

Preparing for Broker-Dealer Examinations

By Matthew C. Dwyer

A call from your examining authority announcing an examination at your firm adds to your stress and workload. However, if you prepare carefully for an examination throughout the year and after the dreaded announcement, you can keep your stress levels and workload manageable. More importantly, you will present your firm in the best possible light. As a former examiner, compliance professional and a current consultant to the industry, I have a unique perspective on regulatory exams. In the following pages, I will try to share my experience by discussing sensible ways in which you can manage examinations by leveraging your existing resources. Hopefully, the result will be the best possible outcome for your on-site regulatory examination.

Many different exchanges and SROs employ examiners. However, in this article, we will focus on FINRA and SEC examinations. The vast majority of compliance personnel have had some type of contact with FINRA and/or SEC examiners. Although we won't specifically discuss other SROs, you will find that there are many more similarities than differences in examination processes across all SROs.

Preparation Prior to the Exam Announcement

The best way to prepare for an exam is to prepare before it has been announced. This means that items such as 3012 Annual Testing (including a thorough WSP review), CEO Certification, Anti-Money Laundering (AML) audits and other required reviews need to be completed on schedule. Your WSPs should be thorough, but uncomplicated. You are probably better off having examiners tell you to strengthen your WSPs than to have them find that you failed to follow your procedures.

Once you complete these reviews, it is equally important that you follow up on any recommendations made within these reports. Failure to follow up on audit findings reflects poorly on your compliance department and serves as a road map. Conversely, if audit issues have



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been rectified, examiners are less likely to pursue that area and it builds credibility for the firm in the eyes of the examiners.¹ Make sure to build time and resources into your compliance schedule for follow up on all required reports and reviews.² If you have not completed these duties and an exam is imminent, make sure that all issues have been addressed prior to the start of the exam.

Why Me, Why Now?

The SEC and FINRA both rely upon a host of factors to determine when your firm is due for an examination. The riskiest firms, according to FINRA's risk profile model,³ will have a FINRA examination every year. The least risky firms will be examined every 4 years. FINRA takes many factors into account when determining a firm's risk profile model. Some of the factors FINRA considers are the firm's net capital category, whether the firm introduces accounts or is self-clearing, the size of the firm (both revenue and number of registered employees are considered), past examination results and a host of other information. With the existence of Trading and Market Making Exams (TMMS-discussed in the next section), cycle examinations and sweep examinations, it can feel like there is a revolving door of examiners in your office. If you wish, try requesting that TMMS and cycle examiners conduct their examinations during the same time period. The time that examiners are on site will be extremely busy, but it will reduce the amount of days that examiners are in your offices.

FINRA Examinations

There are two types of FINRA on-site examinations. TMMS exams cover issues such as trading, trade reporting and market making activity. Many firms that engage in little or no true trading activities will never undergo a TMMS exam. Routine "cycle" exams cover virtually all business and operational areas that affect the firm. During a routine examination, FINRA will review the firm's financial condition, supervisory system, internal controls, Anti-Money Laundering (AML), sales practice issues, business continuity planning and other operational and business areas.

SEC Examinations

Most compliance personnel at broker-dealers have gone through a FINRA examination of some type.

In addition, contact with FINRA coordinators regarding FOCUS filings and other issues means that most firms have some level of familiarity with FINRA and their examiners. Consequently, a FINRA exam may not necessarily put the compliance department on pins and needles.

SEC examinations tend to bring a little more anxiety. First, unlike FINRA examinations, SEC exams are not expected on a regular basis. Additionally, most firms have little or no contact with the SEC prior to their examination. Consequently, there may be no prior relationship upon which to build. As compliance personnel, we tend to fear the unknown. For many of us, SEC exams rank high on the "unknown" list.

For broker-dealers, there are two main types of SEC examinations. The first, less common examination is an oversight exam. The SEC has oversight authority over FINRA. Most oversight work conducted by the SEC is done off-site. Often, firms do not know that the SEC has conducted oversight work regarding a FINRA examination of their firm. From time to time, the SEC will visit a firm to conduct oversight work. The oversight work usually focuses on one area of the examination as opposed to the entire examination. There are a few reasons the SEC might conduct an oversight examination of your firm. They are:

- **Review of FINRA's examination techniques** – As mentioned above, the SEC has oversight authority over FINRA. To fulfill that responsibility, the SEC staff must look at a representative sample of FINRA's work. Your firm's examination may fall within the SEC's sample. However, although the SEC may be reviewing FINRA's examination, you should consider that your firm is still being examined. Consequently, firms should still remember that they are going through an examination. The SEC will follow up on any deficiencies not previously detected by FINRA.
- **Sweep Examinations** – The SEC may decide to review an area of your firm's exam because of recent developments in that business area. Recent examples of this would include asset-backed securities, structured products and private placements. Again, the SEC will most likely focus on this portion of your business and the FINRA examination work related to this business. The SEC wants to research not only how firms such as yours handle this business

area, but also to know how FINRA examines firms that engage in a particular business.

- **New Information** – Another reason the SEC may conduct an oversight exam is if new information leads them to believe there is increased regulatory risk at your firm. This new information might come in the form of a complaint or tip. It also might be discovered during oversight review of the firm's most recent FINRA examination. Again, a visit from the SEC for this reason does not mean they believe your firm has violated any rule or regulations. It may also mean that, for a variety of reasons, the SEC does not believe that all regulatory issues have been properly addressed. Although, the SEC obviously cannot follow up every anonymous tip with an on-site visit, regulators face additional scrutiny in the wake of recent financial scandals. They cannot always discern a disgruntled customer or former employee from a credible source without an on-site visit.

The SEC decides to perform a routine examination based on a number of risk factors. One of those factors is the amount of time since the last SEC exam. Consequently, the chances are high that, sooner or later, you will be subject to an SEC on-site examination. There are a host of other factors, such as previous disciplinary history, change in business mix, and wide variations in profits (or losses) that also play a part in the SEC's risk matrix that helps them determine their examination schedule.

FINRA and SEC Differences

Since we have begun to discuss deficiencies, now is a good time to discuss the major differences between FINRA and SEC examinations. Keep in mind that we will be discussing this topic in general. Specific details change from examination to examination.

When FINRA conducts an examination, there are many areas that they must review. For instance, even though your firm may do a relatively small amount of municipal securities business, FINRA will still review your municipal business because they are obligated to. The same is true for your options business. Relative to the amount of revenue you may generate in municipals or options, the examination of these areas will take a disproportionate amount of time. On the other hand, the SEC will likely do no more than give municipals

a cursory review if it is not a major part of your business and there is no regulatory concern. The SEC will conduct a more thorough review on a limited number of areas. For instance, if your firm's main business is proprietary trading, the SEC will likely devote most of the exam to topics such as inventory pricing, position limits and stress testing. An area that produces much less revenue for your firm will most likely be given less attention by the SEC. In summary, think of FINRA's approach as all-encompassing, with attention being given to many areas. The SEC takes a "narrow but deep" approach. Neither approach is right or

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wrong. Given their responsibilities, each organization seems to function in a way that is practical for them. In recent years and again in FINRA's 2012 Regulatory and Examination Priorities Letter,⁴ a risk-based approach is a cornerstone of FINRA's approach. Additionally, firms will be required to complete a Risk Control Assessment for 2012. These are positive steps, but no matter what risk assessment tools FINRA employs, they will not have the flexibility the SEC enjoys when determining the scope of examinations.

Pre-Exam Preparation

SROs generally will call to announce the exam 2 to 4 weeks prior to the on-site visit. Shortly after FINRA announces the exam, the firm will be asked to complete a Web Information Request (Web IR).⁵ The firm will be required to review and update information that FINRA keeps regarding your firm. After the Web IR has been completed, FINRA will use this information as well as other information to produce a Records Request List. For SEC exams, your firm will receive an Examination Information Request List shortly after the exam is announced. As we all know, each firm's documents come in slightly different formats and styles. Rather than trying to work through any confusing areas of the list, it may be really helpful to coordinate a conference call with the examiners who will visit the firm prior to any information gathering begins at your firm. All

firm employees who will play a key part in the information gathering process or the exam as a whole should participate in the conference call. This helps on a number of levels. First and foremost, it alleviates any confusion that may exist due to the requested information. Second, it lets the examiners know that you take your compliance duties (and this examination) seriously and that you are committed to giving the examiners accurate information on a timely basis. Examiners are like most of us. The last thing they want to do is sit in your conference room and twiddle their thumbs while information they need to do their work trickles in. If you make sure that accurate information is waiting for the examiners upon their arrival (or sent to them prior to the exam), your examination is likely to go much more smoothly. Do not take the approach of assuming that some information will get them started and you can “piecemeal” the rest of the information. The examiners most likely have a plan of what areas of your business they will review first. If all the requested information is not available, that makes their plan difficult to achieve.

To make a pop culture analogy, consider the movie *Goodfellas*. During the beginning stages of the movie, the main character, Henry Hyde (played by Ray Liotta) states that whenever he was assigned a job by the “bosses”, he would carry out every minute detail of their directions.

Obviously, there’s no comparison between organized crime and SEC examiners, but try taking this approach when you are gathering information for your upcoming exam. Provide the examiners *exactly* what they requested. If you cannot provide the information in their preferred format, contact them immediately and tell them what and how you can provide the information in question.

Arrival

When preparing for the arrival of SEC or FINRA examiners, make sure that the area you have reserved for the examiners is adequate. Their surroundings do not have to be lavish, but it’s important that they have enough space for all examiners, there is an internet connection, and any other requested items are provided. However, it is unwise to grant examiners unfettered access to firm systems and information such as intranets, operating systems, etc. Consequently, any computer terminals that you

provide to examiners should be inspected to make sure that examiners can only access the requested information and tools.

On the day the examiners arrive, it is wise to organize an introductory conference between key firm personnel participating in the exam and the examiners. Often, the examiners’ direct supervisor will participate via telephone. Supervisor participation is fairly common and is not something that should cause concern for the firm. This meeting is another important opportunity to convey that your firm takes its compliance duties seriously. Introduce all key personnel and their roles. When appropriate, have key personnel describe their professional experience and education so that examiners realize that compliance personnel are highly qualified.

In addition to ensuring your examiners know who in the firm is available to answer questions, set up a communication process between the examiners and their point of contact (usually the CCO, compliance officer or internal audit director). There will likely be future information requests. Ask that all information requests be written. Even if the requests are hand-written, having something in writing eliminates any confusion both at the time of the request and when the information is provided. Also, a written request establishes a timeline, which makes documenting the timeliness of your response much easier.

This is also a good time to distribute key cards or describe protocols regarding building access. If possible, you need only give examiners access to the floor where they will be stationed. This eliminates the possibility of examiners disrupting work or showing up in business areas unannounced. Further, restricting access to any guests is a necessary step when safeguarding client and firm data.

It is usually best to meet with examiners informally once early in the morning and once before the end of the work day. You will no doubt have more contact with examiners, but this will keep the communication steady and minimize surprises on both ends. Finally, the initial conference is not the time and the place for examiners to begin interviewing employees in depth. If that begins to occur, interrupt the examiner (graciously) and indicate that in-person interviews can be set up with firm personnel throughout the examination.

Interviews

Interviews of firm personnel occur frequently in examinations. For all interviews, it is important that a member of the compliance department be present. Additionally, make sure that you and the employee to be interviewed clearly understand the scope of the interview. This helps the interviewee to prepare as much as possible as well as have material for the examiners to illustrate concepts and points. However, make sure that any material that will be provided to examiners is reviewed by compliance personnel prior to the interview. Firm employees should be prepared to discuss their job-duties in-depth. For employees who are not accustomed to working with examiners, a prep session, or phone call with compliance may be beneficial. This allows you to allay any fears the employee may have and discuss expectations of the interview.

Your participation in the interview is also important. Although you will likely not be asked any questions directly, you may need to clear up any confusion or tell the examiner that certain questions are outside of the pre-arranged scope of the interview. The vast majority of examiners will adhere to the agreed-upon scope of the interview. If you find an examiner does not stick to the scope, offer to set up an additional interview at a later time. Tell the examiner, “We can talk about those topics later, but right now let’s stick to the scope we agreed upon earlier.” Tread carefully here. Be professional and gracious, but let the examiner know that you are surprised at the turn of events. It might help to let the examiner know that Employee A cannot give you all the answers about a topic or area that they suddenly wish to address. Let the examiners know that they may want to interview different employees to get a full picture of the process.

Additionally, tell the interviewee that “I don’t know - that’s not my responsibility” is a perfectly acceptable answer. The interviewee should avoid guessing or speculating. Under no circumstances should the interviewee admit to an error in judgment, firm deficiency or gap in supervision, etc. This may sound basic, but remember that many of your employees have never been interviewed by an examiner. The interviewee may also appreciate a brief outline or list of topics to be covered during the interview. If the examiner seems to believe a violation has occurred, it is important that you interject and tell the examiner, “That’s not his/her

call to make. Let us take a look at the information and we’ll have those answers to you soon.” Remember, this is an informal interview. Your employee is not testifying. In extreme cases, take steps to stop the interview. It is very important that, if necessary, you take steps to protect your firm and employees. Although professionalism is important, your objective during the examination is not to make friends.

Difficult Examiners

I have the privilege of knowing dozens and dozens of examiners and other regulatory employees. The vast majority of these individuals are professional and helpful. Having said that, if you spend enough time in compliance and risk management, you will likely experience some frustration with regulators.

If you have carefully prepared for the examination and have set up clear lines of communication, these types of experiences are likely to be minimal. However, let’s assume that your preparation was excellent, but you still have an examiner on-site who is creating a difficult environment. Is the examiner simply being rude or is he/she failing to abide by the conditions both parties agreed to? If the examiner is merely being impolite, you might decide that this is not a battle worth fighting. On the other hand, if the conduct borders on being unprofessional or if he/she is trying to set up interviews or gain access to business areas without contacting the compliance department, take a direct approach. Explain to the examiner that this is not the type of conduct your firm has seen from other examiners and this is not part of the examination process that was agreed upon. If that fails to improve the situation, contact the senior examiner on-site to discuss the conduct in question. You may ask, “What do I do if the senior examiner’s conduct is unprofessional?” If that happens, skip to the step discussed next. However, of the few “difficult” examiners that I have encountered while coordinating exams, none of them have been the senior examiner on-site. This may be due to the fact that many unprofessional examiners are simply inexperienced and are not fully versed on appropriate conduct in all situations. Often, a private talk between a senior examiner and a newer examiner helps immensely to improve the situation.

If the matter still has not improved, discuss the situation with your immediate supervisor. Ask other members of your firm for a little perspective.

Are the demands and conduct of the examiner really at issue or is there simply a miscommunication? Is the conflict merely a personality issue? If you still feel members of the examination team are being unreasonable, contact their supervisor. If you have reached out to examiners and supervisors at the beginning of the examination process, this is when you may reap the benefits. Hopefully, your firm gave a professional, articulate impres-

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sion during initial dialogues. Start by letting the supervisor know that you do not object to giving the examiners the information requested (unless you do; then make sure to clearly state why you object). However, your firm questions the information gathering methods and/or conduct of one or more examiners. Explain that their methods are making it difficult for you to manage the flow of information during this examination.

If this fails, your last recourse may be to reach out to any contacts at the agency, such as directors. Do not reach out to your contacts prior to discussing the situation with the examiner's direct supervisor. Part of the supervisor's job is to manage examiner conduct. Give the staff the opportunity to rectify the situation. If you go over the examiner's head without warning, it leads to hurt feelings and professional embarrassment, and gives the impression that perhaps the firm, not the examiner, is the problem.

Again, the vast majority of examiners are extremely professional and helpful. During my career, I have only been involved in this type of experience once. However, while there is no reason to anticipate this conflict, you do want to be prepared for the worst.

During the Exam

If everything has gone according to plan so far, the examiners have the vast majority of information they have requested and they have conducted several interviews with firm personnel. Hopefully, the examiners are busy evaluating information and you have a chance to catch up on other duties. Remember to check in with examiners both in the

morning and afternoon. These visits are an excellent way to keep apprised of the examination's progress and discuss compliance in general. Take this opportunity to ask the examiners about regulatory trends. What are the hot-button topics this year? What changes do examiners see in the next 12-24 months? Remember that examiners see the inner workings of numerous firms each year. They have access to a tremendous amount of information. Obviously, do not ask them to divulge secrets; just ask for their help to remain ahead of the curve. Last year, one of my investment adviser clients underwent an SEC exam. During the exam, an examiner recommended adding a small audit staff. The client, who had been asking senior management for an auditor, was wise enough to ask the examiner to put that in writing as a best practice recommendation. Shortly after the examination, my client was given the budget to hire an auditor. That's just one of example of using good communication with examiners to your benefit. Ask the examiners to bring any potential issues to your attention as soon as possible. When they bring up an issue, do not panic. Review the information carefully with the examiner. Often, there may be some slight confusion which may make something innocuous look problematic. Remember, examiners look at an infinite number of documents at many firms each year. It's extremely easy to misinterpret something, especially if the format is somewhat unique to your firm. You may have to explain it a few different times to several examiners. Stay patient.

If there is a major issue, let senior management know as soon as possible. Hopefully, any issues found are minor in nature. For instance, some WSPs may need to be updated or your net capital computation may require several adjustments. Keep senior management apprised of the progress on a periodic basis regarding minor issues. Resist the urge to fight every exam finding. Is it really worth it to fight a \$3,000 net capital adjustment if it does not affect your processes? Probably not. Think about the big picture and save your "silver bullets" for an issue that may have a much larger impact on your firm.

Remember, examiners do not plan on spending 1-3 weeks at your firm without finding any deficiencies. That may sound like a cliché, but a cliché usually exists because there's some truth to the statement.

Exit Conference and Preliminary Findings

At the completion of the on-site portion of the examination, an exit conference is held with the examiners and any personnel from the firm you want present. If the exam has gone well, consider inviting members of senior management. It reflects a culture of compliance to the examiners. It is also confirmation to senior management that the compliance department is competent and effective.

Your main job in preparing for the exit conference is to ensure there are no surprises. If you have communicated well with the examiners, you should know about all topics to be covered during the conference. Also, request a copy of the exit conference summary prior to the conference.

If there are issues that have not been resolved or there is disagreement about certain items, ask the examiners to list these items as “open” or “preliminary”. This avoids any assumption of guilt on the part of SRO supervisors that may see the exit conference summary. This also buys the firm some time to reinforce your argument with further documentation and research.

Even if there has been some tension during the exam, set a positive tone during the exit conference. Make sure that you thank the examiners for their professionalism and courtesy. You may be surprised at some of the positive comments from the examiners. They spend all of their time looking for firm deficiencies and errors. The exit conference is one of their few opportunities to tell firms what they are doing well. This is another reason that inviting senior management is wise. Finally, at the conclusion of the exit conference, verify any requests for additional information.

Final Disposition

Most examinations reach their final disposition within 120 days after the on-site examination.⁶ FINRA examinations conclude in one of four dispositions;⁷

- ***No Further Action*** – No violations have been cited. This disposition is somewhat rare. As mentioned before, you should expect examiners to find something that your firm is not doing as well as possible.
- ***Cautionary Action*** – This is the most common type of disposition. There are two important things to remember. First, make sure to reply

to FINRA by the deadline with an analysis on why the deficiency occurred and what the firm will do (or preferably has already done) to prevent future deficiencies of the same nature. During your next Rule 3012 annual testing, make sure to re-test any areas mentioned in the Cautionary Action to ensure that the deficiency has been rectified. A Cautionary Action is not reportable on Forms U4 and BD.

- ***Compliance Conference*** – This indicates that FINRA is concerned about your overall compliance and supervisory structure or there are major issues in critical business or operational areas. Although this is an informal action and not reportable on Forms U4 or BD, you should take this seriously and consider adding additional resources to your firm’s compliance and supervision structure. Additionally, look for future examinations to be more rigorous. However, use the Compliance Conference as a way to learn exactly where your firm has failed to meet FINRA’s expectations. Is it a question of resources? Did your predecessor fail to meet major compliance obligations?
- ***Enforcement Referral*** – The last type of disposition is the most painful. An enforcement referral leads to a hearing panel or a Letter of Acceptance, Waiver and Consent (AWC). Although this is unfortunate, it does happen. For instance, most AML violations result in an enforcement referral. During TMMS examinations, trade reporting errors often result in enforcement referrals. At this point, many firms engage outside counsel to determine whether it makes sense to fight the findings or work toward an AWC.

SEC examinations are a little different. First, more follow up work, including interviews and information requests occur after SEC exams than FINRA exams. One reason for this is the “narrow but deep” approach of the SEC.

The manner in which the SEC closes their exams is very similar to FINRA. These final dispositions include the following;⁸

- ***Concluded Without Findings*** – This is obviously the most desirable outcome. If this occurs, the firm will receive a “no further action letter.” This type of disposition is more common than FINRA’s *No Further Action* letter, but it is still rare.

- **Deficiency Letter** – This is very similar to FINRA’s *Cautionary Action*. The firm is required to respond to this letter with an explanation of why they feel no violation occurred or how the violation will be rectified. This means you can argue your case, to a certain extent. This is much different than FINRA’s *Cautionary Action*. In response to a *Cautionary Action*, FINRA is only interested in how the deficiency will be corrected.
- **Deficiency Letter and Enforcement Referral** – This is the most serious type of disposition. Just like FINRA enforcement referrals, an SEC enforcement referral can lead to censures, fines and other formal actions. Again, many firms believe it is wise to engage outside counsel when a matter has been referred to the Commission’s Division of Enforcement. As the Enforcement

Divisions of most SROs are comprised mainly of attorneys, this makes sense. Another obvious point to consider is that the stakes are much higher during an enforcement referral.

Conclusion

Preparation for an exam starts with an organized and effective compliance department. Good communication starts as soon as the examination is announced. Stay professional, but protect the interests of your firm and its employees. Finally, take the opportunity to learn from the examiners about industry trends and developments. Even if you have never been a part of a regulatory exam, you are capable of coordinating a successful examination. Diligent preparation, excellent communication and professionalism are the keys to a successful examination.

ENDNOTES

¹ There is debate about the fairness of using firm-generated reviews as examiner roadmaps. You can attempt to mitigate this risk by providing information about your review processes instead of actual audit findings. However, given the current regulatory environment, examiners will most likely ask for all audit findings. Documents such as FINRA’s and OCIE’s joint statement (FINRA RN 11-54) about more robust branch office examination programs clearly indicate that audit work papers will be requested during exams.

² <http://www.finra.org/Industry/Issues/SupervisoryControl/P037999>

³ <http://www.finra.org/Newsroom/Speeches/Luparello/P117765>

⁴ www.finra.org/web/groups/industry/@ip/@reg/.../p125492.pdf

⁵ *Preparing for a FINRA Cycle Examination-Webinar-* <http://www.finra.org/web/groups/industry/@ip/@edu/documents/education/p038336.pdf>

⁶ *Examination Information for Broker-Dealers, Transfer Agents, Clearing Agencies, Investment*

Advisers and Investment Companies pp. 3- SEC 2389 (11-07) http://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf

⁷ *Preparing for a FINRA Cycle Examination-Webinar-* <http://www.finra.org/web/groups/industry/@ip/@edu/documents/education/p038336.pdf>

⁸ *Examination Information for Broker-Dealers, Transfer Agents, Clearing Agencies, Investment Advisers and Investment Companies pp. 3- SEC 2389 (11-07)* http://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf

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