

V(a) BD Regulatory Examinations (Large Firms)

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I. INTRODUCTION¹

The handling of regulatory examinations is an important part of the duties and responsibilities of many compliance and legal professionals. In today's regulatory climate, where the SEC and FINRA intensely scrutinize firms' activities, it is critical to understand the regulatory examination process and the key issues relating to such inspections. This outline discusses several important topics in an effort to provide information concerning regulatory examinations and to furnish practical guidance on the handling of such inspections.

II. BACKGROUND INFORMATION ON 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.²
2. Cause examinations are typically triggered by events that would require firms to make certain filings such as on Forms U4 and U5 or pursuant to new FINRA Rule 4530. For example, a regulator may initiate a cause examination based upon an employee's termination for cause, as a result of a customer complaint or series of complaints regarding a broker or a particular type of investment (e.g., annuities or principal protected notes). 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 sales of structured products to retail customers, advertisements and sales literature for exchange traded products, and bank broker-dealer services.
4. FINRA also conducts examinations of branch offices and market regulation exams focusing on compliance with various trading and market conduct rules.

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² Both the SEC and FINRA have posted various written materials, webcasts and podcasts on their websites relating to the routine examination process. The materials provide an overview of their examination programs and practical guidance on preparing and handling inspections. Cites to such materials are included below.

5. In addition to routine, cause and sweep exams, the SEC also conducts “oversight” examinations of firms that have been recently inspected by FINRA. In an oversight examination, the SEC is evaluating a firm’s compliance with relevant rules and the efficacy of FINRA’s examination program.³

III. THE EXAMINATION PROCESS

A. Notice of Commencement of Exam

1. Notice

- a. SEC and FINRA 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 however, the SEC and FINRA will publicly hint at or actively announce impending or ongoing sweeps.

- (i) Routine examinations initiated by FINRA generally will be announced up to 30 days in advance. Certain examinations may be announced earlier, up to 60 days, where additional time is necessary for pre-examination data gathering.⁴
- (ii) Prior notice by SEC staff ranges from a few days to a few weeks for routine examinations. However, the staff may arrive unannounced to conduct cause examinations, the first examination of a firm, or certain other examinations focused on particular areas.⁵

2. Benefits of Notice

- a. Documents can be located and organized in advance.
- b. Supervisors and compliance personnel can be prepared for anticipated questions.

³ 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.

⁴ *See* FINRA Compliance Boot Camp, “Preparing for an Exam/Responding to Regulatory Inquiries,” September 6-7, 2007; “What Dually Regulated Firms Should Expect Upon Consolidation,” September 20, 2007; and the “What to Expect” Webcast series: Preparing for a FINRA Cycle Examination.

⁵ *See* OCIE Examination Information for Broker-Dealers, Transfer Agents, Clearing Agencies, Investment Advisers and Investment Companies (Nov. 2007) and OCIE’s Examinations by Securities and Exchange Commission’s Office of Compliance Inspectors and Examiners (Feb. 2011) (“February 2011 OCIE Update”) on the SEC’s website.

- 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.

B. Pre-Exam Work by a Regulator

- 1. Prior to the commencement of any regulatory examination, SEC and FINRA 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 FINRA (including information relating to customer complaints, prior disciplinary history, litigation, statistical data, etc.) and requesting information and records from the firm.
- 2. As part of the pre-exam process, FINRA members are required to review and update their information on Web IR. FINRA also routinely asks for information regarding branch offices that the examiners may visit during their inspection. This provides information on a firm's structure and activities.
- 3. The pre-examination process is the opportunity for the regulator to gain an understanding of the firm, its registered persons and business activities in order to focus the inspection on relevant issues.

C. Handling the Day-to-Day Examination

- 1. Notification of Requested Material/Information
 - a. 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 may raise issues that should be addressed with the staff.

2. Initial Meetings

Both FINRA and SEC examiners hold initial meetings with firms upon their arrival for the on-site portion of an examination. These meetings typically involve compliance professionals and may also include senior business executives.

3. 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.

4. Status Reports

- a. 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 any open issues. A firm might then be in a position to explain or clarify certain information before it becomes part of the exit interview.
- b. The examiners will usually provide interim information or findings prior to the exit interview. This could be partly affected by the individual involved and the ability of each firm to establish an appropriate rapport with the examiners.

5. Exit Interviews and Examination Reports

- a. FINRA and the SEC typically hold an exit interview at the conclusion of a routine examination. To a great extent, this meeting has become a formality where the examination staff goes through the alleged violations with the firm's senior management on what was found during the course of the examination and what they may include in their written report to the firm.
- b. 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.

- c. 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.
- d. Regulatory examinations typically conclude with the delivery of a report to the firm identifying the results of the inspection. Such reports require a written response by the firm, typically within 30 days.

6. Examination Results

- a. At FINRA, the results of an examination can include:
 - (i) No further action
 - (ii) Cautionary action
 - (iii) Compliance conference
 - (iv) Referral to Enforcement for review and final disposition
- b. SEC examinations can result in:
 - (i) No further action
 - (ii) A deficiency letter
 - (iii) A meeting or conference call to emphasize the seriousness of the deficiencies identified above and beyond the sending of the deficiency letter.
 - (iv) Referral to Enforcement for further review.
 - (v) Referral to an SRO for further investigation.

IV. 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 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.⁶
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, providing the examiners with their own designated space will minimize the disruption of normal business activity.
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.

⁶ See Kirsch & Smith at 23-4.

- 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; this includes documents provided to regulators on CD or in any other electronic medium. 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 and any necessary attachments documenting corrective action 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.

E. Using the Exam Process to Improve Compliance⁷

- 1. After an examination, firms should consider taking various steps to use the results of such inspections to enhance their compliance protocols, including:
 - a. Actively monitoring for compliance with any new procedures put in place;
 - b. Including the examination findings in supervisory control processes;
 - c. Training employees on examination findings; and
 - d. Incorporating the findings into continuing education plans and programs.

**V. RECENT REGULATORY DEVELOPMENTS CONCERNING
BROKER-DEALER EXAMINATIONS**

⁷ See “Leveraging the Exam Process to Improve Firm Compliance Practices,” FINRA PowerPoint presented at its Oct. 2008 Fall Securities Conference.

A. FINRA

1. Personnel changes
 - a. Suzanne Axelrod has been appointed head of Member Regulation Sales Practice
 - (i) Michael Rufino was named Ms. Axelrod's Deputy.
2. FINRA's examinations are much more risk-based than in the past and now focus on detecting potential instances of fraud at member firms.
3. FINRA examiners will devote more time and effort to inspecting firms' branch offices.⁸

B. SEC

1. Personnel changes
 - a. Last year the SEC selected Carlo di Florio to run OCIE. Norman Champ was made the Deputy Director in this office.
2. OCIE's self assessment²
 - a. OCIE embarked on a wide-ranging "self assessment" of its entire examination program and operations. As a result of that exercise, OCIE has developed the following four core principles:
 - (i) Risk-based approach
 - (ii) Teamwork and collaboration
 - (iii) Ongoing improvement and accountability
 - (iv) Focus
 - b. Additionally, OCIE developed a new governance structure for its National Examination Program, which includes the creation of several steering committees tasked with focusing on personnel, the exam process, technology, and compliance, ethics and internal controls.

⁸ See Officials Tell Registrants to Get Ready for SEC, FINRA's New Risk-Based Exams, BNA broker/dealer Compliance Report (Mar. 2, 2011).

² See February 2011 OCIE Update.

VI. EXAMINATION PRIORITIES

A. FINRA 2011 Examination Priorities¹⁰

1. Fraud detection
2. Fraudulent activity associated with customer accounts
3. High-frequency trading, algorithms, sponsored access, direct market access and trading pauses
4. Short sales and Regulation SHO
5. Information barriers
6. Private placements and private self-offerings
7. Trading in non-public securities
8. High-yield investments
9. Municipal securities
10. Non-conventional investments
11. Exchange-traded funds and notes
12. Vulnerable customers
13. Electronic communications and social media
14. Consolidated account reports
15. Hiring and compensation practices
16. Outside business activities and private securities transactions
17. Master/sub-account relationships
18. Funding and liquidity risk management
19. Intercompany transactions/affiliate relationships and activities
20. Governance and control over margin lending

¹⁰ See February 8, 2011 Annual Regulatory and Examination Priorities Letter, available on FINRA's website.

B. SEC “Select Areas of Focus” for Broker-Dealers Examinations¹¹

1. Verification of assets and controls
2. Oversight of dually registered or affiliated entities
3. Manipulations
4. Structured products
5. Reasonable inquiry procedures
6. Compensation incentives and other compliance issues associated with registered representatives switching firms
7. Adequacy of broker-dealers’ branch office audits
8. Broker-dealers maintaining customer accounts utilizing a “master/sub-account” structure
9. Broker-dealers offering sweep arrangements to affiliated and non-affiliated banks
10. Exchange-traded fund sponsors, distributors and markets
11. Compliance with supervisory control requirements: Compliance with NASD Rule 3012 and FINRA Rule 3130
12. Oil and gas offerings
13. Prime brokerage
14. Regulation SHO
15. Sales to senior citizens
16. DMA
17. Misuse of non-public institutional order information
18. Anti-money laundering
19. Internal controls
20. Information barriers

¹¹ See February 2011 OCIE Update.

VII. 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 requests 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.