

Regulatory Securities Examinations and Inquiries: The Firm's Perspective

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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 the SROs are placing increased scrutiny on 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. Specifically, the outline covers the following topics: (1) background information regarding the regulatory exam process; (2) recent FINRA and SEC examination program developments; (3) specialized exams - sweeps and inquiries; (4) practical guidance for handling an inspection; (5) special issues regarding regulatory examinations; and (6) SEC and FINRA examination findings, priorities and referral factors.

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 file Forms U4, U5, NYSE RE-3 or 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 sales to seniors, false or misleading rumors, mutual fund sales practices, information barriers,

¹ This outline was drafted by Ben A. Indek, a partner of Morgan, Lewis & Bockius LLP, with assistance from Kerry Land, an associate at the Firm. Sections II 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 National Society of Compliance Professionals seminars. Mr. Indek is greatly indebted to the work of those persons and wishes to acknowledge their efforts. This outline was prepared in January 2009. The outline represents the views of Mr. Indek and not those of the other panelists and their organizations.

² FINRA has posted various written materials and a webcast on its website relating to the routine examination process. The materials provide an overview of the FINRA's examination program and practical guidance on preparing and handling inspections. See FINRA Release "What to Expect" Webcast Series: Preparing For an FINRA Cycle Examination.

fairness opinions, hedge funds and the role and activities of Compliance Departments.

4. Regulatory inquiries are triggered by surveillance of trading activity conducted by the various market centers and FINRA. Regulatory inquiries are generally issued in a less formal manner by the market surveillance units of the regulatory body with regulatory authority for those markets when the surveillance results in an exception. If warranted, results of a regulatory inquiry will be referred to the examination division for further scrutiny, or directly to enforcement for formal action.
5. In addition to routine, cause and sweep exams, the SEC also 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.³

B. Pre-Exam 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. 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. Notice of Commencement of Exam

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.
 - (i) Routine examinations initiated by FINRA generally will be announced up to 30 days in advance. Certain examinations

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.

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.
- 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. Handling the Day-to-Day Examination

1. Notifications 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-

⁴ See FINRA Compliance Boot Camp, "Preparing for an Exam/Responding to Regulatory Inquiries," September 6-7, 2007. See also "What Dually Regulated Firms Should Expect Upon Consolidation," September 20, 2007.

⁵ See OCIE: Materials from February 9, 2007, *SEC Speaks in 2007* Conference, posted to sec.gov website on March 22, 2007

mail records and other related materials may raise issues that should be addressed with the staff.

2. 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.

3. 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.

4. Results of a Regulatory Examination

- a. 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 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.
 - (i) SEC examiners hold exit interviews as a part of its examination process.⁶
- b. Firms should view the exit interview the same way they view status reports. In other words, every opportunity should be taken

⁶ See OCIE: Materials from February 9, 2007, *SEC Speaks in 2007* Conference, posted to sec.gov website on March 22, 2007.

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.
- e. Following review of the firm's response to the examination report, FINRA will send the firm an Examination Disposition Letter categorizing exam findings into: No Further Action, Cautionary Action, Compliance Conference, or Referral to Enforcement for Review and Final Disposition.⁷

E. Deficiency Letter/Response and Potential Enforcement Follow-up

1. 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. RECENT REGULATORY DEVELOPMENTS CONCERNING BROKER-DEALER EXAMINATIONS

A. FINRA: NYSE Regulation and NASD Consolidation Update⁸

1. The NASD and NYSE Regulation merged to form FINRA in July 2007. FINRA's unified examination program is up and running. FINRA has one team of examiners for each exam. The team coordinates information requests, conducts one opening meeting and one exit meeting with management and issues one exam report.
2. FINRA is continuing to work on consolidation of the NASD and NYSE rulebooks. FINRA is conducting a comprehensive review of the existing rules to identify rules that need to be amended or rewritten.
3. FINRA began proposing new rules in phases for approval by the SEC. As rules are approved by the SEC and become effective, they will replace the

⁷ See Robert C. Errico, et. al., Letter to FINRA Members, March 24, 2008.

⁸ See Mary L. Shapiro, Remarks at the CCO Outreach BD National Seminar, March 7, 2008. See also Susan L. Merrill, Executive Vice President, Chief of Enforcement, Remarks at the NAVA Conference, June 3, 2008.

existing NASD and NYSE rules. FINRA will release the new rulebook in phases over the coming months and will announce effective dates in Regulatory Notices every other month.⁹ The first phase of new FINRA rules took effect December 15, 2008.¹⁰

4. Until the rules are consolidated, dually-regulated firms will continue to be subject to the Transitional Rules, which includes both NASD and NYSE rule sets. Additionally, FINRA will continue to apply the same interpretive materials that NASD and NYSE applied prior to consolidation.¹¹ Until the rulebooks are consolidated, information request lists, exit meeting reports, examination reports and disposition letters will reference both applicable NASD and NYSE rules.¹²
5. In 2008, FINRA announced a change to its exam program, stating that firms would no longer be required to respond to exit meeting reports but rather must reply to the examination report within 30 days of receipt. As noted above, after a review of the response, the staff will send a disposition letter, classifying the exceptions in the report as no further action, cautionary action, compliance conference or referred to Enforcement.

IV. SPECIALIZED EXAMS – SWEEPS AND REGULATORY INQUIRIES

A. Background

1. FINRA 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.¹³
2. SEC and SRO examiners are using sweeps more frequently in sales practice and related areas than in the past.
3. Regulators carefully select those firms included in a sweep.
4. Regulatory inquiries tend to be less formal and do not require authorization from a senior member of the regulatory organization.¹⁴

⁹ See FINRA Information Notice: Rulebook Consolidation Process, October 6, 2008. See also FINRA Information Notice: Rulebook Consolidation Process, March 12, 2008.

¹⁰ See FINRA Information Notice: Continuing Application of NASD Rules and Incorporated NYSE Rules, December 8, 2008.

¹¹ See “What Dually Regulated Firms Should Expect Upon Consolidation,” September 20, 2007.

¹² See “What Dually Regulated Firms Should Expect Upon Consolidation,” September 20, 2007.

¹³ See Mary Schapiro, Remarks at the October 2004 NASD Fall Conference. While the following sections A-C are mainly drawn from these remarks that focused on Market Regulation Department sweeps, the concepts should apply to all FINRA sweeps.

¹⁴ FINRA makes regulatory inquiries under its Rule 8210.

B. The Sweeps 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. FINRA Staff Commitments to Firms

1. FINRA will track and approve centrally; different offices will not conduct 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. FINRA will coordinate with the SEC and other securities regulators to eliminate duplication and the burdens of such redundancies.
4. FINRA 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 are made with the caveat that investor protection and the integrity of the market are paramount concerns.

D. Recent SEC, FINRA and NYSE Regulation Sweeps¹⁵

¹⁵ FINRA now posts its sweep exam letters on its website.

1. **Abusive Short Selling Activity:** In September 2008, the SEC announced an expansion of its ongoing investigation into possible market manipulation through abusive short-selling activity. Investigators from FINRA and NYSE Regulation specifically, in coordination with the SEC, began on-site visits of broker-dealers to address certain issues concerning short selling.
2. **False or Misleading Rumors:** In July 2008, FINRA and NYSE Regulation began a sweep of firms' compliance with NYSE, NASD and SEC rules prohibiting the spreading of false or misleading rumors that may effect market price.
3. **Information Barriers:** In January 2008, FINRA began a sweep of firms' policies, procedures and controls designed to monitor the flow and use of material non-public information, trading of securities that appear on restricted and watch lists, and employee trading in outside accounts.
4. **Issues Concerning Senior Investors:** In December 2007, FINRA began a sweep to examine the sale of collateralized mortgage obligations.

V. PRACTICAL GUIDANCE FOR HANDLING REGULATORY EXAMINATIONS

A. SEC Developments

1. **OCIE Risk Management Examinations**
 - a. In 1995 – at OCIE's creation – the staff developed a risk management examination program. For many years, OCIE focused this exam on the largest and most complex firms. In late 2007, OCIE announced that it planned to use the program in connection with mid-sized firms that had significant customer accounts.¹⁶
 - b. On November 28, 2007, Mary Ann Gadziala, Associate Director of the SEC's OCIE, spoke at the 2007 AICPA/FMD National Conference on the Securities Industry, in New York.¹⁷ In her remarks, entitled "Risk Management for Broker-Dealers," Gadziala made the following key points regarding OCIE risk management examinations:
 - (i) The main purpose of OCIE risk management examinations is to understand a firm's activities, risks and control

¹⁶ See Mary Ann Gadziala, Speech by SEC Staff: The Regulatory Focus on Broker-Dealer Legal and Compliance Issues, June 7, 2007. See also Mary Ann Gadziala, Speech by SEC Staff: A Regulatory View-Broker-Dealer Internal Audit/Compliance Priorities, October 17, 2006 and Mary Ann Gadziala, Speech by SEC Staff: Risk Management for Broker-Dealers, November 28, 2007.

¹⁷ See Mary Ann Gadziala, Speech by SEC Staff: Risk Management for Broker-Dealers, November 28, 2007.

processes, to evaluate those controls and to identify potential weaknesses.

- (ii) During an internal controls exam, OCIE examiners inspect the following areas:
 - (a) Internal audit: ensure that management and the board receive results of audits and that deficiencies are timely addressed.
 - (b) Senior management: look for active involvement in establishing policies and oversight of controls.
 - (c) Adequacy of risk management resources.
 - (d) Market risk in trading activities and firm inventory.
 - (e) Funding, liquidity and credit risks.
 - (f) Operational risks: among other things, look for checks and balances in duties, protection of customer funds, securities and identity, and the development of contingency plans.
 - (g) Legal and compliance controls: review surveillance and other independent oversight functions.
 - (h) Timely and appropriate assimilation of new products and activities into the firm's risk management system.
- (iii) Through its risk management examinations, OCIE staff has identified several best practices implemented by firms to mitigate risks. Examples of the legal and compliance best practices were:
 - (a) "Complete, up-to-date written legal and compliance policies and procedures;
 - (b) Effective monitoring and surveillance of compliance and legal issues;
 - (c) Legal and compliance committee approval participation for new and high-risk business, products, or transactions;
 - (d) Clear assignment of authority and responsibility for legal and compliance; and

(e) Strong overall compliance culture at the firm.”¹⁸

B. 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.¹⁹
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.).

C. 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

¹⁸ Id.

¹⁹ See Kirsch & Smith at 23-4.

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; 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.

D. 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.

E. 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.

VI. 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.

VII. EXAMINATION FINDINGS, PRIORITIES AND REFERRAL FACTORS

A. Issues Frequently Found in FINRA Examinations²⁰

1. Supervisory Controls
2. Written Supervisory Procedures
3. Anti-Money Laundering
4. Business Continuity Planning
5. Reg S-P
6. Changes in Account Name or Designation
7. Time and Price Discretion
8. Net Capital
9. Customer Protection
10. Order Data Transmission Requirements
11. Transaction Reporting

²⁰ See FINRA.org, Rules & Regulation, "Improving Examination Results," May 2008.

B. Recent FINRA Examination Priorities:²¹

1. Senior Investors
2. Deferred Variable Annuities
3. Anti-Money Laundering (AML)
4. Protection of Customer Information
5. Supervision and Supervisory Controls
6. Sales of New or Non-Conventional Products (Fee-Based Accounts)
7. Transaction Reporting
8. Business Continuity Planning (BCP)
9. Data Integrity (Information Barriers)
10. Bank Sweep Programs
11. Agency Lending Disclosure
12. Inventory Valuations
13. Outsourcing
14. Order Audit Trail System (OATS)
15. Regulation NMS
16. Short Interest Reporting

C. Deficiencies Found in Recent SEC Examinations of Broker-Dealers²²

1. Examinations of Securities Firms Providing “Free Lunch” Sales Seminars: In 2007, FINRA, NASAA and the SEC conducted over 100 examinations of firms that offered “free lunch” seminars targeting seniors. Examiners found that some firms used misleading or exaggerated advertising and sales materials, seminars were often inadequately supervised, and some seminars may have involved fraud.

²¹ See FINRA.org, Rules & Regulation, “Improving Examination Results,” May 2008. See also Robert C. Errico, Letter to FINRA Members, March 24, 2008.

²² See SEC OCIE Compliance Alert, July 2008. See also SEC Release: SEC Alerts Compliance Officers About Deficiencies and Weaknesses Found During Recent Compliance Examinations, July 22, 2008.

2. Valuation and Collateral Management Processes: SEC and FINRA examiners assessed firms' valuation and management of subprime mortgage products. Examiners noted deficiencies in price verification, staffing levels, policies and procedures, documentation, and margin on collateral.
3. Broker-Dealers Affiliated with Insurance Companies: Examiners reviewed broker-dealer subsidiaries of insurance companies and observed unsuitable recommendations and inadequate supervisory procedures related to mutual fund and/or variable annuity transactions.
4. Supervision of Solicitations of Advisory Services: Examiners noted that broker-dealer registered representatives designated as investment advisors' solicitors were providing investment advice to customers by guiding the selection of both the program and the products in the program.
5. Mortgage Financing as Credit for the Purchase of Securities: Examiners found suitability and supervisory issues where customers used a second mortgage or reverse mortgage to purchase securities.
6. Office of Supervisory Jurisdiction (OSJ) Supervisory Structure: Examiners found deficiencies in supervisory policies and procedures and record-keeping where OSJ structures were used.

D. SEC Examination Priorities²³

1. Portfolio management: Examiners look for deviation from investment objectives.
2. Financial controls: OCIE examiners will focus attention on broker-dealer controls, such as compliance with net capital requirements, that are intended to protect customer accounts.
3. Controls over valuation: Examiners will focus on controls and procedures for valuation of illiquid and difficult-to-price securities.
4. Sales of structured products: Examiners will focus on products marketed as relatively "safe."
5. Controls and processes at recently merged or acquired firms.
6. Money market funds: Examiners will determine whether funds are stretching for yield and subjecting the fund to undisclosed risk.

²³

See Lori A. Richards, Speech by SEC Staff: Compliance Through Crisis: Focus Areas for SEC Examiners and Compliance Professionals, October 21, 2008. *See also* Lori A. Richards, Speech by SEC Staff: Frequently-Asked Questions About SEC Examinations, at the SIFMA Compliance and Legal Division January General Luncheon, January 17, 2008.

7. Short selling and compliance with Reg SHO.
8. Suitability and appropriateness of investments for senior investors: Examiners focus on suitability and disclosure issues, with particular focus on protecting seniors from investment fraud and unsuitable securities transactions. Other products and practices carefully monitored for suitability issues are 529 plans, variable annuities, CMOs, REITs, and mutual fund “breakpoint” violations.
9. Disclosure: Examiners will specifically review how firms represent their participation in the Treasury’s money market guarantee program, and whether recent firm actions are consistent with firm disclosures.
10. Controls over non-public information and to prevent insider trading.
11. Trading, brokerage arrangements and best execution: Examiners will look to see that firm policies are consistent with disclosures and whether any conflicted relationships exist.
12. Proprietary and employees’ personal trading.
13. Undisclosed payments: Examiners will look for any revenue sharing arrangements or other undisclosed compensation arrangements with third parties.
14. Safety of customer assets: Safety from theft, loss or misuse.
15. Anti-money laundering: SEC examinations review compliance programs, customer identification programs, suspicious activity reporting, currency transactions and wire transfers.
16. Compliance, supervision, and corporate governance: Firms should have written supervisory procedures that are complete and are followed by the firm. Areas of focus for the examiners include transferring customer accounts, outsourcing, outside business activities, and producing managers.

E. Factors Considered in Determining Whether OCIE Refers Exam Findings to the Division of Enforcement.

In considering whether to refer its exam findings to the Division of Enforcement, OCIE considers various factors, including:²⁴

1. Did fraud occur?

²⁴

See Lori Richards, Speech at the Financial Services Institute: First Annual Public Policy Day, “An Update on the SEC’s Examination Program,” October 13, 2004.

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?