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EDITOR'S NOTE: FINANCIAL FRAUD LAW IN THE COURTS
Steven A. Meyerowitz

FATE OF SECURITIES CLASS ACTIONS IN QUESTION FOLLOWING ARGUMENT BEFORE HIGH COURT IN *HALLIBURTON CO. v. ERICA P. JOHN FUND, INC.*
Michael R. Smith, Jeffrey S. Bucholtz, Benjamin Lee, and M. Andrew Zee

TESTIFY FIRST, KNOW WHY LATER: RESPONDING TO CIVIL INVESTIGATIVE DEMANDS FOR TESTIMONY IN FALSE CLAIMS ACT CASES
Karen F. Green and James J. Fauci

THE SURVIVAL GUIDE TO REGULATORY EXAMINATIONS
John Sakhleh

FATCA UPDATE FOR INVESTMENT FUNDS
Joseph A. Riley

DEFERRED PROSECUTION AGREEMENTS ENTER INTO FORCE IN THE UK
Lord Goldsmith QC, Karolos Seeger, Matthew Howard Getz, and Robin Lööf

COMPLIANCE RISK MANAGEMENT: WHAT FINANCIAL INSTITUTIONS NEED TO KNOW ABOUT REPORTING ELDER FINANCIAL EXPLOITATION
V. Gerard Comizio, Kevin L. Petrasic, and Amanda Kowalski

ANTI-MONEY LAUNDERING GUIDANCE ISSUED FOR BANKS SEEKING TO SERVICE MARIJUANA-RELATED BUSINESSES
Jodi L. Avergun and Joseph V. Moreno

DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT UPDATE
David A. Elliott, Rachel Blackmon Cash, Kristen Peters Watson, and E. Jordan Teague

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The Survival Guide to Regulatory Examinations

JOHN SAKHLEH

This article is intended to serve as a guide to handling regulatory examinations for registered investment advisers or broker-dealers.

The regulatory environment for registered investment advisers and registered broker-dealers has changed since the financial meltdown from a few years ago because of more aggressive enforcement actions by the U.S. Securities and Exchange Commission ("SEC") and the Financial Industry Regulatory Authority, Inc. ("FINRA"). In a regulatory environment where the securities regulators are pursuing vigorous compliance examinations and increased cooperation between the SEC's compliance and enforcement staff, it is important that firms are well prepared to handle these examinations.[1] 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.

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The following is intended to serve as a guide to handling regulatory examinations for registered investment advisers or broker-dealers.[2] The following highlights 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 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 continuously prepare for an exam and assume that an exam may occur at any time. By using the information in this article, firms will be better equipped to deal with examiners and to navigate through the regulatory examination process.[3] Further, by eliminating the private adviser exemption, the Dodd-Frank Act[4] required a number of advisers to private funds to register with the SEC. As a result, in October 2012, the SEC launched an initiative to conduct focused, risk-based examinations (known as "Presence Exams") of investment advisers to private funds that recently registered with the SEC.[5] The SEC's Office of Compliance Inspections and Examinations ("OCIE") designed these Presence Exams, which are expected to last approximately two years, to examine a substantial percentage of new registrants, analyze examination findings and report the staff's observations to the industry.[6]

The information below provides a brief summary of the statutory basis for the regulatory authority to conduct examinations of firms. Following that introduction, the majority of this article is devoted to offering practical tips and suggestions that firms should consider when undergoing a regulatory examination, as well as a common sense approach to building and maintaining good, working relationships with the regulators.

STATUTORY BASIS FOR REGULATORY AUTHORITY 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 a self-regulatory organization ("SRO"), over registered broker-dealers.

SEC's Examination Authority

In general, OCIE administers the SEC's National Exam Program ("NEP").[7] OCIE is located at the SEC's headquarters and in 11 Regional Offices. In general, the NEP uses a risk-based inspection and examination program that collects and analyzes data about registrants to focus its exam priorities.

Examinations of Registered Broker-Dealer

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 conduct 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]

Examinations of Registered Investment Advisers

Section 204 of the Investment Advisers Act of 1940 ("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 neces-

sary 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]

National Exam Program

In 2011, OCIE restructured its examination process and implemented the NEP to coordinate examinations of the nation's registered broker-dealers, transfer agents, investment advisers, investment companies, national securities exchanges, clearing agencies, SROs and other registered entities, across the SEC's offices.[15] When selecting registrants to examine, the NEP employs a risk-focused exam strategy, identifying areas of focus based on, among other things, investor communication, prior examination findings, and registrant disclosures. To assist in this analysis, OCIE has established an Office of Risk Assessment and Surveillance ("ORAS") to strengthen its risk-assessment capabilities across all markets and registrant categories examined by the NEP. In addition, the OCIE staff and the Division of Risk, Strategy, and Financial Innovation work together to identify registrants to examine based on certain criteria.[16]

FINRA's Examination Authority

FINRA is a private SRO registered with and regulated by the SEC pursuant to certain provisions of the Exchange Act. Generally, FINRA's regulatory authority is derived from Section 15A of the Exchange Act.[17] As such, the scope of FINRA's jurisdiction is governed by the Exchange Act, interpretations by the SEC and the federal 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 Rule 8210 provides FINRA with the right to "(1) require a member, person associated with a member, or any other person subject to FINRA's jurisdiction to provide information…with respect to any matter involved in [a FINRA] investigation, complaint, examination or proceeding; and (2) inspect and copy the books, records and accounts of such member or person with respect to any matter involved in [such] investigation, complaint, ex-

amination or proceeding that is in such member's or person's possession, custody or control." FINRA Rule 8210 permits FINRA to request and obtain copies of the books and records of the following three categories of persons: (i) a member firm, (ii) a person associated with a member firm, and (iii) any other person subject to FINRA's jurisdiction. Recently, FINRA amended the rule to take the position that, with regard to the scope of records that may be requested and obtained, the relevant standard is documents that are in the member's (or other person's) "possession, custody or control." FINRA added the phrase "possession, custody or control" to link this concept to case law that has defined possession, custody or control as used in Rule 34 of the Federal Rules of Civil Procedure.[18] 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.[19]

TYPES OF REGULATORY EXAMINATIONS

Risk-Based Examinations

In recent years, the securities regulators have moved toward a "risk-based" approach to their examination program, which includes risk-based examinations. Risk-based examinations seek to identify those firms that present a high level of risk, based on information gathered by the regulators. The examination staff reviews tips, complaints, referrals, prior examination findings, significant changes in the registrant's business activities and disclosures regarding regulatory or other actions brought against the firm or its personnel.

In connection with FINRA's examinations of broker-dealers, 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.[20] 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. While the regulators have moved toward a risk-based examination program, the following are types of examinations that the regulators have historically initiated to examine broker-dealers and investment advisers.

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.

Cause Examinations

Cause examinations are 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 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 on conducting more cause examinations, rather than routine examinations.[21]

Sweep Examinations

Sweep examinations are initiated by the securities regulators in an effort to review and learn more about a particular issue or practice in the industry.[22] Typically, sweep examinations are 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 exami-

nations 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.[23]

Oversight Examinations

Oversight examinations are 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.[24]

Other Examinations

In addition to the types of examinations noted above, Rule 206(4)-2 under the Advisers Act was 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.[25]

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 an exam.

THE EXAMINATION PROCESS

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.

- ***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 convey to the examiners that all communications and correspondence related to the exam should go through her/him.[26] In this regard, the designated person's responsibilities should include, among other things:

  – 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);

  – 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;

  – maintaining a log and photocopies of all information provided to the examiners;

  – attending any meetings or discussions with the examiners;

  – handling and scheduling interviews by the examiners and attending such interviews;[27] and

  – 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.

- ***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 docu-

ments should be reviewed to ensure that the firm has addressed any deficiencies noted in the prior regulatory inquiries.

- ***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 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.

- ***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.

- ***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 appropriately labeled, so that when examiners request specific information, it is easily identifiable. Proper organization of files will also help to ensure that the documents provided to the staff are responsive to the request, and any documents outside the scope of the request are not provided to the exam staff. Further, 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 date they were produced) and bates-stamp the documents.

- ***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.

- ***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.

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 make sure to explicitly state the scope of its response. That is to say, the firm should clearly say what it understands the examiner's requests to be.

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 them on the firm's progress). 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. The number of unannounced examinations may increase in the near future. For example, in November 2011, the SEC and FINRA issued Joint Guidance on Effective Policies and Procedures for Broker-Dealer Branch Inspections, stating that they intend to "engage in a significant percentage of unan-

nounced exams, selected through a combination of risk based analysis and random selection."[29] Further, for broker-dealer exams, the SEC acknowledges that unannounced examinations "may yield a more realistic picture of a broker-dealer's supervisory system as they reduce the risk that individual RRs [registered representatives] and principals might attempt to falsify, conceal, or destroy records in anticipation of an internal inspection."[30]

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 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 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 the safeguards that are in place for protecting confidential

information. Usually, examiners provide the firm with advance 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 to be missing.

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). The firm may use this meeting as an opportunity to ask questions of the examiners about 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 below) from the staff and then respond in writing to such findings.

It is important to remember that the staff's exam does not end once the on-site portion of the examination is completed. The staff typically will continue to review documents 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.

After the Exam Is Complete

At the completion of the examination, the staff may: (i) conclude its ex-

amination 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.

- ***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 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, depending on the facts, outside counsel should not be visible to the staff, *i.e.,* outside counsel should remain in the background, and the response letter should be on the firm's letterhead.[31]

- ***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 seek 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 alleged 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.[32] 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. Once a formal proceeding is initiated, outside counsel should 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 take proactive steps 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, as needed, 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 and require new policies and procedures or revisions to existing policies and procedures. Firms should consider providing firm personnel with "compliance alerts" that summarize these rules and regulations during the year and incorporating the applicable compliance alerts into their written compliance manuals.

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.[33] 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.[34] 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. Firms should seek the assistance of outside counsel in determining whether the privilege applies. In addition, outside counsel should be consulted for matters where the firm is considering waiving the attorney-client privilege.[35]

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).[36] 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 of identifying and produc-

ing electronic communications and should consider seeking the assistance of consultants or outside counsel.

Interviews of Firm Personnel

During an exam, the regulators may request to interview certain of the firm's personnel in order to, among other things, obtain additional information on a specific issue or to 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 in fact do not know the answer to a specific question, it is fine to respond with "I do not know."

Additional Practical Guidelines when Dealing with Regulators

The following are additional tips for handling an exam.

- ***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, accounting firms, 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.

- ***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 the firm. Firms often take the view that the examiner does not "understand" the business reasons for a transaction or activity. 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 should 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 when dealing with the exam staff.

- ***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.[37] 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.

- ***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 and should avoid appearing combative to the examiners. To benefit both themselves and the examiners, firms and their counsel should cooperate with the exam-

iners and provide them with the requested information, 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.

- ***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. The bottom line is – be honest with the exam staff.

- ***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 complete and accurate and should address the relevant issues requested by the regulator.

- ***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 return phone messages 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.
- ***Outside Counsel***. Firms generally have a longstanding 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) a good working relationship with the regulators; (ii) the expertise to handle the matter; and (iii) most importantly, previously worked as a regulator conducting 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.
- ***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. Rather than 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 help to avoid other, potentially 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.

- ***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, in order 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.

NOTES

[1] For purposes of this article, the terms "examiners," "exam staff," "examination staff," "staff," and "regulators" are used interchangeably. For purposes of this article, the term "firm" is used for both registered investment advisers and registered broker-dealers.

[2] The information in this document is designed to assist firms in preparing for a regulatory examination. Each examination is different and the information set forth in this article is not intended to constitute legal advice.

[3] 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.

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

[5] *See* "SEC Letter to Newly Registered Investment Advisers re: Presence Exams" (Oct. 9, 2012), *available at* http://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf.

[6] *See* National Exam Program, Office of Compliance Inspections and Examinations, Examination Priorities for 2013 (Feb. 21, 2013), *available at* http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf.

[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

Web site, *available at* http://www.sec.gov/about/offices/ocie.shtml (last visited Nov. 21, 2013). *See also* SEC, Examinations by the SEC OCIE (Feb. 2012), *available at* http://www.sec.gov/about/offices/ocie/ocieoverview.pdf.

[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.

[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, municipal advisor, 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. Firms should review this section and the rules and regulations thereunder in order to ensure that they meet these recordkeeping requirements. *See* SEC Release No. 34-44992, 66 Fed. Reg. 55,818 (Oct. 26, 2001).

[13] 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).

[14] *See* 17 C.F.R. § 275.204-2(a). 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. 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.

[15] The Dodd-Frank Act broadens OCIE's examination authority to include municipal advisors, investment advisers to certain private funds, security-based swap dealers, security-based data repositories, major security-based swap participants, and securities-based swap execution facilities. Furthermore, OCIE may obtain records from custodians of investment company and investment adviser client assets.

[16] *See* Examinations by the Securities and Exchange Commission's Office of Compliance Inspections and Examinations, at 8 (Feb. 2012), *available at* http://www.sec.gov/about/offices/ocie/ocieoverview.pdf.

[17] 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 12 months of the broker-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).

[18] *See* FINRA's Information and Testimony Requests, Regulatory Notice 13-06 (Jan. 2013), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p197763.pdf.

[19] *See id.* §§ 8210(b), 8310(a).

[20] *See* FINRA, 2012 Regulatory and Examination Priorities Letter (Jan. 31, 2012), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p125492.pdf.

[21] *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.

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

[23] Two examples of sweep exams conducted by FINRA include reviews of high frequency trading (July 2013) and alternative trading systems (May 2013). *See* FINRA, Targeted Examination Letters, *available at* http://www.finra.org/Industry/Regulation/Guidance/TargetedExaminationLetters (last visited Jan 22, 2014).

[24] 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*, § 416.

[25] 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.

[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.

[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] *See* FINRA and the SEC Issue Joint Guidance on Effective Policies and Procedures for Broker-Dealer Branch Inspections, Regulatory Notice 11-54 (Nov. 2011), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125204.pdf.

[30] *See* SEC Staff and FINRA Issue Risk Alert on Broker-Dealer Branch Office Inspections, For Immediate Release 11-250 (Nov. 30, 2011), *available at* http://www.sec.gov/news/press/2011/2011-250.htm.

[31] 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.

[32] *See* FINRA, Investigations and Formal Disciplinary Actions, Regulatory Notice 09-17 (Mar. 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.

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

[34] 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.

[35] 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 (Oct. 9, 2013), *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.

[36] 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 (Dec. 2007), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p037553.pdf.

[37] 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 about the process for retrieving the requested data.