

Practical tips for preparing for your next regulatory examination

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Anxiety, stress and uncertainty – these are all words that may describe feelings when a firm is notified that a regulatory examination is looming. Given the many new regulations and regulatory requirements, firms are faced with a growing number of policies and procedures to develop and implement, which often leads to the question, "are we ready for our regulatory exam?"



Taking steps now to prepare can help. The following practical tips are designed to help you get started and may assist with planning for your next audit by the Securities and Exchange Commission (SEC), Financial Industry Regulatory Authority (FINRA), or state regulator.

What to review prior to the regulatory exam

Prior to the regulators arriving to your firm, it is important to be aware of potential enterprise risks. There are several ways to assess this.

- **1. Conduct a conflict inventory:** Detecting and mitigating conflicts is one of the most important steps toward unveiling potential problems that the regulators will focus on during an examination. For example, if you are a dual registrant (i.e. both a broker-dealer and investment adviser) and the investment adviser recommends use of the affiliated broker-dealer's trade desk, then you have a potential conflict of interest based on the firm's remuneration from both businesses, as well as certain best execution obligations. The firm needs to be aware of the conflict and be able to discuss the steps it takes to mitigate such conflicts.
- **2. Review prior regulatory deficiency letters:** Deficiencies noted in your prior examinations typically require attention. Make sure that all were addressed.
- **3. Review prior internal and external reviews:** It is important to periodically check your annual reviews, internal/external audits, and consultant reviews to ensure all recommendations were adequately addressed. If there are still open items, then progress should be documented, and an expected completion date should be included.

- **4. Consider new regulations:** Determine whether the firm needs to develop new policies and procedures or enhance existing processes.
- **5. Consider any changes in your business activities:** Changes in your business model might suggest a need to revise your current policies and procedures. Such changes could range from implementation of new products or investment strategies, expansion into new markets or new distribution channels, new contractual arrangements (i.e. selling agreements), key staffing departures, and strategic reductions in the workforce or outsourcing.
- **6. Make note of customer complaints and allegations of wrongdoing:** In 2011, the SEC issued a final rule implementing whistleblower provisions under the Dodd-Frank Wall Street Reform and Consumer Protection Act and instituted a tips, complaints and referrals (“TCR”) exam system. Since that time, the SEC, FINRA, and the states are assertively following up with whistleblower notifications and TCRs. Be sure that your internal controls and procedures cover how the firm addresses such notifications and complaints and establish heightened supervision controls, as needed.
- **7. Conduct a risk assessment:** Risk assessments help to identify what gaps exist within the firm's compliance program. It is important to make sure that the firm is able to discuss what gaps, if any, may exist. Ensure that books and records capture those areas requiring attention and identify how the firm proposes to address potential risks.
- **8. Gather evidence to illustrate that your compliance program is *dynamic*:** This area of focus during the examination is increasingly important. Consider the development of a report to reflect all the steps you have taken to educate staff, as well as the chief compliance officer (CCO), about ongoing compliance requirements and append training that may have occurred over the examination period.

Once these vitally important steps are taken, it is time to focus on specific items that the examiners will likely request. Consider performing a mock SEC, FINRA, or state regulatory examination to help better determine your preparedness. Your outside counsel or compliance consultant may be able to help you in obtaining a sample examination request list.

Prepare employees for the examination

It is important that all employees are aware that the firm is about to undergo an exam. They should be told when the exam is scheduled to start, its expected duration, and where the examination team will be located. Additionally, prior to the examination, it is essential to remind everyone of general office protocols that reflect good business practices, which should always be adhered to regardless of whether or not regulators are onsite. These practices include:

- Do not have business discussions in public areas within office space, on elevators, or in building lobbies;
- Do not leave any documents lying around in conference rooms or at photocopiers;
- Do not toss documents containing client information into wastebaskets; these should always be shredded or put into secure bins;
- Do not prop open entry doors; they should remain secure;
- If you see anyone you do not recognize on the floor, be helpful and guide them to their destination; and
- Adhere to a "clear desk policy" whereby all information is cleared from desks at night, file cabinets are locked, and offices are secured.

Today's regulatory examinations often focus on a firm's culture of compliance, including the "tone at the top" and effectiveness of the compliance program. To evaluate these areas, the examiners frequently review such items as e-mail business communications (particularly to and from senior management team members), compliance program assessments, lists of material, and/or recurrent minor violations uncovered by the firm during the examination period and what actions, if any, were taken by the firm to address violations.

It is critical for key employees to understand and be prepared for the examination process. They should be knowledgeable about the firm's policies and procedures for which they are accountable. The examiners will ask to speak to specific employees responsible for business risk areas such as trading, operations, finance, and legal/compliance. Prior to meeting with the examiner, be sure that the designated employee is the most appropriate and knowledgeable person to speak about the applicable policies, procedures, documentation, reports, and tests used as internal controls for that particular area. Also, consider conducting a practice interview to help the employee prepare for the examiner's questions. Remind the employee to always be honest and forthcoming with the regulators.

Make a good first impression

First impressions say a lot about the firm and its culture of compliance. The opening interview often sets the tone for the examination. Consider preparing a presentation that covers, among other matters, an overview of your organization, your affiliates, the products and services offered, the firm's internal control environment, and your compliance culture.

For your document production, make sure that all files address the examiners' requests and that they appear

in the order requested. Typically, initial documentation is requested prior to the examination commencing. Dependent upon the regulator, firms must be prepared to submit such documentation electronically, with confidential data encrypted. For onsite document production, be sure to clearly identify the request to which the document is responding. Remember that the goal of your document production is to demonstrate the effectiveness of your firm's compliance processes. Therefore, documentation should reflect how your daily processes and workflows help to achieve compliance with your firm's policies and industry regulations. Consider whether a brief memorandum or narrative may be needed to describe the purpose and flow of your firm's internal controls.

Set the ground rules

During the initial interview, set the ground rules for the examination and points of contact for the regulatory examiners. For example, establish early-on who is the firm's primary contact for the examiners, what days and times interviews will be conducted, who from the examination staff will explain the purpose and scope of the interview, who must be present for the interview (the CCO, legal counsel, etc.), and expected duration of the in-house examination. If you detect any hesitancy or you are uncomfortable with the communication you are receiving from the examiners, feel free to contact their supervisor for assistance.

Additionally, it is very important to know what is being copied by the examiners. At the outset of the examination, consider providing for the examiners a set of Post-It Notes for them to flag which documents they wish you to duplicate. That way you will be able to duplicate copies of all documents produced to the examiners so that you may easily refer to them should the examination staff have additional questions. Also, you may wish to consider keeping a third set of these documents for your outside counsel.

Demonstrate competency and knowledge

It is critical for firm members to demonstrate competency and knowledge of the firm's compliance program, particularly for their personal areas of responsibility. Before the examination, evaluate whether firm supervisors can clearly articulate their risk controls and oversight/supervision of critical practice areas. Ensure that managers understand their roles, responsibilities, and the firm's escalation processes. Evaluate whether employees know the firm's e-mail and social media etiquette (i.e., what to say and what not to say). In addition, all personnel should be able to describe how the firm communicates newly adopted internal policies (i.e., through departmental meetings, training, e-news bulletins, teleconferences, etc.)

In a 2004 speech, "The New Compliance Rule: An Opportunity for Change," Lori Richards, director of the SEC's Office of Compliance Inspections and Examinations, provided the following guidance.

"...Compliance staff should continually be asking: Are we detecting problematic conduct with this policy? Based on what we've detected, should we alter our policy? Is there a better way to detect problematic conduct? ... Were the actions we took, once problematic conduct was detected,

adequate to deter problematic conduct by this individual or others?"

Being able to answer these questions articulately and competently is essential to today's examination process. Given the complexity of the processes, many firms elect to conduct a mock regulatory exam to help them gain the competency (and confidence) on how best to approach the examination process. A mock regulatory examination helps firms to identify risk management areas, as well as those areas which require additional training, which if addressed, will further help to advance the firm's compliance efforts. Knowledge of what gaps exist in the compliance program, demonstrating how the firm has enhanced its policies, having a dynamic training program, and articulating what steps the firm takes to deter problematic conduct are key factors in establishing your firm's core competencies with the examination staff.

Advocate your position

A prime goal once the examination begins is to be an advocate for your firm – and the compliance program it has developed. If you believe that the examiners are concerned about a violation that you do not believe has been interpreted correctly, advocate your case. Be able to explain why the questioned practices are permissible or why they are inadvertent. In doing so, be careful and try to avoid confrontations with the examiners. If you believe something is awry, then request a meeting with the senior inspection examiner to advocate your position further.

Conclusion

The best preparations for a regulatory exam begin with establishing a sound culture of compliance. Focus on compliance and its resources, advancement, and support by senior management. Preparing for a regulatory examination now will not only help to instill confidence for when the examination occurs, but will also help to advance enterprise risk management, which serves as the foundation for the firm and its business practices.

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