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The Regulatory Examination Process

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Introduction¹

Handling 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 the activities of securities firms, it is critical for compliance officers to understand the regulatory examination process and the key issues relating to such inspections. This White Paper 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 White Paper outlines the following topics: (1) background information regarding the regulatory examination process, (2) practical guidance for handling regulatory examinations, (3) the role of outside counsel, (4) special issues during regulatory examinations, (5) NASD sweep examinations, (6) SEC examination program developments, (7) current NYSE and NASD examination priorities, and (8) recent deficiencies found by state regulators in connection with broker-dealer examinations.

Regulatory Examinations

Types of Examinations

- (i) A routine examination is the most common examination type and generally follows a set schedule and procedures. Such an examination regularly involves inspection of a securities firm's financial, operational, and sales practice compliance to determine whether the firm is in compliance with applicable laws, rules, and regulations.²
- (ii) Cause examinations are typically triggered by events that would require securities 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.

¹ In creating this outline, the authors used 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. We are indebted to the work of those individuals and wish to acknowledge their efforts.

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

- (iii) Sweep or special examinations typically involve a large number of firms that are scrutinized relating to a specific industry issue. Recent examples of sweep examinations include those relating to mutual fund sales practices, information barriers, fairness opinions, hedge funds, and the role and activities of compliance departments.
- (iv) The SEC conducts “oversight” examinations of firms that have been recently inspected by an SRO. In an oversight examination, the SEC evaluates a firm’s compliance with relevant rules and the efficacy of the SRO’s examination program.³

Preexamination Work by a Regulator

- (i) 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, and so forth) and requesting information and records from the firm.
- (ii) This process is intended to gain an understanding of the firm, its registered persons, and business activities and to focus the inspection.

Initial Communication by a Regulator

- (i) 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, however, the SEC and SROs will publicly hint at or actively announce impending sweeps.
- (ii) 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 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.

- (iii) Benefits of No Notice
 - (a) Regulators believe that the integrity of the information provided by a firm is enhanced when it is produced with little or no notice.
 - (b) When 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.

Notifications of Requested Material/Information

- (i) 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 email records, and other related materials raise issues that should be addressed with the staff.
- (ii) It is becoming increasingly common for regulators to ask for data mining, i.e., the aggregation of data, in forms different from how it is routinely kept by the securities firm.

The Duration of Regulatory Examinations

The duration of routine examinations varies based on the size of the 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 make sure that the examiners understand the firm's business and methods of operation, the less time the regulators are likely to spend completing the examination.

Status Reports

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

Results of a Regulatory Examination/the Exit Interview

- (i) 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 examiners recite the alleged violations they intend to report in their letter.

- (ii) 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.
- (iii) Firms should carefully consider who attends the exit interview. When a firm sends senior representatives to this meeting, it demonstrates respect and concern for the examination process.
- (iv) Regulatory examinations typically conclude with the delivery of a report to the firm identifying the results of the inspection. Such reports require a response by the firm.
- (v) 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.

Staffing and Coordination by Regulators

- (i) SEC examinations are coordinated by the Commission's Office of Compliance, Inspections and Examinations (OCIE). These examinations may be conducted by staff from regional offices, district offices, or the SEC's principal office in Washington, D.C.
- (ii) NYSE examinations are staffed by the Division of Member Firm Regulation located in New York City.
- (iii) NASD examiners from its district offices conduct examinations. Typically, but not always, examiners conduct inspections within their respective districts.
- (iv) Efforts have been made to coordinate examinations. On November 30, 1995, the SEC released a Memorandum of Understanding signed by the SEC, the examining SROs, and NASAA "to promote cooperation and coordination among the examining authorities as well as to eliminate unnecessary and burdensome duplication in the examination process." Dual NASD and NYSE members may request that a coordinated examination be conducted by those regulators.
 - (a) More recently, according to the Securities Industry Association, OCIE, NYSE, and NASD are working together to reduce examination program duplication:

"NASD and NYSE have identified common areas that they will allocate when conducting routine inspections so that only one regulator will be responsible for reviewing that area at a particular firm. These areas include: anti-money laundering, research analysts, regulation SP, business continuity planning, regulation SHO, monitoring of registered representatives subject to statutory disqualification, continuing education, new supervisory controls rules, internal controls, and electronic

communications. As both regulatory organizations are responsible for such rules, there may be times, such as with cause examinations or sweeps where both organizations are reviewing the referenced areas but with respect to different regulatory initiatives or scope.

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

- (b) In 2005, the NYSE and NASD agreed to and conducted 65 coordinated examinations of dual-member firms.
- (c) Recent coordination efforts include:
 - (1) SEC, SRO, and state agreement to coordinate examinations of securities firms that hold "free lunch" seminars for senior citizens that may include high-pressure sales practices.
 - (2) NASD and NYSE coordination of firms' options business with the public.
 - (3) Inclusion of language in SEC, NASD, and NYSE letters commencing examinations asking firms to inform the staff about any duplicative efforts of the regulators.
- (v) With the increasing vitality of state regulators and the effectiveness of the SEC's long-awaited books and records rule in May 2003, state regulators currently play an important role in broker-dealer examinations.
- (vi) The Upcoming Merger of the NASD and the regulation operations of the NYSE.
 - (a) On November 28, 2006, the NASD and the NYSE announced that they would consolidate their member regulation operations into a single entity. The consolidation is subject to SEC approval, but the parties have indicated publicly that they hope to close the transaction during the second quarter of 2007.

⁴ See also Lori Richards, "Transparency in Regulatory Examinations," NYSE Regulation Second Annual Securities Conference, June 20, 2006.

- (b) On January 21, 2007, the NASD announced that a majority of its members had approved by-law changes necessary for the consolidation of the NASD and NYSE member regulation functions into a single SRO.
- (c) “The securities industry has embraced replacing an outdated regulatory structure with one that better serves firms and investors in a fast-changing marketplace,” said Mary L. Schapiro, NASD Chairman and CEO. “Firms took the lead in shaping the future of self-regulation, and I applaud them for the mandate they gave this consolidation. I appreciate that so many NASD members took the time to study the proposal and to participate in the voting process.” (January 21, 2007 NASD Press Release.)
- (d) According to the NASD and the NYSE, the new SRO, which will be named later, will consist of the current 2,400-person NASD organization and approximately 470 persons from the NYSE’s member regulation, arbitration, and related enforcement teams. The plan is designed to create a single regulator for the country’s nearly 5,100 broker-dealers, eliminating overlapping regulation and reducing costs to the industry.
- (e) The consolidated entity proposed by the NASD and the NYSE would largely implement the “Hybrid SRO Model,” which the SEC described in a concept release issued on November 18, 2004. Under the Hybrid SRO Model, the SEC would designate a single, market-neutral entity to regulate all SRO members with respect to membership rules, including rules governing members’ financial condition, margin practice, handling of customer accounts, registered representative registration, branch office supervision, and sale practices. Each SRO that operates a market would be solely responsible for its own market operations and market regulation. The new entity would be responsible for all enforcement functions.
- (f) Although neither the NASD nor the NYSE has discussed publicly how the examination process will work in the new entity, it is likely that the former NASD examination staff will focus on sales practice examinations in the field and sweeps relating to retail sales practice issues and core issues like registrations, filings, and so forth. Given the NYSE’s expertise on the capital markets and operational side, it is likely that the former NYSE examination team and its customs and practices will dominate in that area and will be run from New York. From a process perspective, given how much more detailed the NASD rules are with regard to the examination and investigative process, and the broad interpretation that the SEC has given to the NASD’s Rule 8210 (to obtain information and documents), it is likely that the new SRO will adopt the NASD model in that regard.
- (g) The NASD and the NYSE have indicated that the consolidated entity would have a single rulebook, but they have not yet provided details on how they would harmonize their separate rulebooks. According to the NASD, once the consolidation is complete, the new entity—in consultation with industry committees and after board approval—would adopt a uniform set of rules designed to accommodate the different business mixes and firm sizes in the broker-dealer industry.

- (h) While it is not yet clear when or how the new rules might be implemented, it is probable that enforcement proceedings initiated before the effective date of the uniform rules will be governed by the old rules. In 1997, when the NASD obtained approval from the SEC for broad changes in the rules related to membership and disciplinary proceedings, application of the new rules in enforcement proceedings was based on whether attempted service of the complaint was first made before or after the effective date of the new rules. However, the NASD allowed respondents to “opt-in” to the new rules in proceedings where the first attempted service was made within 14 calendar days prior to the effective date of the rules.

Practical Guidance for Handling Regulatory Examinations

Steps to Take Before the On-Site Portion of the Examination Begins

- (i) Notify senior management and compliance and legal departments 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 overbroad.
- (ii) Review records from prior examinations to confirm that noted deficiencies have been addressed.⁵
- (iii) Designate a knowledgeable, cooperative, and personable employee to be the primary liaison with the examiners during the examination. Advise other personnel of the upcoming examination, and tell them who the primary liaison will be. Suggest that all communications with the examiners be handled by the primary liaison.
 - (a) A senior compliance department employee is the ideal choice for a liaison, but each firm should carefully identify the “right person.”
- (iv) Organize and have ready for inspection the documents requested by the regulator. Have personnel available for the first meeting.
- (v) Set aside space in each of the firm’s offices to be visited by the examiners to enable them to work more efficiently to conclude their examination in a timely manner. Also, removing the examiners to their own designated space will minimize the disruption of normal business activity.
- (vi) If possible, ask the examiners in advance what resources they will need from you (e.g., computers, printers, telephones).

⁵ See Kirsch & Smith at 23–24.

Actions to Take During the Examination

- (i) 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 examiners are "on the same page."
- (ii) Encourage communication between firm representatives and examiners to gauge the examiners' progress and impressions.
- (iii) 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 less confident they may become about the firm's ability to produce information promptly. Such concerns and the additional time spent waiting may also contribute to additional document requests.
 - (a) While firms should be 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 liaison. Examiners should not ask administrative staff or other personnel for information.
 - (b) SEC Rule 17a-4(l) requires firms to make and keep current, separately for each office, certain books and records relating to the office. Where a firm does not maintain the records at an office, the firm may choose to produce the records promptly at the request of the regulator. The term "promptly" is not defined in the rule. According to the SEC, requests for records should generally be filled on the day the request is made. The SEC has informed the industry that "valid reasons for delays in producing the requested records do not include the need to send the records to the firm's compliance office for review prior to providing the records."
 - (c) Particular care should be taken to withhold any record that is privileged or otherwise protected from disclosure, but be certain any information withheld is actually privileged. Just because a document may be labeled "privileged" or "confidential" does not make it so.
 - (d) Copies of any records provided to a regulator should be maintained by the firm and appropriately labeled to maintain the confidential nature of such materials. Make sure to replace originals in the file from which they were obtained.
- (iv) 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.
- (v) Prior to the examiners leaving the premises, attempt to locate any missing documents requested during the inspection and provide such materials to the staff.

- (vi) When disagreements occur during the course of an examination, the firm should make clear its 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.

Responding to the Examination Report

- (i) 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.

Tracking Corrective Action Plans

- (i) 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.
- (ii) The plan could identify the issue, describe the remedial steps, assign responsibility, and define timelines for the action items.
- (iii) 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.

The Role of Outside Counsel

Although securities firms do not always engage outside counsel in connection with regulatory exams, outside counsel can provide assistance with the examination process in a number of ways. There may be some risk that prominent assistance by outside counsel might undercut the regulator's perception of the ability of the firm to handle the demands of the examination. For this reason, outside counsel should generally "stay in the background" lest the regulator question the firm's readiness absent outside help.

Preexamination "Check-Ups"

- (i) Outside counsel can provide the securities firm with advice about the current topics of interest that regulators are most likely to focus on in the examination.

- (ii) Outside counsel can investigate potential problem areas in advance of an examination. The scope of such a review could be narrow or broad. It could consist merely of a review of certain of the securities firm's written supervisory procedures (WSPs). Alternatively, it could be a full-scale investigation into particular product areas or sales practices, including reviews of relevant documents and personnel interviews.
- (iii) Outside counsel may also conduct this sort of review after an examination has occurred, for the purpose of preparing a presentation to the regulators outlining the securities firm's view of the facts and applicable regulations.

To Support Document and Electronic Document Production

- (i) Because of their experience with handling large document productions and with issues related to searching and producing email and other electronic data, outside counsel can provide valuable assistance with these tasks. Securities firms' compliance departments and in-house legal personnel can find themselves quickly overwhelmed by the complexities of data collection, review, and production.
- (ii) Regulators are increasingly requesting that securities firms provide representation letters attesting to the fact that firms have produced all responsive materials. Thus, firms may wish to use outside counsel to track and document each step in the document collection and review process.

To Advise on Privilege and Confidentiality Issues

- (i) Outside counsel can be used to quickly determine whether documents or materials requested by a regulator are covered by the attorney-client privilege or any other privilege. Such determinations often need to be made with great speed, as regulators often request immediate access to requested materials.

To Assist with Negotiations

- (i) Outside counsel can assist with negotiations with regulators regarding any issues that arise during an examination. Firms sometimes find it particularly helpful to have outside counsel interface with the regulators when issues arise concerning the conduct of, or the firm's cooperation with, the examination itself. In such a circumstance, compliance and in-house legal personnel may be too closely involved with the issues to effectively negotiate with the regulators.

To Represent Employees Being Interviewed

- (i) If the regulators insist on conducting personnel interviews as part of the examination process, outside counsel should be engaged to provide counsel to the employees being interviewed. Before representing any individual employee, in-house and outside counsel must evaluate the potential for conflict, determine if employees need separate counsel, and avoid placing themselves in a position that may impede their ability to defend the firm itself.

To Provide Materials to the Regulator

- (i) Outside counsel may have obtained relevant material during a prior internal review or may have compiled relevant material as part of a production previously made to another regulator.

To Prepare the Firm's Response to the Examination Report

- (i) Firms may engage outside counsel to prepare a response to the regulator's examination report. Depending on the issues raised in the examination report, the preparation of a thorough response may involve employee interviews, document collection, and review and data analysis. In addition, the response letter must clearly and persuasively articulate the securities firm's view of the facts and its position as to the law or applicable regulations.

Special Issues During Regulatory Examinations

Internal Audit Reports

- (i) SROs generally take the position that internal audit and other internal investigative reports will not be requested on a routine basis but production of them will be required when special circumstances dictate. On the other hand, a firm's effort to cloak, with the attorney–client or any other privilege, routine reviews that are otherwise mandated under SRO or SEC rules (e.g., annual branch visits, AML testing) will be met with skepticism and would likely provoke a confrontation.
- (ii) 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 nonattorneys.
- (iii) 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. The following criteria 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, and (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.

- (iv) 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.

Employee Interviews

- (i) SRO rules and regulations arguably permit examiners to conduct employee interviews during the course of an examination.
- (ii) 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 titled “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.
- (iii) 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 expected to proceed to enforcement or involves privileged information.
- (iv) 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 a branch office, the branch manager or operations manager should be assigned that task. The examiner should be informed that all requests for information and documentation should 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 that it may discuss the issue with the employee and allow the employee to decide if he or she wishes to seek advice of counsel.
- (v) Firms should insist that examiners 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 questions asked by the examiner.

Cooperation

- (i) On September 14, 2005, the NYSE issued an Information Memo 05-65 on cooperation. While the memo applies most directly to the obligations of those under NYSE investigation, the principles could also be applicable to Exchange MFR examinations. The memo sets out the NYSE's views on three specific topics: (1) required cooperation, (2) extraordinary cooperation, and (3) credit for extraordinary cooperation. For purposes of this outline, it is appropriate to focus on the eight factors that are often considered by the NYSE's Division of Enforcement in assessing a firm's cooperation during an investigation. They are:
 - (a) Prompt, full disclosure coupled with thorough internal review.
 - (b) Candor with the NYSE.
 - (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 NYSE.
 - (g) Culture of compliance.
 - (h) Partnering with the NYSE to uncover wrongdoing.

NASD Sweep Examinations

Background

- (i) NASD defines a sweep as a method used to obtain information and conduct examinations and investigations concerning systemic issues that are common to the entire industry or a certain segment.⁶
- (ii) NASD is using sweeps more frequently in sales practice and related areas than in the past.
- (iii) NASD has indicated that it carefully selects those firms included in a sweep.

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

The Sweep Process

- (i) Identification of a sweep topic.
- (ii) Preparation, review, and approval of staff action plan.
- (iii) Delivery of specialized training to examiners.
- (iv) Development of special exam tools, templates, and request letters.
- (v) Selection of firms:
 - (a) Based on various factors, including level and type of activity, complaints, regulatory history, and prior examination findings.
 - (b) Attempt to include variety of broker-dealers (based on size and structure).
- (vi) Commencement of initial exams.
- (vii) Incorporation of information from initial examinations into final plans.
- (viii) Deployment of examiners to conduct the sweeps.
- (ix) Report to sweep leadership.
- (x) Findings used to determine regulatory response.

Staff Commitments to Firms

- (i) NASD will track and approve centrally; different offices will not conduct the same or competing sweeps.
- (ii) 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.
- (iii) NASD will coordinate with the SEC, NYSE, and other securities regulators to eliminate duplication and the burdens of such redundancies.
- (iv) NASD will communicate with firms to assure that requested information is necessary, response dates are fair and reasonable, and technology is used to facilitate production.
- (v) These commitments are made with the caveat that investor protection and the integrity of the market are paramount concerns.

SEC Examination Program Developments

Background

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

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

Factors Considered in Determining Whether OCIE Refers Examination Findings to the Division of Enforcement

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

- (i) Did fraud occur?
- (ii) Were investors hurt?
- (iii) If no fraud occurred, is the conduct ongoing, repetitive, systemic, or severe?
- (iv) Did the firm tell OCIE about the conduct and remedy it?
- (v) Is the conduct the type that the SEC or other regulators should address?
- (vi) Is the conduct in a "message" area?
- (vii) Did the firm profit?
- (viii) Did the firm act with intent?
- (ix) Is the firm a recidivist?
- (x) Were the firm's WSPs inadequate?

Recent Developments in SEC Examinations⁷

- (i) 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.
- (ii) OCIE is updating its examination brochure that is provided to firms at the beginning of an examination. The new brochure includes more information on the examination process.
- (iii) OCIE's new policy is to advise firms of the status of examinations; when an examination 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 completion date.
- (iv) 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.
- (v) OCIE has been meeting with firms throughout the country to provide information on common examination findings.
- (vi) OCIE has been reviewing the language in its deficiency letters to assure that the text is appropriate and conforms to the findings.⁸
- (vii) OCIE is attempting to better understand the work of firms' internal auditors to gauge brokers-dealers' internal controls. The staff is seeking to meet with internal auditors to understand their risk-assessment protocols, cycles, reports, and follow-up procedures. The staff may also seek some specific audit reports during exams.⁹
- (viii) 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.¹⁰

7 See Lori Richards's remarks at the NYSE Regulation Second Annual Securities Conference for information on these topics.

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

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

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

Current NYSE and NASD Examination Priorities

The following are the current NYSE examination priorities¹¹

- (i) Quality of markets issues (firm quote, limit order display, execution of ITS trades, hybrid market issues)
- (ii) Market timing (the NYSE's focus is shifting from firms to individual brokers and supervisors)
- (iii) Sales practice issues (e.g., sales practice issues with respect to registered representatives' handling of family member accounts and outside business activities)
- (iv) Anti-money laundering.
- (v) Nonmanaged fee-based accounts
- (vi) Customer privacy (Regulation S-P).
- (vii) Nonpurpose loans
- (viii) Internal controls
- (ix) CEO certification/annual compliance reports
- (x) Supervision of electronic communications
- (xi) Investment Advisory amendments (Section 202(a)-11)
- (xii) Operational controls on outside investment advisors
- (xiii) Hedge funds
- (xiv) Indexed CDs
- (xv) Reg T extensions
- (xvi) Mark-up/mark-down of fixed-income products
- (xvii) Statutorily disqualified individuals and member organizations
- (xviii) Use of activity letters
- (xix) New products/business lines

¹¹ The priorities were provided by NYSE Regulation in the fall of 2006.

The following are the current NASD examination priorities¹²

- (i) Variable annuities, including issues surrounding the exchange of variable annuities for equity-indexed annuities
- (ii) Bank-affiliated broker-dealers and variable annuities marketed through those affiliates
- (iii) Research analyst rules, including disclosures, employment relationships, and trading against recommendations
- (iv) Anti-money laundering
- (v) Municipal Securities Rulemaking Board (MSRB) issues
- (vi) Microcaps
- (vii) Marketing of closed-end funds
- (viii) Accuracy of U-5 reporting
- (ix) Special-purpose acquisition companies
- (x) Mutual fund share sales practices
- (xi) Electronic communications
- (xii) Branch office sales practices
- (xiii) Sales seminars
- (xiv) Private securities transactions
- (xv) Regulation S-P
- (xvi) Heightened supervision and supervisory controls
- (xvii) New products and nonconventional instruments

¹² These priorities were provided by the NASD in the fall of 2006. On February 13, 2007, Robert C. Errico, Executive Vice President of NASD Member Regulation, sent a letter to member firms highlighting additional issues that are currently of particular significance to the NASD's examination program. These issues include data integrity, protection of customer information, hedge funds, TRACE reporting, Order Audit Trail System (OATS) reporting, fixed income research, gifts and gratuities, and business continuity planning. The letter is available at http://www.nasd.com/web/groups/corp_comm/documents/home_page/nasdw_018635.pdf.

NASAA Top 10 Broker-Dealer Examination Deficiencies

At the recent NASAA conference, 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 2006.¹³ These examinations encompassed 228 broker-dealer firms. The top 10 deficiencies found were as follows:

- (i) Maintenance of customer account information
- (ii) Sales practices—suitability
- (iii) WSPs—failure to follow procedures
- (iv) Advertising/sales literature
- (v) Outgoing/incoming correspondence
- (vi) Blotters/exception reports
- (vii) Email correspondence
- (viii) Internal audits—non-OSJ branches
- (ix) Outside business activity/selling away
- (x) WSPs—failure to maintain as current

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¹³ See September 18, 2006 NASAA Report: “NASAA Examinations Identify Top BD Compliance Deficiencies State Securities Regulators Propose Series of Best Practices.”