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Examinations From the Regulators' Perspective

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I. INTRODUCTION[1]

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

II. BACKGROUND INFORMATION ON REGULATORY EXAMINATIONS

A. Types of Examinations

1. Routine examinations typically 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 and generally follow a set schedule and procedures.[2]

2. Cause examinations are typically triggered by events that would require firms to make certain filings such as on Forms U4 and U5 or pursuant to new FINRA Rule 4530. For example, a regulator may initiate a cause examination based upon an employee's termination for cause, as a result of a customer complaint or series of complaints regarding a broker or a particular type of investment (e.g., annuities or principal protected notes). Cause examinations may also result from arbitration referrals, surveillance triggers or referrals from other securities regulators.

3. Sweep or special examinations typically involve several firms that are scrutinized relating to a specific industry issue. Recent examples of sweep examinations include those relating to spread-based structured products, conflicts of interests, and alternative trading systems. (Further information on sweeps can be found in section V. below.)

4. FINRA also conducts examinations of branch offices and market regulation exams focusing on compliance with various trading and market conduct rules.

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[1] This outline was drafted by Ben A. Indek, a partner of Morgan, Lewis & Bockius LLP. Sections II, III and IV are edited and enhanced versions of outlines developed by a number of individuals for use in connection with past SIFMA Compliance and Legal Society 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 February 2013. The outline represents the views of Mr. Indek and not those of the other panelists and their organizations.

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

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

6. At the Federal Reserve, the vast majority of its insights and intelligence is gathered through its day-to-day contact with firms through its "continuous monitoring" program. This process includes having large on-site teams at the major institutions covered by the Federal Reserve.

III. THE EXAMINATION PROCESS

A. Notice of Commencement of Exam

1. Notice

a. SEC and FINRA rules do not require that notice be given in advance of an examination. Yet, notice is generally provided for routine examinations in order to facilitate advance production of requested material and an overall orderly examination. Cause and sweep examinations typically involve little or no notice. Often however, the SEC and FINRA will publicly hint at or actively announce impending or ongoing sweeps.

(i) Routine examinations initiated by FINRA generally will be announced up to 30 days in advance. Certain examinations may be announced earlier, up to 60 days, where additional time is necessary for pre-examination data gathering.[4]

(ii) Prior notice by SEC staff ranges from a few days to a few weeks for routine examinations. However, the staff may arrive unannounced to conduct cause examinations, the first examination of a firm, or certain other examinations focused on particular areas.[5]

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

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

[5] *See* OCIE Examination Information for Broker-Dealers, Transfer Agents, Clearing Agencies, Investment Advisers and Investment Companies (Nov. 2007) and a paper entitled Examinations by the Securities and Exchange Commission's Office of Compliance Inspections and Examinations (Feb. 2012) ("February 2012 OCIE Update") on the SEC's website.

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.

B. Pre-Exam Work by a Regulator

1. Prior to the commencement of any regulatory examination, SEC and FINRA examiners spend considerable time and effort gathering and reviewing available data regarding the firm to be inspected. This process includes obtaining information from within the SEC or FINRA (including information relating to customer complaints, prior disciplinary history, litigation, statistical data, etc.) and requesting information and records from the firm.

2. As part of the pre-exam process, FINRA members are required to review and update their information on Web IR. FINRA also routinely asks for information regarding branch offices that the examiners may visit during their inspection. This provides information on a firm's structure and activities.

3. The pre-examination process is the opportunity for the regulator to gain an understanding of the firm, its registered persons and business activities in order to focus the inspection on relevant issues.

C. Handling the Day-to-Day Examination

1. Notification of Requested Material/Information

   a. Documents that are typically requested for routine examinations are limited to a specified period of time and are usually standard in nature. Requests for internal audit reports, branch examination reports, records regarding internal disciplinary actions, extensive e-mail records and other related materials may raise issues that should be addressed with the staff.

2. Initial Meetings

   Both FINRA and SEC examiners hold initial meetings with firms upon their arrival for the on-site portion of an examination. These meetings typically involve compliance professionals and may also include senior business executives. In announcing its 2013 examination priorities, the SEC's OCIE stated that its examination program emphasizes corporate governance and enterprise risk management. Specifically, the staff stated that as part of the National Examination Program, the staff "will continue to meet with senior management and boards of entities registered with the Commission and their affiliates to discuss enterprise risk, and in particular, how a firm govern and manage financial, legal, compliance, operational, and reputational risks. This initiative is designed to: (i) understand firms' approach to enterprise risk management; (ii) evaluate firms' tone at the top; and (iii) initiate a dialogue on key risk and regulatory requirements.[6]

3. The Duration of Regulatory Examinations

   The duration of routine examinations varies based on the size of a firm and the number of examiners dedicated to the project. For large firms, routine examinations may take six months or longer to complete. (Of course, much of that time will be spent off-site analyzing materials and following-up on open issues.) Firms should keep in mind, however, that the more effort they put into producing requested material on a timely basis, and the more effort that is made to making sure that the examiner(s) understand the firm's business and methods of operation, the less time the regulators are likely to spend completing the examination.

4. Status Reports

   a. Generally, firm representatives involved in the examination process shy away from asking the regulators for interim status reports. Firms are concerned that by asking too many questions,

[6] *See* January 11, 2013 Annual Regulatory and Examination Priorities Letter, available on FINRA's website ("2013 Priorities Letter")

the regulators may become overly suspicious. Yet, a reasonable and timely request for interim status reports may enable a firm to promptly respond to any open issues. A firm might then be in a position to explain or clarify certain information before it becomes part of the exit interview.

b. The examiners will usually provide interim information or findings prior to the exit interview. This could be partly affected by the individual involved and the ability of each firm to establish an appropriate rapport with the examiners.

5. Exit Interviews and Examination Reports

a. FINRA and the SEC typically hold an exit interview at the conclusion of a routine examination.[7] To a great extent, this meeting has become a formality where the examination staff goes through the alleged violations with the firm's senior management on what was found during the course of the examination and what they may include in their written report to the firm.

b. Firms should view the exit interview the same way they view status reports. In other words, every opportunity should be taken to demonstrate to the examiners the firm's commitment to the compliance function and to advocate its position with respect to each of the preliminary findings.

c. Who attends the exit interview from the firm's standpoint should be considered carefully. When a firm sends senior representatives to this meeting, it demonstrates respect and concern for the examination process.

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

6. Examination Results

a. At FINRA, the results of an examination can include:

(i) No further action.

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[7] At the Federal Reserve, these kinds of sessions are referred to as "soft close meetings." These meetings are an opportunity for the examiners to confirm the facts developed during their review. They also give the examiners a forum to point out the practical or technical issues noted by the staff regarding a firm's supervision. In turn, it is incumbent upon firms to take the staff's concerns seriously and adjust their posture appropriately.

(ii) Cautionary action.

(iii) Compliance conference.

(iv) Referral to Enforcement for review and final disposition.

b. SEC examinations can result in:

(i) No further action.

(ii) A deficiency letter.

(iii) A meeting or conference call to emphasize the seriousness of the deficiencies identified above and beyond the sending of the deficiency letter.

(iv) Referral to Enforcement for further review.

(v) Referral to an SRO for further investigation.

c. At the Federal Reserve, examinations can result in the following:

(i) Observations.

(ii) Matters Requiring Attention.

(iii) Matters Requiring Immediate Attention

IV. PRACTICAL GUIDANCE FOR HANDLING REGULATORY EXAMINATIONS

A. Steps to Take Before the On-Site Portion of the Exam Begins

1. Notify senior management, compliance and legal of an upcoming examination. Review the examination notice and identify and notify parties responsible for responding to the request. Discuss with the examiners before they arrive any requests that are unclear or potentially over-broad.

2. Review records from prior examinations to confirm that noted deficiencies have been addressed.[8]

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.

[8] *See* Kirsch & Smith at 23-4.

a. A senior Compliance Department employee is ideal, but each firm should carefully identify the "right person."

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

5. Set aside space in each of the firm's offices visited by the examiners enabling them to work more efficiently to conclude their examination. Also, providing the examiners with their own designated space will minimize the disruption of normal business activity.

6. If possible, ask the examiners in advance what resources they will need from you (e.g., computer, printer, telephone, etc.).

B. Actions to Take During the Exam

1. Educate the examiner about the nature of the firm's business activities, philosophy, and organizational structure. It is critical to make sure that the firm and the examiner(s) are "speaking the same language."

2. Encourage communication between firm representatives and examiners to gauge the examiner's progress and impressions.

3. Firms should cooperate and accommodate all reasonable requests by producing and reviewing requested documents as quickly as possible. Firms will not gain points by making the staff sit idly waiting for documents.

   a. Ask examiners to communicate all requests in writing through the primary interface.

   b. When faced with potentially burdensome and/overly broad requests (e.g., "all e-mails" for a lengthy period of time), negotiate with the examiners reasonable limitations that narrow the scope of the request, or suggest alternative methods such as a sample of documents, index to extensive procedures that the examiners can then choose from or using search terms for e-mail requests.

   c. 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."

d. 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.

e. 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 confirm that they have received all materials that they have requested and produce any outstanding items.

6. Where disagreements have occurred during the course of an examination, the firm should make its position on the issue clear 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. In connection with the examination report, firms should:

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 for the first time in the report.

c. Draft and be prepared to provide revised procedures that address any identified concerns.

d. Consider disagreeing with exceptions stated in the report if there is a strong legal or factual basis for doing so. Ensure that the firm has discussed the basis for the disagreement with the examination staff before submitting the written response.

e. Draft and circulate a detailed response.

f. Include responses and any necessary attachments documenting corrective action to all items identified in the report.

D. Tracking Corrective Action Plans

1. A firm should develop and implement 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 should 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 next examination to confirm that any deficiencies have been adequately addressed.

E. Using the Exam Process to Improve Compliance[9]

1. After an examination, firms should consider taking various steps to use the results of such inspections to enhance their compliance protocols, including:

   a. Actively monitoring for compliance with any new procedures put in place;

   b. Including the examination findings in supervisory control processes;

   c. Training employees on examination findings; and

   d. Incorporating the findings into continuing education plans and programs.

V. SWEEP EXAMINATIONS

A. Background

As previously noted, sweep examinations typically involve a specific industry issue and review the activities of a cross section of firms. At the SEC, a sweep examination may be undertaken when the staff identifies a pattern of emerging or recurring risks based on routine examinations or its own internal risk assessment protocols.[10]

B. Recent FINRA Sweeps

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[9] *See* "Leveraging the Exam Process to Improve Firm Compliance Practices," FINRA PowerPoint presented at its Oct. 2008 Fall Securities Conference.

[10] "U.S. Securities and Exchange Commission Fiscal Year 2012 Agency Financial Report," available at: https://www.sec.gov/about/secpar/secafr2012.pdf

1. **June 2010 – Spot-Check of Non-Investment Company Exchange Traded Products Communications**

In June 2010, FINRA requested that firms provide information regarding communications relating to non-investment company exchange traded products ("ETPs"). Among other things, the request seeks copies of advertisements, sales literature and institutional sales material promoting ETPs, evidence regarding the written approval by a registered principal of advertisements and sales literature, offering documents, and firms' written supervisory procedures "concerning the production, approval and distribution of ETP communications" in effect between November 2009 and May 2010.

2. **August 2010 – Direct Market Access, Naked Access, Electronic Access or Sponsored Access ("DMA")**

In August 2010, FINRA announced that it was conducting an examination of broker-dealers that provided Direct Market Access, Naked Access, Electronic Access or Sponsored Access (collectively referred to by the staff as "DMA") to customers during the period January 1, 2009 to August 2010. The staff sought information, data and documents regarding 10 separate requests, including a detailed description of the recipient's DMA business and operations, customer account documentation, written supervisory procedures (including those that relate to the firm's AML program), information regarding master/sub-accounts, trader log-ons, position and credit limits and copies of any risk assessments regarding DMA business undertaken by the firm.

3. **October 2010 – Placement Agents**

In October 2010, FINRA began a review of firms acting as or working with placement agents in soliciting and/or obtaining business with municipalities and public pension funds. In connection with this examination, the staff sent a letter requesting seven categories of documents and information, including a list of the third parties used to solicit and/or obtain business, the services and costs of those entities, the firms' own compensation structure for their services, and copies of relevant written policies and procedures.

4. **October 2010 – Bank Broker-Dealer Services**

Also in October 2010, FINRA's Strategic Initiatives Group within the Enforcement Department began an inquiry concerning broker-dealer services involving customers of financial institutions, including federal and state-chartered banks. To commence that inquiry, the staff sent a detailed 14-item request to firms covering a more than two-year period. Among other things, FINRA sought: copies of networking and brokerage affiliate arrangements; descriptions of sales contests; cash and non-cash incentives and other promotions aimed at obtaining securities business from financial institution customers; information regarding the methods used to solicit securities business from current customers of financial institutions; a description of customer information sharing arrangements; sample

copies of various disclosures; copies of advertisements and sales literature; firms' written supervisory procedures; copies of exception reports used to monitor financial institution customer solicitation activity; and internal audit procedures. FINRA also asked firms to create and produce data regarding all customer complaints and arbitrations. Significantly, the staff sought copies of certain branch office audits conducted by the firms.

5. March 2011 – Spot-Check of Reverse Exchangeable Securities (Reverse Convertibles) Advertising and Sales Literature

In March 2011, FINRA posted a letter indicating that it was engaging in a review of reverse convertible advertising and sales literature. This was not surprising in light of the enforcement activity surrounding this product. Among other things, the request seeks copies of advertisements, sales literature and institutional sales material regarding Reverse Convertibles used between September 1, 2010 and February 28, 2011, evidence regarding the written approval by a registered principal of advertisements and sales literature, offering documents, and firm's written supervisory procedures "applicable to the production, approval and distribution of Reverse Convertible communications" in effect between September 1, 2010 and February 28, 2011.

6. November 2011 – Spread-Based Structured Products

In November 2011, FINRA's Advertising Regulation Department and the Department of Enforcement Case Development Team announced that they were conducting an inquiry regarding spread-based structured products. The staff requested extensive documents and information from firms including materials relating to advertisements, suitability procedures, written supervisory protocols, risk disclosure documents and customer complaints.

7. July 2012 – Conflicts of Interest

In July 2012, FINRA began a review of firms' identification and management of conflicts of interest. The staff requested that firms submit the following information: (i) summaries of the most significant conflicts currently being managed; (ii) the types of reports/documents prepared at the conclusion of a conflicts review; (iii) the identity of persons and departments responsible for conflicts reviews; and (iv) the identity of the persons who receive final reports/documentation of a conflicts review. In connection with this sweep, FINRA requested to meet with senior executives and compliance staff to discuss how firms approach identifying and mitigating conflicts of interest. At such meetings, the firms are to present on the most significant conflicts they managed and the protocol in place to identify and assess potential conflicts between the firm and its clients' interests.

8. **September 2012 – Alternative Trading Systems**

In September 2012, FINRA's Trading Examinations Unit of the Market Regulation Department began an inquiry concerning Alternative Trading Systems ("ATS"). To commence that inquiry, the staff sent a detailed 18-item request to firms. FINRA asked for the following key information and documents: (i) identification of any ATS affiliated with or operated by the firms; (ii) copies of most recent Form ATS filed with the SEC; (iii) marketing materials or responses to client inquires regarding ATS operation; (iv) written supervisory procedures relating to ATS and Fair Access Procedure; (v) the levels of access available to ATS clients; (vi) identity of personnel or business units with access to client information in any ATS of the firm; and (vii) the percentage of broker-dealer and non broker-dealer ATS subscribers. FINRA also asked whether firms act as principals on ATS transactions, whether firms' ATS's send or receive indications of interest, whether firms' affiliated ATS interact with other ATS, and to explain in detail firms' interaction with ATS's order flow, how the firms' trading systems handle odd-lot quantities, how customer errors or ATS errors are handled and how the firms generate compensation from each ATS. Lastly, FINRA asked firms to explain the nature and resolution of all complaints received regarding orders sent to any ATS affiliated with them.

9. **September 2012 – Spot-Check on Non-Traded REIT Communications**

In September 2012, FINRA's Advertising Regulation Department requested that firms provide information regarding communications relating to Non-Traded REIT ("NTR") Communications. Among other things, the request seeks copies of advertisements and sales literature relating to NTRs, an "Approval and Recordkeeping" Excel spreadsheet with certain data (e.g. description of communication, dates and method of distribution, date of approval and name of approving principal) for all advertisements and sales literature related to NTRs, evidence regarding the written approval by a registered principal of advertisements and sales literature, offering documents, and the firms' written supervisory procedures "concerning the production, approval and distribution of NTR communications" in effect between January 1, 2012 and June 30, 2012.

10. **October 2012 – Order Protection Disclosure Practices**

In October 2012, FINRA's Trading and Market Making Surveillance Examinations group of the Market Regulation Department began an inquiry concerning firms' compliance with FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders). In a detailed request, the staff asked for documents and information from firms, including, among other things, descriptions of systems of controls, the method, surveillance and copies of written supervisory procedures established to ensure compliance with Rule 5320; copies of notices to customers regarding protections they are entitled to under Rule 5320; and information regarding any and all Rule 5320 breaches identified between December 2011 and June 2012.

11. November 2012 – Business Continuity Plans

In November 2012, FINRA, together with the SEC and CFTC, began a review of the impact of Hurricane Sandy on firms' operations and abilities to conduct business (both securities and futures business) when business continuity plans ("BCP") were enacted. The staff sent a detailed 31-item request to firms asking questions regarding firms' BCPs and their effectiveness when put in place in connection with Hurricane Sandy; the firms' plans and procedures in place to allow for continued trading after Hurricane Sandy and testing of the procedures during BCP; firms' abilities to communicate with customers during the contingency event and customers' access to funds; as well as whether the Hurricane resulted in financial/regulatory consequences such as requests for regulatory relief, settlement, clearing, and books and records issues.

C. Recent SEC Sweeps

1. Structured Products

In July 2011, the SEC staff issued a report on a sweep examination conducted by OCIE in 2009 regarding the retail structured securities products business of 11 broker-dealers, which covered a cross-section of the industry. The staff's report noted that broker-dealers may have (i) "recommended unsuitable structured securities products to retail investors;" (ii) "traded at prices disadvantageous to retail investors;" (iii) "omitted material facts about structured securities products offered to retail investors;" and (iv) "engaged in questionable sales practices."[11] The staff also observed potential supervisory deficiencies. Specifically, the staff noticed inadequate training requirements for supervisors and registered representatives who market structured products.

The report contained a list of key issues that broker-dealers should focus on in the sale of retail structured products based upon the staff's review. For larger broker-dealers, those issues included: (i) "having adequate procedures and controls to prevent and detect possible abuses in the secondary market for structured securities products;" (ii) "disclosing material facts regarding the structured securities products being offered;" (iii) "requiring registered representatives and their supervisors to complete specialized training in structured securities products before selling these products to customers;" (iv) "accurately listing structured securities products on customer statements; (v) "having controls to independently review their desk prices of structured securities products in the secondary market;" (vi) "having controls to adequately review the suitability of these products for customers;" and (vii) having controls to review customer concentrations in the structured securities products it sold."[12] For smaller broker-

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[11] "SEC Staff Issues Summary Report of Sweep Examination of Structured Products Sold to Retail Investors," available at: http://www.sec.gov/news/press/2011/2011-157.htm.

[12] *Id.*

dealers, those issues included: (i) "the suitability of structured securities products recommended to retail customers;" (ii) "establishing, maintaining and enforcing proper supervisory procedures relating to suitability determination for purchasers of structured securities products;" and (ii) "having adequate training for registered representatives who sell structured securities products and for their supervisors."[13]

2. **Information Barriers**

In September 2012, the SEC staff issued a report on examinations of broker-dealer practices related to information barriers under section 15(g) of the Securities Exchange Act of 1934. The examination was conducted by the staff of SEC, FINRA, and the NYSE and focused on the existing programs broker-dealers have in place to protect against the misuse of material nonpublic information ("MNPI"). Specifically, the regulators looked at whether broker-dealers are in compliance with Section 15(g) of the Exchange Act requirements surrounding MNPI, and to ascertain "how broker-dealers consider and analyze new business practices, new technologies, and new controls that may impact their compliance efforts."[14]

The report included a list of the concerns identified during the examination, which were: (i) the difficulty in tracing disclosures of MNPI resulting from the considerable amount of interactions between groups in possession of MNPI (such as investment banking, capital markets, or syndicate groups) and sales and trading groups, which should not be privy to MNPI; (ii) "above-the-wall" classifications given by firms to certain individuals or groups in light of the lack of mitigating controls such as physical barriers, documentation or monitoring of individual and groups with conflicting business responsibilities and which receive MNPI; (iii) the occurrence of communications between broker-dealer groups, in which MNPI is provided to sales, trading or research for business purposes and the lack of review of the trading conducted after traders received MNPI; and (iv) the gaps in oversight in coverage of MNPI received by groups or individuals (e.g. when MNPI came through business activities outside of the investment banking department).

The report also included effective broker-dealer practices related to information barriers noted by the regulators: "[b]roker-dealers were developing processes that differentiated between types of MNPI based on the source (e.g., business unit) from which the information originated within the broker-dealer or the nature (e.g., transaction type) of the information. In some cases, broker-dealers were creating tailored exception reports that took into account the different characteristics of the information;" and (ii) "[b]roker-dealers were expanding the scope of instruments

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13 *Id.*

14 "Staff Summary Report of Examinations of Information Barriers: Broker-Dealer Practices Under Section 15(g) of The Securities Exchange Act of 1934," available at: http://www.sec.gov/about/offices/ocie/informationbarriers.pdf.

that they reviewed for potential misuse of MNPI by traders, including: credit default swaps, equity or total return swaps, loans, components of pooled securities such as unit investment trusts and exchange traded funds, warrants, and bond options."[15]

3. **Automated Trading Systems**

According to media reports, in September 2012, the SEC commenced a review of major firms' internal controls regarding their automated trading systems. Among other things, the sweep reportedly asked for information about which individuals have responsibility for technology and the policies for developing and testing computer code. The review also apparently seeks information regarding "automatic shut-offs or kill switches" that are designed to stop automatic trading systems.[16]

D. Federal Reserve "Horizontal Reviews"

1. The Federal Reserve undertakes "horizontal reviews." These are efforts to understand industry practices across a group of comparable firms and is an important part of its approach to supervision. Examples of these kinds of reviews include capital stress testing tests.

VI. RECENT REGULATORY DEVELOPMENTS CONCERNING BROKER-DEALER EXAMINATIONS

A. FINRA

1. The following FINRA examination program developments are worth noting:

   a. FINRA continues to develop and implement its risk-based examination program. By risk-based, FINRA has indicated that "the scope, content, frequency, and nature of an individual examination will depend on the operational and risk characteristics associated with that firm."[17]

   b. As part of that process, FINRA is engaging in a "broader data collection effort and more comprehensive risk-assessment process."[18]

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15 *Id*.

16 "SEC Looks for the 'Kill Switches'," Jacob Bunge, Wall Street Journal (Sept. 26, 2012).

17 *See* 2013 Priorities Letter.

18 *See* 2013 Priorities Letter.

(i) The first step in that process was the deployment of a Risk Control Assessment ("RCA"), intended to assist FINRA in better understanding its membership's activities, mix of products and services, customer base and controls. The RCA was voluntary; approximately 45% of member firms completed the survey. FINRA is currently using the information to plan and scope its examinations and was reportedly close to "pushing the [RCA] out to the examination staff" as of early July 2012.[19]

c. FINRA examiners are being encouraged by senior Staff to increase their dialogue and communication with firms as issues are identified during an inspection. Where appropriate, the Staff may ask for a firm to provide an "action plan" to address the issues identified by FINRA. In some cases, such a plan may be sufficient to remedy the issue; in others a referral to Enforcement may still be warranted.[20] Generally, FINRA has assured firms that experienced Staff members are involved in the evaluation and decision make process concerning referrals to Enforcement.[21]

d. FINRA plans to increase the number of surprise visits to firms, particularly in "for cause" situations.[22]

e. FINRA continues to focus on branch offices during its inspections.[23]

2. In early 2013, FINRA released various statistics and information regarding its examination program. Among other things, FINRA noted the following:[24]

a. Last year it initiated 1,846 routine examinations, more than 800 branch office examinations and 5,100 cause examinations.

b. FINRA created new technology to make more efficient its exam process through the use of new tools, data and examination content. According to FINRA, its new "modernized framework

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19 *See* Yin Wilczek, "SEC Shifting Focus of Risk Analytics to Problematic Branch Offices, Official Says" BNA Securities Regulation and Law Report, July 2, 2012 ("SEC Shifting Focus").

20 *See* Campbell Miller and Recine.

21 *See* Campbell Miller and Recine.

22 *See* Campbell Miller and Recine.

23 *See* Campbell Miller and Recine.

24 *See* press release 2012: FINRA Year in Review" (Jan. 8, 2013).

for the risk-based examination process" is important in helping it identify and prioritize risk exposure at firms.[25]

B. SEC

1. OCIE's self assessment[26]

a. OCIE continues to implement the recommendations that came out of its wide-ranging self assessment of its entire examination program and operations. As a result of that exercise, OCIE has developed the following four core principles:

(i) Risk-based approach

(ii) Teamwork and collaboration

(iii) Ongoing improvement and accountability

(iv) Focus

b. In addition, OCIE has developed a National Examination Program whose goals are to:[27]

(i) Improve compliance

(ii) Prevent fraud

(iii) Inform policy

(iv) Monitor firm-wide and systemic risk

c. In publishing its 2012 Update, OCIE noted that due to its close cooperation with the Division of Enforcement, a significant number of cases were brought in 2011 as a result of National Examination Program referrals. Such cases, included those involving Ponzi schemes, material misrepresentations or omissions, undisclosed compensation or hidden fees and expenses charged to investors, false and/or inflated valuations and compliance controls.[28]

d. In June 2012, senior OCIE staff outlined the seven key findings identified in its 2011 broker-dealer examinations:

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25 *Id*.

26 *See* February 2012 OCIE Update.

27 *See* Id.

28 *See* Id.

(i) Problems in calculating the reserve formula and net capital

(ii) Accounting and safekeeping customer funds

(iii) Deficiencies relating to key risk and control functions

(iv) Supervision, particularly relating to independent contractors

(v) Various sales practices (e.g., suitability, churning, misrepresentation and unauthorized trading)

(vi) Order handling and execution

(vii) Underwriting and distribution of securities[29]

e. OCIE has made at least two changes in its staffing model. First, it has created specialized working groups in the following areas:

(i) New and structured products

(ii) Valuation

(iii) Equity and market structure and trading practices

(iv) Fixed income and municipal markets

(v) Microcap fraud

(vi) Marketing and sales practices[30]

f. The second change involves "project-based" exam teams, which allows for the use of examiners on an inspection based on expertise rather than from a single "branch" of examiners.[31]

g. In February 2012, OCIE Director Carlo di Florio announced that the National Examination Program manual had been distributed to the OCIE Staff. The manual, which sets forth OCIE's key policies and standards was going to be reviewed by the Staff in the field and revisions made to it. In the end, Mr. di Florio stated that he

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[29] Diana C. Campbell Miller and Susan George, "SEC's Carlo di Florio Speaks About the Commission's National Examination Program With a Focus on Broker-Dealer Examinations," published by Bressler, Amery and Ross (June 22, 2012).

[30] *See Id.*

[31] *See Id.*

hoped to make the manual publicly available on the SEC's website.[32]

h. OCIE has been active in issuing Risk Alerts. In March 2012, it published an alert reminding broker-dealers of their due diligence and supervisory obligations in connection with municipal securities underwritings.

i. OCIE and FINRA are reportedly working more closely on broker-dealer examinations than they have in the past. According to senior staff at both agencies, the SEC and FINRA are coordinating regularly on such examinations. In some instances, the two are having daily discussions about broker-dealer risks.[33]

j. Finally, much like FINRA, the Staff at OCIE is focusing on branch office inspections of broker-dealers.[34]

VII. EXAMINATION PRIORITIES

A. FINRA 2013 Examination Priorities[35]

1. Business conduct and sales practice concerns for retail customers

a. Suitability and Complex Products

b. Business Development Companies

c. Leveraged Loan Products

d. Commercial Mortgage-Backed Securities

e. High-Yield Debt Instruments

f. Structured Products

g. Exchange-Traded Funds and Notes

h. Non-Traded REITs

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[32] Yin Wilczek, "SEC to Focus on Firms Where Management Not Setting Appropriate Tone of Compliance," BNA Securities Regulation and Law Report, February 6, 2012.

[33] Yin Wilczek, "SEC Broker Exam Program Targeting Firms' Diligence, Separation of IA, B/D Arms," BNA Securities Regulation and Law Report, May 28, 2012.

[34] Yin Wilczek, "SEC Shifting Focus of Risk Analytics to Problematic Branch Offices, Official Says," BNA Securities Regulation and Law Report, July 2, 2012.

[35] *See* 2013 Priorities Letter.

i. Closed-End Funds

j. Municipal Securities

k. Variable Annuities

l. Cyber-Security and Data Integrity

m. Microcap Fraud

n. Private Placement Securities

o. Anti-Money Laundering

p. Automated Investment Advice

q. Branch Office Supervision

2. Insider Trading

3. Financial and Operational Priorities

a. Guarantees and Contingencies

b. Margin Lending Practices

c. Leverage and Liquidity

d. Valuation of Securities and Concentrations of Market, Credit and Liquidity Risk

4. Market Regulation Priorities

a. Algorithmic Trading

b. High-Frequency Trading Abuses

c. Alternative Trading Systems

d. Options Origin Codes

e. Large Options Position Reporting

f. Fixed Income

B. SEC OCIE 2013 Examination Priorities for Broker-Dealers

1. On February 21, 2013, OCIE published its 2013 examination priorities for regulated entities, including broker-dealers. In its announcement, Carlo V. di Florio, Director of OCIE, stated "we are publishing these priorities to

promote compliance and communicate with investors and our registrants about areas that we perceive to have heightened risk."[36]

2. OCIE's priorities were selected by its senior staff, managers in the Commission's regional offices and other Divisions using a variety of information and data, including the following:

   a. Tips, complaints and referrals from several sources, including information received from whistleblowers, customers and investors.

   b. Filings made with the Commission.

   c. Information obtained in connection with SEC examinations and reviews by other regulators.

   d. Communication with other regulators both in the U.S. and abroad.

   e. Media coverage of regulatory issues.

   f. Information in third-party databases.

   g. Communication with regulated entities, trade groups and service providers outside the context of routine examinations.

3. OCIE has indicated that there are several examination priorities that apply to almost all regulated entities (e.g., broker-dealers, clearing agencies, mutual funds, hedge funds, etc.). The most important initiatives across the exam program include:

   a. Fraud detection and prevention

   b. Corporate governance and enterprise risk management

   c. Conflicts of interest

   d. Technology

4. Specifically, in the broker-dealer area, OCIE has indicated that it will consider the following areas when scoping and carrying out examinations in 2013:

   a. Ongoing risks

      (i) Sales practices/fraud

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[36] *See* Commission Press Release "SEC Announces 2013 Examination Priorities," February 21, 2013 and the accompanying National Exam Program Examination Priorities for 2013, available at: www.sec.gov.

(ii) Trading

(iii) Capital

(iv) Anti-money laundering

b. New and emerging issues

(i) The Market Access Rule

(a) Master/sub-accounts

(b) Proprietary trading

(c) Supervision of technology system controls and governance

(d) Dual registrants/regulatory coordination

(ii) Exchange-traded funds

c. Policy topics

(i) JOBS Act

(ii) Other regulatory requirements, including registration of municipal advisors and compliance with Security-Based Swap Dealers rules

VIII. 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. 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.

2. 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.

3. 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 (i.e., FINRA Rule 8210(a)) 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 in writing 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.