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COMPLIANCE

The Survival Guide to Regulatory Examinations

BY JOHN SAKHLEH

The regulatory environment for registered investment advisers and registered broker-dealers has changed dramatically over the last couple of years due to corporate scandals, the Madoff and Stanford ponzi schemes, recent market declines, and more aggressive enforcement actions by the U.S. Securities and Exchange Commission (''SEC'') and the Financial Industry Regulatory Authority, Inc. (''FINRA''). In light of these events, SEC and FINRA examiners have: (i) improved and modified their examination programs; (ii) enhanced their scrutiny of firms' compliance with the securities laws; and (iii) enhanced their scrutiny of firms in order to better detect fraud.[1] In a regulatory environment where the securities regulators are pursuing vigorous compliance examinations over registered investment advisers and registered broker-dealers, it is important that firms are well prepared to handle these examinations.[2] The failure to take regulatory examinations seriously or devote the requisite resources to compliance and internal controls could result in firms incurring significant fines, receiving negative publicity, damaging relationships with its investors (or even losing investors), or being subject to suspensions or bars from the industry. For these reasons, senior executive officers, compliance officers, and legal departments must recognize the importance of properly preparing for and handling exams, in addition to cooperating with examiners during an examination. To work successfully with the examiners, firms should employ the right attitude and assemble the right team to address the issues raised during an exam.

The following is intended to serve as a guide to handling regulatory examinations for registered investment advisers or broker-dealers.[3] The purpose of this docu-

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[1] For purposes of this guide, the terms ''examiners,'' ''exam staff,'' ''examination staff,'' ''staff,'' and ''regulators'' are used interchangeably.

[2] For purposes of this guide, the term ''firm'' is used for both registered investment advisers and registered broker-dealers.

[3] The information in this document is designed to assist firms in preparing for a regulatory examination. Each exami-

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ment is to highlight legal and regulatory issues, as well as practical issues, that firms should consider and be ready to address during a regulatory examination. The mere fact that a firm has updated written supervisory procedures, implemented adequate controls and maintained records, does not mean the firm is well-prepared to handle an actual examination. Preparing for an examination takes time and resources and firms should begin proper preparation for an exam the moment the firm registers with the SEC. Firms should assume that an examination will occur at any point and firms' preparation for an examination should be a continuous process. By using the information in this guide, firms will be better equipped to deal with examiners and to navigate through the regulatory examination process.[4]

Further, the ''Private Fund Investment Advisers Registration Act of 2010,'' the formal name of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (''Dodd-Frank Act''), significantly impacts registration requirements for advisers to private funds under the Investment Advisers Act of 1940 (''Advisers Act'').[5] In summary, by eliminating the private adviser exemption, the Dodd-Frank Act will, among other things, require a number of advisers to private funds to register with the SEC and, therefore, subject such advisers to SEC examination authority.

In addition, the SEC's Division of Investment Management recently conducted a study in which the agency reviewed and analyzed the need for enhanced examination and enforcement resources for investment advisers.[6] The study describes, among other things, the process by which the SEC currently examines investment advisers' books, records and activities. In general, the study indicates that the ''SEC likely will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency.'' Thus, the SEC's staff recommends that Congress consider three options to strengthen the SEC's investment adviser program: (i) imposing user fees on SEC registered investment advisers to fund the SEC's examinations; (ii) authorizing one or more self-regulatory organizations (''SROs'') to examine, subject to SEC oversight, SEC registered investment advisers; and (iii) authorizing FINRA to examine dual registrants for compliance with the Advisers Act. Depending on the implementation of these recommendations, registered investment advisers may be subject to examinations by an SRO, in addition to the SEC.

The information below provides a brief summary of the statutory basis for the regulators to conduct examinations of firms. The majority of this guide is devoted to offering practical tips and suggestions firms should consider when undergoing a regulatory examination in addition to a common sense approach to building and maintaining good working relationships with the regulators.

I. Statutory Authority of Regulators to Conduct Exams of Registered Broker-Dealers and Registered Investment Advisers

The following provides a general overview of (i) the SEC's examination authority over registered broker-dealers and registered investment advisers, and (ii) FINRA's examination authority, as an SRO, over registered broker-dealers.

A. SEC's Examination Authority

In general, the SEC's Office of Compliance Inspections and Examinations (''OCIE'') administers the SEC's nationwide examination and inspection program.[7] OCIE is located at the SEC's headquarters and in 11 Regional Offices.

1. *Examinations of Registered Broker-Dealers*. Under Section 17 of the Securities Exchange Act of 1934, as amended (''Exchange Act''), the SEC has authority to conduct inspections over registered broker-dealers.[8] Specifically, Section 17(b) of the Exchange Act states that ''[a]ll records of persons described in [Section 17(a) of the Exchange Act] are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the [SEC] and the appropriate regulatory agency for such persons as the [SEC] or the appropriate regulatory agency for such persons deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this chapter.''[9] Based on the foregoing, the SEC is authorized to con-

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nation is different and the information set forth in this guide is not intended to constitute legal advice.

[4] Firms should strongly consider seeking outside legal counsel when subject to an examination with respect to preparing for it, dealing with the regulators and responding (orally or in writing) to requests for information by the regulators.

[5] *See* Dodd-Frank Wall Street Reform and Consumer Prot. Act, Pub. L. No. 111-203 (July 21, 2010).

[6] The study was conducted pursuant to Section 914 of Title IX of the Dodd-Frank Act which mandated that the SEC conduct a study to review and consider, among other things, whether a self-regulatory organization would supplement the SEC's oversight of investment advisers. *See* Study on Enhancing Investment Adviser Examinations (January 2011) *available at* http://www.sec.gov/news/studies/2011/914studyfinal.pdf (''SEC Investment Adviser Study'').

[7] In addition to having exam authority over registered investment advisers and registered broker-dealers, OCIE has, among other things, responsibility for conducting examinations of investment companies, transfer agents and self-regulatory organizations. More information about OCIE can be found on their website, *available at* http://www.sec.gov/about/offices/ocie.shtml (last visited February 9, 2011). *See also* SEC, Examinations by the SEC OCIE (Feb. 2010), *available at* http://www.sec.gov/about/offices/ocie/ocieoverview.pdf. While OCIE has such authority, it is important to note that the Dodd-Frank Act includes a provision that requires examination and inspection personnel to be housed in both the SEC's Division of Trading and Markets and Division of Investment Management. At this time, it is too early to determine the impact of this provision on the examination process. *See* Dodd-Frank Act, *supra* note 5, § 965.

[8] *See* 15 U.S.C. § 78q.

[9] *Id*. § 78q(b)(1). Note that the Exchange Act provides the SEC with authority to examine broker-dealers but also to investigate them. In general, pursuant to Section 21 of the Exchange Act, the SEC is authorized to conduct investigations as it deems necessary to determine whether any person has violated the federal securities laws. *See id*. § 78u. With this authority, the SEC is empowered to ''administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records which the Commission deems relevant or material to the inquiry.'' *Id*. § 78u(b). Investigations are primarily conducted by the SEC's Division of Enforcement.

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duct examinations ''at any time, or from time to time.''[10]

Section 17(a) of the Exchange Act states that registered broker-dealers ''shall make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the [SEC], by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title.''[11] Rule 17a–3 and Rule 17a–4 under the Exchange Act provide for minimum requirements with respect to the records that registered broker-dealers must make and how long those records and other documents relating to a broker-dealer's business must be kept.[12]

2. *Examinations of Registered Investment Advisers*. Section 204 of the Advisers Act authorizes the SEC to conduct ''at any time, or from time to time, . . . such reasonable periodic, special, or other examinations . . . as the [SEC] deems necessary or appropriate in the public interest or for the protection of investors.''[13]

Rule 204-2 under the Advisers Act requires registered investment advisers to make and keep true, accurate books and records in connection with their investment advisory business.[14] In general, this rule requires registered investment advisers to maintain books and records including but not limited to the following: (i) journals, including cash receipts/disbursements, records and any other records of original entry forming the basis of entries in any ledger; (ii) ledgers reflecting assets, liabilities, reserves, capital and income and expense reports; (iii) memoranda of orders given by the investment adviser for the purchase or sale of any security; (iv) check books, bank statements and cash reconciliations; (v) bills or statements relating to the business of the registered investment advisers; (vi) trial balances, financial statements and internal audit working papers relating to the business of the registered investment adviser; (vii) originals of written communications received and copies of written communications sent by the registered investment adviser related to recommendations, receipt/disbursements of funds or securities, or placing or executing any order to purchase or sell; and (viii) written agreements entered into by the investment adviser with any client or otherwise relating to the business of the investment adviser as such.[15]

B. FINRA's Examination Authority

FINRA is a private organization registered with and regulated by the SEC pursuant to certain provisions of the Exchange Act. The scope of FINRA's jurisdiction is primarily governed by the Exchange Act, interpretations by the SEC and the courts. FINRA's jurisdiction generally extends to any securities activity by a FINRA member firm or associated person that is governed by the Exchange Act or FINRA's rules. FINRA's regulatory authority is generally derived from Section 15A of the Exchange Act.[16]

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[10] *Id*. § 78q(b)(1).

[11] *Id.* § 78q(a)(1). The complete list of entities subject to the requirements of Section 17(a) of the Exchange Act include every ''national securities exchange, member thereof, broker or dealer who transacts a business in securities through the medium of any such member, registered securities association, registered broker or dealer, registered municipal securities dealer, registered securities information processor, registered transfer agent, nationally recognized statistical rating organization, and registered clearing agency and the Municipal Securities Rulemaking Board.'' *Id*.

[12] *See* 17 C.F.R. § 240.17a-3 to a-4 (2010). Further, under Section 17, registered broker-dealers must maintain extensive records of their activities. The type of record and period of time vary. Firms should review this section and the rules and regulations thereunder in order to ensure that they meet these recordkeeping requirements. *See* Exchange Act Release No. 34-44992, 66 Fed. Reg. 55,818 (Oct. 26, 2001).

[13] 15 U.S.C. § 80b-4(a). In addition to the requirements of the Advisers Act, for investment companies, Section 31(a) of the Investment Company Act of 1940 (''ICA'') requires the following entities to maintain and preserve records for time periods designated by the SEC: (i) registered investment companies; (ii) underwriters, brokers, dealers, or investment advisers that are majority-owned subsidiaries of investment companies; and (iii) each investment adviser that is not a majority-owned subsidiary, depositors of any registered investment company, and each principal underwriter for any registered investment company other than a closed-end company. *See* 15 U.S.C. § 80a-30(a)(1). Section 31(b)(1) of the ICA states that the records required to be maintained in accordance with Section 31(a) of the ICA are subject to ''reasonable periodic, special and other examinations'' by the SEC ''at any time and from time to time.'' *Id*. § 80a-30(b)(1). Section 31(b)(2) states that any persons subject to the requirements of Section 31(b)(1) ''shall make available to the [SEC] or its representatives any copies or extracts from such records as may be prepared without undue effort, expense, or delay as the [SEC] or its representatives may reasonably request.'' *Id*. § 80a-30(b)(2). In addition, Section 32(c) of the ICA provides the SEC with the authority to ''require accountants and auditors to keep reports, work sheets, and other documents and papers relating to registered investment companies for such period or periods as the [SEC] may prescribe, and to make the same available for inspection by the [SEC] or any member or representative thereof.'' *Id*. § 80a-31(c).

[14] *See* 17 C.F.R. § 275.204-2(a).

[15] *See id*. The foregoing list does not include all of the records that registered investment advisers are required to maintain in connection with their books and records requirements. As a result, to ensure complete compliance, firms should review Rule 204-2 under the Advisers Act and any interpretations thereunder.

[16] The Maloney Act of 1938 originally added Section 15A to the Exchange Act, permitting an association of brokers and dealers to apply to the SEC for registration as a national securities association. Under the supervision of the SEC, such an association would regulate more directly and comprehensively individual brokers and dealers in the over-the-counter markets. The National Association of Securities Dealers (the ''NASD'') was the only association to register (1940). (The current national securities association is FINRA, formed in 2007 when the NASD merged with certain regulatory divisions of the New York Stock Exchange.) In describing the application process, Section 15A(b) sets out the necessary qualifications of a national securities association. Among these are the capacity to enforce compliance by its members and persons associated with its members with the Exchange Act and the rules and regulations thereunder, creating rules to prevent fraud and manipulation and promote just and equitable principles of trade, and providing a fair procedure for disciplining members, denying membership, and suspending or barring persons from associating with a member firm.

Under Section 15(b)(2)(C) and Rule 15b2-2 of the Exchange Act, within six months of a broker-dealer registering with the SEC, the exchange or national securities association (FINRA) of which the broker-dealer is a member must examine the broker-dealer to determine that it is operating in conformity with applicable fiscal responsibility rules. *See* 15 U.S.C. § 78o; 17 C.F.R. § 240.15b2-2(b). (The SEC has the discretion, however, to delay the initial examination for up to six additional months.) Within twelve months of the broker-

In addition, FINRA may request information from its member firms pursuant to FINRA's rules. Generally, FINRA Rule 8210 permits the FINRA staff to (i) request the books and records of member firms, and (ii) take sworn testimony of firms' associated persons.[17] Further, FINRA member firms and their associated persons are required to respond to a request for information pursuant to FINRA Rule 8210, and failure to do so could result in a fine, suspension, or bar from the industry.[18]

II. The Different Types of Regulatory Examinations

A. Routine Examinations

Routine examinations are generally conducted according to a cycle schedule that is based on the firm's business activities and risk profile as determined by the examining authority. These examinations generally are not triggered by any perceived wrongdoing by the regulator. Rather, routine exams are designed to review the firm's overall compliance program and procedures. Routine exams generally cover a broad range of topics including, among other things, the firm's sales practices, financial reporting, supervisory procedures, capital requirements, and books and records obligations.

B. Cause Examinations

Cause examinations are generally initiated by the examining authority based on information of a potential problem at a particular firm. Cause examinations may be triggered as a result of, among other things, referrals from other regulators, customer complaints, Form U-5 disclosures, information obtained during arbitration hearings, news or press reports, anonymous tips or automated surveillance. For example, the SEC may initiate a cause examination after receiving a reliable tip about a certain type of alleged improper conduct at a securities firm. In another example, a regulator's surveillance tools may detect potential wrongdoing (*e.g.*, a hedge fund participated in a secondary offering and also entered into short sales during the restricted period of the same stock in the offering – thus, triggering a cause exam as to whether the firm violated Rule 105 of Regulation M). In addition, as a result of the Madoff and Stanford ponzi schemes, there appears to be an increased focus by the securities regulators to conduct more cause examinations rather than routine (or cycle) examinations.[19]

C. Sweep Examinations

Sweep examinations generally are initiated by the securities regulators in an effort to either review or learn more about a particular issue or practice in the industry.[20] Sweep examinations are typically limited in scope and focus on specific areas of a firm's business and may involve a number of regulated entities in connection with such areas. For example, the SEC has conducted sweep examinations requesting information from a number of firms in connection with reviewing custodial controls and arrangements for safekeeping of client assets. According to FINRA, sweep examinations are also used to focus on emerging regulatory issues.[21]

D. Oversight Examinations

Oversight examinations are generally conducted by the SEC for registered broker-dealers that have been recently examined by an SRO. For example, once FINRA has completed an examination of a member firm, OCIE may conduct its own review of the firm in order to evaluate the quality of FINRA's examination of such firm.[22]

E. Other

In addition to the types of examinations noted above, Rule 206(4)-2 under the Advisers Act was recently amended to require, among other things, that registered investment advisers deemed to have custody over client funds or securities, subject to certain exceptions, engage an independent public accountant to conduct an annual ''surprise examination'' to verify that client assets exist and to confirm that the books and records of the adviser and the custodian are consistent.[23]

In recent years, the securities regulators have been moving toward a more ''risk-based'' approach to their examination program.[24] To that end, the staff of OCIE has been implementing a new examination framework that is more risk-based and strategic. In that regard, OCIE appears to be focusing on, among other things, learning about the firm's business model, risks and conflicts of interests in order to identify high risk areas and determine whether OCIE should conduct a further review of the firm. In addition, in the SEC Investment Adviser Study, the staff states that OCIE's investment adviser examination program utilizes a risk-based process stating that OCIE identifies ''higher-risk investment ad-

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dealer's registration with the SEC, the examining SRO must examine the firm for compliance with all other applicable provisions of the Exchange Act and the rules and regulations thereunder. *See* 17 C.F.R. § 240.15b2-2(c).

[17] FINRA Manual – FINRA Rules, § 8210(a).

[18] *See id*. §§ 8210(b), 8310(a).

[19] *See* FINRA, Report of the 2009 Special Review Committee on FINRA's Examination Program in Light of the Stanford and Madoff Schemes (Sept. 2009), *available at* http://www.finra.org/web/groups/corporate/@corp/documents/corporate/p120078.pdf.

[20] Sweep examinations may also be known as targeted examinations.

[21] Two examples of sweep exams conducted by FINRA include reviews of placement agents (October 2010) and direct market access, naked access, electronic access or sponsored access (August 2010), *available at* http://www.finra.org/Industry/Regulation/Guidance/TargetedExaminationLetters.

[22] While registered investment advisers are not subject to regulatory oversight by any SRO, the Dodd-Frank Act requires the Comptroller General of the United States to conduct a study of the feasibility of forming an SRO to oversee private funds. *See* Dodd-Frank Act, *supra* note 5, § 416.

[23] In general, Rule 206(4)-2 under the Advisers Act, commonly referred to as the ''custody rule,'' aims to protect assets managed by registered investment advisers. Under the rule, a registered investment adviser must maintain client funds and securities with a ''qualified custodian'' in accounts that contain only client funds and must segregate and identify client securities and hold them in a reasonably safe place. *See* SEC Release No. IA-2876, 74 Fed. Reg. 25,354 (May 27, 2009). *See also* Andrew J. Donohue, Director of the Division of Investment Management, SEC, Speech by SEC Staff: The Regulatory Landscape for Investment Advisers in 2010 (Feb. 25, 2010), *available at* http://www.sec.gov/news/speech/2010/spch022510ajd.htm.

[24] In the past, Lori Richards (former Director of OCIE) noted in a speech that the OCIE staff was working with other agency staff and FINRA to identify key data points that would facilitate an improved risk-based oversight methodology. *See* Lori Richards, Director of OCIE, SEC, Speech by SEC Staff: Strengthening Examination Oversight: Changes to Regulatory Examinations (June 17, 2009), *available at* http://www.sec.gov/news/speech/2009/spch061709lar.htm.

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visers for examination consideration and focusing examination resources on certain higher-risk activities at selected investment advisers.'' The study further states that ''higher-risk investment advisers are identified based on: (1) information contained in regulatory filings; (2) assessments made during past examinations; and/or (3) other criteria and available information (including, for example, news/media coverage, localized knowledge of advisers from examination staff and tips, complaints and referrals).''

In addition, for broker-dealer examinations, FINRA has stated that its examination program is risk-based – *i.e.*, the frequency, content, and scope of a firm's examination will depend on the risk, scale, and nature of the firm's operations.[25] The examiners are also requesting information from firms related to internal risk assessments in connection with the firm's business activities and how such risks are appropriately addressed in the firm's policies and procedures.

Another recent trend by the regulators is to have members of the regulator's enforcement staff participate in regulatory exams.

Regardless of the type of exam, a key issue upon which firms should be focused is whether they are well prepared to manage a regulatory exam.

III. The Examination Process

A. Preparation by the Firm Prior to the Start of the Examination

Firms subject to an exam should undertake the necessary preparation prior to the start of the exam. Comprehensive and adequate preparation should, among other things, help a firm reduce the amount of time the examiners are on-site and maintain better control over the exam process. To that end, the firm should adequately prepare for the examination by taking the steps discussed below.

1. *Designate a Contact Person*. The firm should appoint one person to be the point of contact with the examiners during the entire examination. Usually, this person is the firm's Chief Compliance Officer (''CCO''). The designated contact should be well informed about the firm's business, structure, and compliance program. This contact person should communicate to the examiners that all communications and correspondence should go through him/her.[26] In this regard, the designated person's responsibilities should include, among other things: (i) communicating with the examiners prior to the on-site visit (*e.g.*, schedule of the on-site visit, defining or limiting the scope of certain requests, as appropriate); (ii) identifying appropriate firm personnel who have information responsive to the relevant requests by the examiners and aggregating such information in an organized manner to provide to the examiners; (iii) maintaining a log and photocopies of all information provided to the examiners; (iv) attending any meetings or discussions with the examiners;[27] (v) handling and scheduling interviews by the examiners and attending such interviews; and (vi) gathering the responsive information and reviewing such information prior to producing it to the staff. The information provided should be responsive to the staff's request – *e.g.*, information outside the scope of the request or irrelevant should not be produced. The designated contact should confirm that the examiners have received responses to their requests and that there are no outstanding items, and follow-up on additional requests in a timely manner.

2. *Review Prior Examination Files*. A review should be conducted of any documentation relating to prior examinations or investigations to which the firm was subject prior to the examiners' arrival on-site. These documents should be reviewed to ensure that the firm has addressed any deficiencies noted in the prior regulatory inquiries.

3. *Reserve/Arrange for Adequate Space and Resources for Examiners*. Firms should provide the examiners with a private working area – typically a conference room or large office – so that they can review the requested documents in a comfortable working environment. A dedicated work area typically should allow the examiners to work more efficiently and may help reduce the amount of time they remain on-site. To the extent possible, this work area should include adequate resources, such as telephones and access to a printer. If possible, the space reserved for the examiners should be in an area that is generally less busy. The examiners should also be able to lock and secure their workroom at the end of each day.

4. *Inform Senior Management and Firm Personnel of the Examination*. Upon receiving notice that the firm will be subject to a regulatory examination, senior management of the firm should be informed. The firm's legal and compliance departments should also be notified. Prior to the on-site examination, firm personnel should be provided with notice that the examiners will be on-site conducting an examination of the firm. Notice to firm personnel should be kept simple and should avoid any personal observations about the examiners and their agency. In addition, the notice should, among other things, remind firm personnel not to engage in any substantive discussions with members of the exam team.

5. *Organize Files Prior to Arrival of Examiners*. Prior to the arrival of the examiners, the firm should be prepared to provide the examiners with responses to their requests in a neat and organized fashion. To this end, documents should be organized and labeled, as appropriate, so that the information is easily identifiable to the corresponding requests of the examiners. Further, the documents provided to the staff should be responsive to the request and any documents outside the scope of the request should not be provided to the exam staff. The firm should provide the staff with copies of requested documents and maintain copies of any and all documents provided to the exam staff. To the extent possible, any information provided electronically to the regulators should be provided in PDF format. The firm should develop and maintain a system to record the documents produced to the exam staff (including the

[25] *See* FINRA, 2010 Examination Priorities Letter (Mar. 1, 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p121004.pdf.

[26] While the CCO is usually the logical choice to serve as the point of contact, each firm should assess its personnel to determine the person most qualified to serve in this role.

[27] While present for these meetings, appropriate notes should be maintained of interviews with firm personnel to ensure that statements made by such personnel during interviews are accurately reflected by the examiners in any findings or reports.

date they were produced) and bates-stamp the documents.

6. *Clean and Organize Firm Workspace*. It is likely that the examiners will request to take a tour of the firm's facilities, office space and trading floor. As a result, prior to the arrival of the examiners, the CCO should conduct a walk-through of the firm's office space to ensure that the office is clean and organized, and sensitive information is secured.

7. *Other Actions to Take Prior to the Exam*. Preparing for a regulatory exam will take a significant amount of time and effort to gather the necessary information requested. As part of these efforts, however, the firm should remain proactive in reviewing firm documents to ensure, among other things: (i) firm documents are current, such as the Form ADV, Form BD, organizational charts, and written supervisory procedures; (ii) the firm has taken corrective action to resolve any deficiencies identified in prior exams or enforcement matters; and (iii) customer complaint files are complete and appropriately addressed. This review allows the firm to be proactive in identifying potential issues, as well as being prepared to address such issues that may be raised by the exam staff during their review.

B. Advanced Notice of the Exam Provided by the Regulator

In general, the exam staff should provide the firm with a letter requesting information prior to the on-site visit. The scope and specific documents requested in the letter generally will depend on the type of examination – *e.g.*, whether it is a routine or cause examination. For example, as part of a cause examination, the staff may request information related to activity of a particular trader or transaction. In addition, the staff's request letter will typically provide for a ''review period'' – *i.e.*, a specific time period in which the examiners seek to review the relevant information.[28]

Upon receiving the request letter, it is important that the firm review the requested information to determine if certain of the requested items are unclear, ambiguous or inapplicable to the firm's business. With respect to requests that are unclear or ambiguous, the firm should contact the exam staff and request clarity. This may also be an opportunity to request that the staff narrow the scope of its request for issues that appear to be overly broad. On the other hand, there may be instances where it is more advantageous for the firm to interpret the request narrowly rather than seek clarification of the requested information. In these cases, when responding to the examiners, the firm should be very careful to draft the response to explicitly state the scope of its response based on the firm's understanding of the request.

The request letter may indicate the date that the examiners plan on arriving on-site. It is important that the firm review the schedules of firm personnel to ensure that such personnel responsible for collecting the necessary documents requested are available prior to and during the on-site visit. Further, to the extent the examiners request to interview certain of the firm's personnel, it is equally important to ensure that such personnel are available during the exam.

In addition, it is important to develop a rapport with the examination team early in the exam process. For example, a firm may, but is not required to, call the regulator to introduce the individuals who will be working on the matter and, if needed, discuss the requested information. Furthermore, the firm may propose to the regulators a method for tracking progress in fulfilling the document request (*e.g.*, scheduling a call with the exam team once a week to update the firm's progress). Further, the firm should discuss with the examiners realistic deadlines for responding to the request. If deadlines cannot be met, the firm should communicate as early as possible with the examiners that additional time is needed to fulfill the request. Examiners appreciate such notification and cooperation, and, generally, should accommodate such requests.

While the regulators usually provide some form of notice to a firm prior to arriving on-site for an exam, examiners may arrive on-site unannounced. At a recent investment management conference, a senior official of the SEC's OCIE stated that the SEC was shifting its focus from regularly scheduled examinations of investment advisers and instead moving toward conducting unannounced inspections based on tips of wrongdoing.[29] In addition, OCIE may generate exam schedules based on referrals from the new SEC Office of Market Intelligence, which receives tips and complaints regarding potential wrongdoing, as well as from information received from other areas of the SEC. The SEC's shift will likely result in more surprise SEC inspections of investment advisers that manage hedge funds.

C. On-Site Visit by Regulators

The duration of the on-site portion of an exam will depend on a number of factors, including, how organized the firm is upon arrival of the examiners, the nature of the request and the size and level of activity of the firm. Upon arrival, the examiners should be taken to their dedicated work-space. The staff usually requests to have an opening meeting with the CCO and other senior management of the firm. At this opening meeting, the firm should be prepared to answer questions regarding, among other things, the firm's organizational structure, lines of business, sources of revenue, operations, types of clients, supervisory system and compliance environment (*e.g.*, internal controls, pending regulatory actions or private litigation). The firm may consider having someone from senior management attend a portion of the opening meeting to emphasize the importance management places on compliance as part of the firm's overall business. The meeting may also be an opportunity to: (i) discuss certain of the staff's requests; (ii) review the manner in which the

[28] At the beginning of an exam, the SEC staff will also provide a copy of Form 1661 (''Supplemental Information for Regulated Entities Directed to Supply Information Other than Pursuant to Commission Subpoena''). *See* SEC, Supplemental Info. for Regulated Entities Directed to Supply Info. Other Than Pursuant to a Comm'n Subpoena (Mar. 2010), *available at* http://www.sec.gov/about/forms/sec1661.pdf. This form provides information concerning the possible uses of information provided to the SEC. In addition, the form states that the SEC's ''principal purpose in soliciting the information is to gather facts in order to determine whether any person has violated, is violating, or is about to violate any provision of the federal securities laws or rules for which the [SEC] has enforcement authority.'' *Id*.

[29] On April 9, 2010, at a Practicing Law Institute conference, Gene Gohlke (Associate Director of OCIE) stated that the SEC is shifting its focus from regularly scheduled examinations of investment advisers and instead moving toward conducting unannounced inspections.

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firm has organized its responses; or (iii) discuss any outstanding requests to which the firm has not provided a response and when the staff can expect a response. The firm should also review the examiner's schedule (*i.e.*, the time the examiners will arrive and leave) to ensure that the designated person is present during this time. The examiners should also be reminded that all questions and requests should be directed toward the designated person and no other person within the firm.

If the examiners have requested a tour of the firm's offices, the firm should have already planned the itinerary of the office tour, including any specific businesses the staff has requested to see. The exam staff may request such a tour in an effort to, among other things, learn more about the firm's organization, information barriers, location of the trading desk in relation to certain of the firm's other businesses or safeguards for protecting confidential information. Further, firm personnel should be provided with notice of the specific date that the exam staff will be touring the firm's facilities.

While on-site, the staff is likely to have additional questions, request additional documents and request interviews with certain of the firm's personnel. Again, these requests should be communicated to the designated contact person. It is important to remember that, while firms should not provide complete access to its information or personnel, it should conduct itself in a manner that is accommodating to the staff. To the extent possible, the firm should seek to provide the examination staff with any additional documents requested while the staff is on-site, and the firm should work diligently to locate any documents that appear missing.

D. After the On-Site Visit

Prior to the staff completing the on-site portion of the examination, the staff will likely schedule a meeting with the firm to go over preliminary findings, make additional requests, or discuss any outstanding items. This meeting should be attended by the CCO (and the designated contact person if other than the CCO). In this meeting, the firm may use this opportunity to ask questions of the examiners regarding the examination or provide clarification on issues identified by the examiners. To the extent that the staff identifies potential deficiencies at this meeting, the firm may seek to provide clarification on those alleged deficiencies at that time. In this regard, however, it is important that the firm be careful in its representations to the examiners. Because the staff's official findings/deficiencies should be provided to the firm in writing, firms may elect to wait to receive a written letter (*e.g.*, deficiency letter – discussed in Section E below) from the staff and then respond in writing to such findings.

Once the on-site portion of the examination is completed, it is important to remember that the staff's exam usually is not complete. The staff typically will continue to review documents while off-site and request additional information of the firm. The firm should continue to demonstrate the same level of timeliness in responding to such requests.

E. After the Exam is Complete

At the completion of the examination, the staff may: (i) conclude its examination with no findings or violations; (ii) identify deficiencies in a letter (referred to herein as a ''deficiency letter'') and require the firm to respond in writing addressing such deficiencies; or (iii) refer the matter to enforcement for further review and investigation.

1. *Deficiency Letters*. In a deficiency letter, the exam staff will identify certain deficiencies of the firm's compliance and supervisory procedures and controls and request that the firm provide a written response addressing such issues. In responding to a deficiency letter, firms should provide the staff with information describing any corrective action taken to address the issues identified by the staff and any related supporting documentation. While the corrective action will depend on the nature of the alleged deficiency, some examples of corrective action that firms may take include revising the firm's procedures, implementing new exception reports or surveillance reports or changing the level or frequency of supervisory reviews. It is important to note that when implementing such corrective measures, the business and operations team who have responsibility over the issue should be consulted to make certain that the revised/enhanced procedures are feasible and can be implemented. In addition, firms should be sure to (i) respond to the specific issue identified by the staff without providing other unnecessary or non-relevant information, and (ii) respond to each item identified in the deficiency letter. Firms should consider employing the services of outside counsel in these matters. If a firm decides to seek outside counsel's assistance in preparing a response to the deficiency letter and outside counsel has not been involved or identified to the exam staff during the exam, the firm should consider remaining the primary contact with the examination staff. Stated another way, outside counsel should not be visible to the staff – *i.e.*, outside counsel should remain in the background to the staff and the response letter should be on the firm's letterhead.[30]

2. *Formal Action and Wells Notices*. If the exam staff believes that its findings rise to the level of an enforcement action, the staff will refer the matter to enforcement for formal disciplinary action. In this case, firms should expect the enforcement staff to request additional information and conduct testimony of certain of the firm's personnel. If a determination is made to move forward with formal disciplinary action, the enforcement staff will likely provide a ''Wells Notice'' informing the firm of the proposed violations and the staff's intent to initiate a disciplinary action. The firm will be provided with an opportunity to submit, in writing, a ''Wells Submission'' which responds to the enforcement staff's proposed charges, discussing applicable law and why formal charges should not be filed against the firm.[31] In responding to a Wells Submission or other requests by the enforcement staff, firms should consider engaging outside counsel in drafting the response and managing the interaction with the enforcement staff. In this circumstance, outside counsel should

[30] Since each matter and fact situation is different in connection with responding to the staff's deficiency letter, there may be times when outside counsel should be the primary contact with the staff.

[31] *See* FINRA, Investigations and Formal Disciplinary Actions, Regulatory Notice 09-17 (March 2009), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118171.pdf. In addition, while the SEC does not have criminal jurisdiction, depending on the alleged violation(s), the SEC may work with the U.S. Department of Justice (''DOJ'') to the extent the DOJ has filed criminal charges against the firm.

be the primary contact with the enforcement staff in connection with all issues related to the matter.

In responding to a deficiency letter or an enforcement investigation, it is imperative to represent accurately the facts and/or potential mitigating circumstances to the regulators. Counsel will need to review all relevant documents and may need to engage in discussions with compliance personnel and/or senior management and conduct employee interviews to gather the necessary information in responding to the regulators.

In addition, as part of the Dodd-Frank Act, the SEC will be required to either file an action or provide notice of its intent not to file an action within 180 days of providing a Wells Notice. Similarly, the SEC will have a deadline of 180 days after completing an on-site compliance examination or inspection or receiving all requested records, whichever is later, to issue a written notification indicating either that the examination or inspection has concluded without findings or that the staff requests the entity undertake corrective action.

Once the examiners have finished their work and communicated their findings, the firm should be proactive to ensure that any deficiencies identified by the examiners are properly and adequately addressed. It is almost a certainty that the next time the firm is examined, the examiners will review the firm's procedures and perform the necessary testing to ensure that prior deficiencies have been corrected. To that end, firms should review and update their compliance policies and procedures at least once a year. In addition, during the year, new regulations and rules may become effective that impact the firm's business requiring new policies/procedures or revisions to existing policies/procedures. Firms should consider providing firm personnel with ''compliance alerts'' that summarize these issues during the year and incorporating the applicable compliance alerts into their written compliance manuals.

F. Privilege and Confidentiality Issues

In general, the attorney-client privilege protects the confidentiality of communications between an attorney and its client. The privilege is intended to encourage clients to make ''full and frank'' disclosures to their attorneys.[32] During an examination or investigation, the issue is likely to arise whether certain of the firm's documents or information fall within the attorney-client privilege.[33] The scope and application of the attorney-client privilege may, at times, be confusing and it is imperative that a firm undertake a careful and thoughtful analysis of the privilege when responding to regulatory inquiries. Further, it is important that the firm avoid inadvertently waiving the attorney-client privilege when responding to regulatory inquiries. Determining whether the attorney-client privilege applies can be complicated and, thus, firms should seek the assistance of outside counsel in making such determinations. In addition, outside counsel should be consulted for matters where the firm is considering waiving the attorney-client privilege.[34]

G. Responding to Requests for Electronic Communications

An important part of any firm's supervisory and compliance procedures is establishing and implementing appropriate reviews of the firm's electronic communications (*e.g.*, e-mails, instant messages).[35] In most, if not all, examinations and investigations, the regulators are likely to request that firms provide them with electronic communications for review. The process of responding to a regulator's request can be time intensive, laborious and expensive. The steps in this process include, among other things, determining the scope of the request, collecting the necessary data, reviewing the information for relevance or privilege issues and producing the information in the proper format to the regulators. As a result, when responding to these requests, firms should take great care in managing the process for identifying and producing electronic communications, and should consider seeking the assistance of consultants or outside counsel.

H. Interviews of Firm Personnel

During an exam, the regulators may request to interview certain of the firm's personnel to, among other things, obtain additional information on a specific issue or learn more about a particular area of the firm's business. When a request is made to interview firm personnel, the designated contact person should try to understand from the exam staff why such personnel has been identified for an interview. This will allow the firm to determine whether the staff has identified the right person(s) to be interviewed and the reasons why such person(s) has been identified. As noted above, the designated contact person should attend interviews of firm personnel and take appropriate notes during the interview.

Depending on the issue and subject matter, it may be prudent to engage outside counsel to assist in the employee interview process. To the extent that the interview is part of a formal investigation, absent any conflicts, outside counsel should help prepare firm personnel for testimony and attend such testimony.

Firm personnel who will be interviewed should understand that their responses to the regulators need to be honest and truthful. In addition, firm personnel should be advised that they should answer only the specific question asked of them and if they do not know the answer to a specific question, it is fine to respond with ''I do not know.''

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[32] *See e.g., Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981).

[33] In preparation for an examination, firms may elect to have a mock exam conducted to help identify, among other things, potential deficiencies in the firm's compliance program. Firms may elect to have this mock exam be conducted by outside counsel so that the information in connection with the mock exam falls within the scope of the attorney-client privilege.

[34] In October 2008, the SEC's Division of Enforcement made public its Enforcement Manual (''Manual'') and states that it ''is designed to be a reference for the staff . . . in the investigation of potential violations of the federal securities laws.'' SEC, Division of Enforcement, Enforcement Manual (Mar. 3, 2010), *available at* http://www.sec.gov/divisions/enforce/enforcementmanual.pdf. In general, the Manual provides important information regarding the SEC decision-making and processes on key matters, including, but not limited to, the attorney-client privilege during an investigation. *See id.*

[35] For broker-dealers, FINRA has provided guidance regarding the review and supervision of electronic communications. *See* FINRA, Supervision of Electronic Communications, Regulatory Notice 07-59 (December 2007), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p037553.pdf.

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I. Additional Practical Guidelines when Dealing with Regulators

The following are additional tips for handling an exam.

1. Don't Underestimate. Government employees have been, at times, perceived as less productive, competent and motivated than their counterparts in the private sector. This perception is incorrect. In truth, many of the examiners were formerly employed with large law firms, large accounting firms, large financial institutions and/or investment advisers and bring a wide breadth of industry experience and knowledge. Thus, when subject to an examination, it is important to afford the examiner the same respect given to others you meet on a professional basis (*e.g.,* clients). Firms should not underestimate the examiner's abilities, competence and dedication.

2. Risk Tolerance. Regulators and private firms have different levels of risk tolerance, resulting from their differing aims. Regulators seek to protect investors from financial loss, while firms seek to maximize investor gains. Regulators, therefore, tend to look upon risks with suspicion; firms may see some risks as presenting opportunities for investors. Firms often take the view that the examiner does not ''understand'' the business reasons to a transaction or activities. Examiners may understand these reasons fully but have concerns nonetheless in light of their overall mission. If firms bear in mind this difference in risk tolerance while preparing for an exam and working with the examiners during the exam, they will reduce the potential for misunderstanding and frustration. To this end, as discussed below, while educating examiners about the firm's business and compliance culture, a firm should adopt a respectful and broad-minded attitude.

3. Educate the Examiner. One goal of an examiner is to gain an understanding of the firm's business practices, corporate culture and organizational structure. It is important for a firm to take the time to educate and explain thoroughly to the examiner how the firm conducts its business. In addition, it is important to assemble the right personnel who are knowledgeable about the subject matter.[36] An important thing to remember is that firms should not be defensive about an examiner's line of questioning regardless of how probing and detailed such questions may be. Further, it is important to keep in mind that examiners tend to ask questions not merely to determine if deficiencies exist but to understand what the organization is doing right, which may serve as a benchmark when the examiner reviews other firms.

4. Don't Litigate from the Beginning. At the beginning of an exam, it is important to establish the right tone with the examiners. Firms should treat an examination as a professional business matter rather than as an enforcement action, and should avoid appearing combative to the examiners. To benefit both themselves and the examiners, firms and their counsel should cooperate with the examiners and provide them with the information requested, to the extent required under the securities laws. As a general matter, examiners become suspicious of firms that act in a difficult manner, such as showing reluctance to produce documents within the examiners' jurisdiction. This is not to suggest that firms should not be mindful of any relevant privileges that may be asserted in a document production. However, a firm should remember that the examiners will not simply go away, and providing documents to which the examiners are entitled allows the exam to proceed more efficiently.

5. Facts Speak. The phrase ''it is what it is'' says it all. It cannot be emphasized enough - be candid during an examination and never provide false or misleading information to a regulator. Firms put themselves at great risk when regulators discover that a firm has withheld important facts or information responsive to a request. In addition, to the extent a regulator suspects a firm has withheld materials responsive to any request, the likelihood that the matter is referred to enforcement increases greatly. This jeopardizes any credibility or goodwill with regards to the exam and the future relationship with the regulators. Bottom line – be honest with the exam staff.

6. Quality Control. Simply stated, on occasion firms respond to regulators' requests in a sloppy manner. A tactic sometimes used by firms is to overwhelm the regulators with a large number of documents in a disorganized manner. In effect, the firm is telling the regulator ''here is everything that could possibly be responsive to your request, now go find it.'' This is not a productive approach for either party as it (i) irritates the examiner, and (ii) prolongs the exam and often the presence of the examiner on-site. Responses to document requests should be organized and allow the examiner to find the relevant material efficiently. As noted above, an organized document production also helps manage the document flow. For example, bates- stamping and/or compiling an index of all documents provided helps both the regulators and the firm reference and keep track of information. In addition, materials provided should be detailed, complete and accurate and should address the relevant issues requested by the regulator.

7. Return Phone Calls Promptly. As basic as this may seem, regulators appreciate it when firms and outside counsel return their phone calls promptly and during normal working hours. Firms should employ a same-day call approach and not leave phone messages until late in the evening, knowing that the regulator has gone home for the day. Returning phone calls promptly provides an opportunity to build goodwill with the regulator.

8. Outside Counsel. Firms generally have a long-standing relationship with outside counsel and rely on them when working on regulatory matters, including examinations. If a firm decides to select outside counsel to work with the regulators on an examination, firms may want to consider whether outside counsel has: (i) good working relationships with the regulators; (ii) the expertise to handle the matter; and (iii) previously worked as a regulator who conducted examinations. Further, firms generally seek the assistance of outside counsel during an examination to help with, among other things, responding to requests for information and drafting correspondence submitted to the regulators.

9. Free Consulting. To some extent, examinations can be viewed by firms as free consulting by the regulators. This requires a shift in how firms view the role and purpose of the examiner conducting the exam. Rather than

[36] For example, in situations where the examiner is asking for archived data, the firm should have the proper technology and business personnel working together in communicating with the examiners and retrieving the requested data.

view regulators as a hindrance or nuisance, firms can use regulators as risk management consultants. Exams can be viewed, at some level, as an opportunity for firms to learn about issues and risk areas on the examiners' radar. Further, the exam process can be used to identify areas of weakness in the firm's operations and internal controls. When regulators identify a potential concern, the firm should welcome their experience and insights in the hope of improving its operations, internal controls and supervisory system. Taking this approach could avoid additional or greater problems in the future. In this regard, however, the firm should be careful not to rely upon the exam staff to interpret an area of the law or conclude that the firm's business and regulatory practices are in compliance with the law.

10. Invest in Technology. Examiners often request information about the systems underlying a firm's compliance processes and internal controls. Firms should regularly review their technology platforms in connection with, among other things, order management, electronic communication surveillance, recordkeeping and financial reporting to ensure the accuracy of the firm's information and the ability to easily retrieve such information. Advanced technology platforms help the firm to demonstrate to the exam staff that it has effective tools and surveillance to monitor the firm's business activities.

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