

The Examination Process From the Regulators' Perspective

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SIFMA Compliance & Legal Division
2007 Fall Compliance Seminar
New York, New York

November 13, 2007

I. INTRODUCTION¹

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) FINRA sweep exams; (5) SEC examination program developments; (6) current FINRA examination priorities; and (7) recent deficiencies found by state regulators in connection with broker-dealer examinations.

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.²
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 sales to seniors, mutual fund sales practices, information barriers, fairness opinions, hedge funds and the role and activities of Compliance Departments.

¹ This outline was drafted by Ben A. Indek, a partner of Morgan, Lewis & Bockius LLP, with assistance from Kerry Land (admission pending), an associate at 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 October 2007. 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 NASD Release "What to Expect: Preparing for an NASD Routine Examination," July 5, 2006.

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.³

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.
 - a. FINRA, for example, typically electronically requests that a firm provide information related to its structure, business operations, and activities through an information request called a WebIR. The firm completes the WebIR and returns it to FINRA. FINRA uses the information in the development of the examination focus.⁴
 - b. SEC examiners use data gathered in the pre-examination process to evaluate risk areas for the risk-based approach.⁵
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. 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.

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 Information for this outline regarding the consolidation was obtained from various FINRA documents and publications including: FINRA Compliance Boot Camp, “Preparing for an Exam/Responding to Regulatory Inquiries,” September 6-7, 2007; FINRA Webcast, “What to Expect: Preparing for an NASD Routine Examination”; “What Dually Regulated Firms Should Expect Upon Consolidation,” a document distributed by Susan L. Merrill during her speech at a DC Bar sponsored luncheon on 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

- (i) Routine examinations initiated by FINRA generally will be announced up to 30 days in advance. Certain pre-identified examinations may be announced earlier where additional time is necessary for pre-examination data gathering.⁶
- (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.⁷

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.

⁶ 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.

⁷ See OCIE: Materials from February 9, 2007, *SEC Speaks in 2007* Conference, posted to sec.gov website on March 22, 2007

E. 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.

F. 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.

G. 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.
 - a. SEC examiners hold exit interviews as a part of the examination process.⁸
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 written response by the firm, typically within 30 days.

⁸ See OCIE: Materials from February 9, 2007, *SEC Speaks in 2007* Conference, posted to sec.gov website on March 22, 2007.

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. RECENT REGULATORY DEVELOPMENTS

A. FINRA: NYSE Regulation and NASD Consolidation

1. On July 30, 2007, the NASD and NYSE Regulation were consolidated into the single self-regulatory organization called the Financial Industry Regulatory Authority (“FINRA”). FINRA plans to have a unified examination program running in January for 2008 examinations, and most of its technology integrated within a year.⁹
2. Over time, FINRA will consolidate the NASD and NYSE rulebooks.¹⁰ Until the rules are consolidated, dually-regulated firms will continue to be subject to 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
3. Prior to consolidation, dually-regulated firms, those subject to both NASD and NYSE rules, were subject to regulatory examinations from both entities. After consolidation, these firms will receive a single sales practice examination by FINRA.¹²
4. Where a firm previously requested coordination of NYSE Sales Practice and FinOp examination components,¹³ and is scheduled to receive both a Sales Practice and FinOp examination this year, FINRA staff will conduct these components simultaneously.¹⁴
 - a. The Firm may choose to receive one consolidated information request list or separate request lists organized by examination component.
 - b. In a coordinated examination, each component will commence on the same day.

⁹ See Mary L. Schapiro, Remarks at the FINRA Fall Securities Conference, October 11, 2007.

¹⁰ See Mary L. Schapiro, Remarks at the FINRA Fall Securities Conference, October 11, 2007.

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

¹² See *Id.*

¹³ Prior to the creation of FINRA, examination coordination among the NASD and NYSE Regulation (and other SROs) was performed under a 1995 Memorandum of Understanding (“MOU”), signed by the SEC, the SROs and NASAA. Under the terms of the MOU, the SROs asked dually-regulated firms if they preferred to have their SRO examinations coordinated. If coordinated, routine examinations by SROs were conducted at the same time and coordinated to prevent duplication. See Mary Ann Gadziala, Remarks Before the National Society of Compliance Professionals, October 19, 2006.

¹⁴ See “What Dually Regulated Firms Should Expect Upon Consolidation,” September 20, 2007.

- c. There will be one initial meeting with FINRA staff on the first day of the coordinated examination.
 - d. The closeout process, including exit meetings, reports and disposition letters may also be consolidated at the firm's preference.
5. Where a firm's existing preference is not to have FINRA coordinate examinations, the separate Sales Practice and FinOp examinations will be conducted separately. The firm will receive separate request lists prior to each examination. Separate kick-off and exit meetings will be held with FINRA staff and the beginning and conclusion of each examination respectively.¹⁵
 6. Until the rulebooks are consolidated, information request lists, exit meeting reports, examination reports and disposition letters will reference both applicable NASD and NYSE rules.¹⁶

B. SEC Exam Program Recent Developments

1. On June 7, 2007, Mary Ann Gadziala, Associate Director of the SEC's Office of Compliance Inspections and Examinations, spoke at the SIFMA Compliance and Legal Division conference. In her remarks, entitled "The Regulatory Focus on Broker-Dealer Legal and Compliance Issues," Gadziala made the following key points:
 - a. The SEC has enhanced the examination program by targeting examinations on specific high-risk areas. For example, with respect to risk management examinations, the SEC leverages effective internal audit work performed by firms, thereby limiting the exam scope to high risk areas not covered by firm reviews.¹⁷
 - b. The broker-dealer examination program has initiated a monitoring and coordination pilot program now covering eight organizations. Exam staff aggregate available regulatory information on all affiliated registered entities together with publicly available information in order to risk scope examinations.¹⁸
2. In August 2007, the US Government Accountability Office ("GAO") reported its findings and recommendations regarding OCIE's examination program. In response to that report, OCIE has taken steps to address the GAO's findings.

¹⁵ *See Id.*

¹⁶ *See* "What Dually Regulated Firms Should Expect Upon Consolidation," September 20, 2007.

¹⁷ *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.

¹⁸ *See* Mary Ann Gadziala, Speech by SEC Staff: The Regulatory Focus on Broker-Dealer Legal and Compliance Issues, June 7, 2007.

- a. The GAO identified a limitation in OCIE’s method of assessing firms’ compliance risk, a critical step in the enhanced risk-based approach to examinations. The GAO noted that OCIE’s formula does not include information about the strength of firms’ internal compliance and audit functions. Without this information, says the GAO, OCIE cannot accurately predict a firm’s level of risk.¹⁹
 - (i) In response to the GAO’s findings, OCIE has committed to actively testing the effectiveness of its risk assessment tools in order to keep up with growth in the number and activities of securities firms.²⁰
 - b. OCIE has established a telephone Examination Hotline where problems, complaints or concerns about an examination (on an anonymous basis if a firm so desires) can be communicated to senior staff. The GAO’s survey of those who might potentially use the hotline found that users may be hesitant to use the hotline because it is located only within the OCIE office.²¹
 - (i) In response to this concern, OCIE is currently developing a revised hotline where callers may choose to speak to senior SEC staff outside OCIE to report issues regarding an examination.²²
 - c. In response to the GAO’s report, OCIE is also making modifications to its internal examination tracking system to ensure better documentation and consistency with respect to providing exit interviews and exam closure letters.²³
3. 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.

¹⁹ See GAO Report, “Securities and Exchange Commission: Steps Being Taken to Make Examination Program More Risk-Based and Transparent,” August 2007.

²⁰ See Lori Richards, Letter to Orice M. Williams dated August 3, 2007, Appendix II of the GAO Report, “Securities and Exchange Commission: Steps Being Taken to Make Examination Program More Risk-Based and Transparent,” August 2007.

²¹ See GAO Report, Securities and Exchange Commission: Steps Being Taken to Make Examination Program More Risk-Based and Transparent, August 2007.

²² See Lori Richards, Letter to Orice M. Williams dated August 3, 2007, Appendix II of the GAO Report, “Securities and Exchange Commission: Steps Being Taken to Make Examination Program More Risk-Based and Transparent,” August 2007.

²³ See Lori Richards, Letter to Orice M. Williams dated August 3, 2007, Appendix II of the GAO Report, “Securities and Exchange Commission: Steps Being Taken to Make Examination Program More Risk-Based and Transparent,” August 2007.

4. OCIE provides an updated examination brochure to firms at the commencement of an examination. The brochure includes more information on the examination process.
5. OCIE's 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.
6. OCIE has been meeting with firms throughout the country to provide information on common examination findings.
7. OCIE has been reviewing the language in its deficiency letters to assure that the text is appropriate and conforms to the findings.²⁴
8. 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.²⁵
9. 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.²⁶

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 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.²⁷
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.

²⁴ See Lori Richards, "Better Than Business As Usual," NSCP National Membership Meeting, October 25, 2005.

²⁵ See Lori Richards, "Internal Audits and SEC Examination," SIA Internal Auditors Division 2005 Annual Conference, October 18, 2005.

²⁶ See Mary Ann Gadziala, Remarks at the SIA Compliance and Legal Division Regional Seminar, October 19, 2005.

²⁷ See Kirsch & Smith at 23-4.

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.
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; 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 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.

V. 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 Information Memo 05-65, which set out the Exchange’s views on three specific topics: (i) required cooperation; (ii) extraordinary cooperation; and (iii) credit for extraordinary cooperation. The NYSE’s Division of Enforcement considered the following eight factors in assessing a firm’s cooperation during an investigation.
 - 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.
2. Although FINRA has no separate statement of its policy on cooperation during examinations, the FINRA Sanctions Guidelines reference giving credit for cooperation in the “Principal Considerations” section.²⁸

VI. SWEEPS

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.²⁹
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.

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

²⁸ The FINRA Sanctions Guidelines, formerly the NASD Sanctions Guidelines, can be found on the FINRA website at www.finra.org. On September 20, 2007, the DC Bar sponsored a luncheon program at which the featured speaker was Susan L. Merrill, Chief of Enforcement at FINRA. Merrill explained that FINRA is considering the issue of cooperation and determining whether to establish new guidelines to reconcile the NYSE memo and the FINRA Sanctions Guidelines. An overview of the event and Merrill’s speech was included in a September 24, 2007 Mayer Brown LLP publication, written by Bruce M. Bettigole and Aimee Latimer-Zayets, and titled FINRA Enforcement Chief Comments on Issues Relating to Unification of NASD and NYSE Enforcement.

²⁹ See Mary Schapiro, Remarks 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.

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 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. 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. Sweeps Targeting Issues Concerning Senior Investors

1. In May 2006, the SEC and the North American Securities Administrators Association (NASAA) launched a coordinated campaign focused on protecting senior investors from fraud and sales of unsuitable investments. FINRA joined the effort and, together, the regulators completed a sweep looking into the sales tactics used at “free lunch” seminars.³⁰

³⁰ See Joint Report by SEC, NASAA and FINRA, “Protecting Senior Investors: Report of Examination of Securities Firms Providing “Free Lunch” Sales Seminars,” September 2007.

2. FINRA announced two new sweeps in September this year. Two additional sweeps relating to seniors are on-going.³¹
 - a. In September, FINRA announced a new sweep which will examine brokers' use of "professional" designations which may mislead or defraud investors. FINRA is particularly concerned with designations that require no meaningful training or specialized knowledge or suggest expertise in issues of particular concern to seniors, such as retirement planning.
 - b. Also announced in September, a second new sweep looks at early retirement seminars that may entice older workers to liquidate their retirement funds and re-invest them with a specific firm or representative.
 - c. FINRA is continuing to examine the sale of collateralized mortgage obligations targeted at seniors.
 - d. FINRA also has an on-going sweep regarding the sale of life settlements.

VII. EXAMINATION FINDINGS, PRIORITIES AND REFERRAL FACTORS

A. Issues Frequently Found in FINRA Examinations³²

1. Written Supervisory Procedures (NASD Conduct Rule 3010)
2. Business Continuity Planning (NASD Rule 3510)
3. Supervisory Control Rule (NASD Conduct Rule 3012)
4. Anti-Money Laundering (AML) (NASD Rule 3011)
5. Electronic Communications (SEC Rule 17a-4(f))

B. Current FINRA Examination Priorities:³³

1. Data Integrity
2. Electronic Communications/Storage Media (including Electronic Filing Requirements)
3. Protection of Customer Information (i.e., Online Brokerage Account Intrusions)

³¹ See FINRA News Release, "FINRA Announces Major Regulatory Sweeps at Seniors Summit," September 10, 2007.

³² See FINRA.org, Rules & Regulation, "Improving Examination Results," May 2007.

³³ See FINRA.org, Rules & Regulation, "Improving Examination Results," May 2007. See also Robert C. Errico, Letter to NASD Members, February 13, 2007.

4. Transaction Reporting (Trade Reporting and Compliance Engine-- “TRACE” and Bluesheets)
5. Regulation NMS Compliance (Completion date for compliance with all phases was October 8, 2007)
6. Order Audit Trail System (OATS)
7. Variable Insurance Products
8. Short Interest Reporting
9. Anti-money Laundering
10. Suitability (New Products, Products with Limited Market)
11. Supervision (Gifts and Gratuities, Business Continuity Planning)

C. Current SEC Examination Priorities³⁴

1. Supervision - 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.
2. Sales Practices - Examiners focus on suitability and disclosure issues, with particular focus on protecting seniors from investment fraud and unsuitable securities transactions. Other products carefully monitored for suitability issues are 529 plans, variable annuities, CMOs, REITs, and mutual fund “breakpoint” violations.
3. Risk Management - Examinations look for operational risks that develop between a firm’s back office operations and compliance functions and the sales and marketing of new products. Other key risk areas include conflicts of interest and information security. Examiners may focus this year on mid-sized firms with relatively large numbers of accounts and small capital cushions.
4. Financial Issues - Of concern are net capital deficiencies and inaccuracies in computing net capital. Examiners are also looking at security evaluations and portfolio margining.

³⁴ See Mary Ann Gadziala, Speech by SEC Staff: The Regulatory Focus on Broker-Dealer Legal and Compliance Issues, June 7, 2007. See also Mr. Indek’s notes of the remarks made by Mary Ann Gadziala on October 18, 2007 at the NSCP National Membership Meeting in Washington, DC. Additionally, notes regarding the SEC examination priorities were provided by Mary Ann Gadziala for inclusion in this outline. As a matter of policy, the SEC disclaims responsibility for any private publication, or statements of any SEC employee or Commissioner. Speeches and notes provided by SEC staff express the views of the author and do not necessarily reflect the views of the SEC.

5. Books and Records - Email retention requirements remain an active topic among SEC staff and the industry.
6. Trading Practices - Key issues are best execution, compliance with Regulation SHO, dark pools, Regulation NMS policies and procedures, and confidentiality of non-public customer trade information.
7. Anti-Money Laundering - SEC examinations review compliance programs, customer identification programs, suspicious activity reporting, currency transactions and wire transfers.
8. BD/IA Examinations - OCIE may focus more attention on conducting joint or coordinated examinations of dually registered entities.
9. Controls Over Customer Assets
10. Business Continuity Planning - Examiners will focus on whether firms have adequately prepared for disasters and planned to resume business operations.
11. Conflicts of Interest - OCIE is focusing on revenue sharing arrangements, soft dollars, and imbedded fees not disclosed to plan participants.
12. Controls Over Non-Public Information - Examiners are focusing on the misuse of customer information, the misuse of material non-public information learned from bankruptcy committees and information barriers.

D. 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:³⁵

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?

³⁵ 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.

8. Did the firm act with intent?
9. Is the firm a recidivist?
10. Were the firm's WSPs inadequate?

VIII. NASAA TOP 10 BROKER-DEALER EXAMINATION DEFICIENCIES

A. At the NASAA conference in September 2006, NASAA representatives announced the results of a series of broker-dealer state examinations conducted in 28 NASAA jurisdictions during a two month period between May and June 2006.³⁶ These examinations encompassed 228 broker-dealer firms. The top 10 deficiencies found were as follows:

1. Maintenance of customer account information
2. Sales practices – suitability
3. Written Supervisory Procedures – failure to follow procedures
4. Advertising/sales literature
5. Outgoing/incoming correspondence
6. Blotters/exception reports
7. E-mail correspondence
8. Internal audits – non OSJ branches
9. Outside business activity/selling away
10. WSP's – failure to maintain as current

B. NASAA Key Concern Regarding Consolidation of SRO Broker-Dealer Examinations

In his statements to a Senate panel on May 17, 2007, NASAA President, Joseph P. Borg outlined the key concerns of state securities regulators regarding the new consolidated SRO. The NASAA is concerned that “consolidation may result in a less effective enforcement regime,” resulting in less detection and punishment of fraudulent conduct and other abuses by broker-dealers and registered representatives. Borg noted that a

³⁶ See NASAA Report, “NASAA Examinations Identify Top BD Compliance Deficiencies State Securities Regulators Propose Series of Best Practices,” September 18, 2006.

strong and effective regulatory structure requires preserving a tough SRO for efficient compliance.³⁷

³⁷ See NASAA News Release, “NASAA Outlines Key Concerns About Merger of Securities Industry Self-Regulatory Organizations,” May 17, 2007.