm so desires) can be communicated to senior staff.

5. OCIE has been meeting with firms throughout the country to provide information on common examination findings.

6. OCIE has been reviewing the language in its deficiency letters to assure that the text is appropriate and conforms to the findings.<sup>8</sup>

7. OCIE is attempting to understand better the work of firms' internal auditors to gauge brokers-dealers' internal controls. The staff is seeking to meet with internal auditors, understand their own risk assessment protocols, cycles, reports and follow-up. The staff may also seek some specific audit reports during exams.<sup>9</sup>

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<sup>7/</sup> See Richards' remarks at the NYSE Regulation Second Annual Securities conference for information on these topics.

<sup>8/</sup> See Lori Richards, "Better Than Business As Usual," NSCP National Membership Meeting, October 25, 2005.

<sup>9/</sup> See Lori Richards, "Internal Audits and SEC Examination," SIA Internal Auditors Division 2005 Annual Conference, October 18, 2005.

8. OCIE is in the process of implementing a system to collect, track and analyze information about all of the SEC-registered entities (including branch offices) in a select group of the larger organizations. OCIE expects to share this information with other regulators.<sup>10</sup>

## **VII. CURRENT SEC AND NASD EXAMINATION PRIORITIES**

### **A. The following areas have been identified as SEC examination priorities for 2006:<sup>11/</sup>**

1. Sales Practices and suitability (including variable annuities, penny stocks, illiquid securities, hedge funds and separately managed accounts);
2. Supervision (focusing on branch offices, outsourcing, remote offices and brokers with disciplinary records);
3. Risk management and internal controls (liquidity, concentration, conflicts of interest, BCP, prime brokerage, and structured finance);
4. Trade reporting, best execution, fixed income mark-ups, potential misuse of customer information and frontrunning;
5. Anti-Money Laundering (CIP, SAR and compliance programs);
6. Books and records, including e-mail retention;
7. Information security (Regulation SP and identity theft);
8. Sales and marketing to senior citizens;
9. Outside business activities of brokers, including mortgage brokers, or sellers of variable insurance products or hedge funds; and
10. Investment advisory activities of broker-dealers that subjects firms to the Advisors Act.

### **B. NASD Examination for 2006<sup>12</sup>**

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| 1. Variable insurance products;   | 8. Private securities transactions;                  |
| 2. Mutual fund sales practices;   | 9. Regulation S-P;                                   |
| 3. Anti-money laundering;         | 10. Heightened supervision and supervisory controls; |
| 4. Electronic communications;     | 11. New products and non-conventional instruments;   |
| 5. Branch office sales practices; | 12. Broker-dealer self and affiliate offerings;      |
| 6. Sales seminars;                | 13. REITs; and                                       |
| 7. Equity indexed annuities;      | 14. Regulation SHO                                   |

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<sup>10/</sup> See Mary Ann Gadziala, remarks at the SIA Compliance and Legal Division Regional Seminar, October 19, 2005.

<sup>11/</sup> These areas were identified by Mary Ann Gadziala of OCIE at the June 22, 2006 SIA Compliance and Legal Division monthly luncheon in New York City.

<sup>12/</sup> See NASD's improving examination results website page updated in May 2006.