

NSCP
East Coast Regional Meeting

New York, New York
May 1, 2006

BD REGULATORY AUDITS

Presented by

Keith Golden
M.R. Beal & Company
kgolden@mrbeal.com

James F. McGuire
LPL Financial Services
james.mcguire@lpl.com

Richard C. Szuch, Esq.
Bressler, Amery & Ross, P.C.
rszuch@bressler.com

Tips on preparing for and handling the Audit

The BD Golden Rule:

“A member in the conduct of his business shall observe high standards of commercial honor and equitable principals of trade.”

NASD Conduct Rule 2110

As one might imagine, regulatory enforcement actions are increasing in numbers. NASD highlighted that it alone conducted 1,400 disciplinary actions and levied over \$125 Million in fines in 2005.¹ The SEC also revealed its “sobering statistic” for 2005, having received more complaints about broker-dealers than any other type of entity, including issuers, mutual fund companies, investment advisers and transfer agents.² The breadth of examinations is unlikely to decrease in 2006.

The SEC and SROs’ regulatory emphasis on investor protection and market integrity has brought an ever-increasing scrutiny to firms’ supervisory structure. Regulators will continue to press firms for accountability and have stressed the importance of comprehensive and effective internal controls, particularly with respect to novel investment products, in order to limit the frequency of violations. The persistent focus on firm's compliance and supervisory systems is no surprise because regulators still rely heavily on broker-dealer self-regulation. The SEC and the SROs have emphasized, therefore, that the key to surviving scrutiny and avoiding enforcement action lies in the development and implementation of a comprehensive compliance program.

In view of some recent scandals in the securities industry, OCIE Director Lori Richards wondered aloud to the audience at the NSCP Fall 2005 conference: “Where was Compliance when these problems arose, took shape, and became entrenched in the offering firms?”³ When regulators call, it is crucial that the firm be in a position to answer the question and to demonstrate it shares the objectives of the regulators in protecting customers and resolving problems.

This outline and seminar are designed to assist you with the management of the audit when it occurs.

¹ Robert Glauber, Chairman and CEO NASD, *Speech by NASD Chairman and CEO Robert Glauber at NASAA Enforcement Conference* (Jan. 9, 2006), http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_015843

² Cynthia A. Glassman, Commissioner, SEC, *Speech by SEC Commissioner: A View From Inside the SEC*, remarks at Financial Service Institute’s 2006 Broker-Dealer Conference (Jan. 25, 2006), <http://www.sec.gov/news/speech/spch012506cag.htm>

³ Lori Richards, Director, OCIE, *Speech by SEC Staff: Remarks before the National Society of Compliance Professionals National Membership Meeting* (Oct. 25, 2005), <http://www.sec.gov/news/speech/spch102605lr.htm>

A. Tips on Dealing with Regulatory Audits

1. Audit Process.

- The OCIE's and the SROs' power to examine regulated broker-dealers is fairly broad. For example, Section 17(b) of the Exchange Act subjects firms to "periodic, special or other examinations" by the SEC "at any time, or from time to time." Likewise, NASD Rule 8210 allows the NASD to "inspect and copy the books, records, and accounts of such member or person with respect to any matter involved in the investigation, complaint, audit, or proceeding."
- The SEC has expressed that the broad goal of its examination program is "to detect fraud and abuse; to foster a strong compliance and risk management culture in the securities industry and to provide the SEC useful information on the capital markets and industry business practices to assist in the informed decision making."⁴
- Since regulatory audits by definition can be performed at "any time", regulators are not required to give prior notice of their intent to perform an audit. However, notice is typically provided for routine and sweep audits in order to set dates for the audit and to allow the firm to organize and prepare pre-audit disclosures. Cause audits are generally unannounced.
- An examination report will be prepared at the conclusion of the audit and will be used by the audit staff to evaluate the results of the audit and form the basis of any deficiency letter.⁵ This report typically includes "background information on the [firm], the particular risks involving the [firm], scope of the examination, deficiencies from prior examinations, work performance, and deficiencies found."⁶

• **Types of Audits**

Regulatory audits are limited in scope, and depending on the type of audit, are directed toward a specific interest. Generally, there are three types of regulatory audits, including: (1) **Routine**, (2) **Sweep**, and (3) **Cause**.

Routine are examinations designed to cover a broad range of issues and have no directed focus on any particular problem or subject.

⁴ Mary Ann Gadziala, Associate Director, OICE, *Speech by SEC Staff: The SEC Examination Program: Coordination and Priorities*, presented at The Bond Market Association's Annual Legal and Compliance Conference (Feb. 7, 2006), <http://www.sec.gov/news/speech/spch020706mag.htm>

⁵ SEC Audit No. 364, *Compliance Examination Deficiency Letter Process* (Sep. 23, 2003), <http://www.sec.gov/about/oig/audit/364fin.htm>

⁶ *Id.*

Sweeps are a drag-net type of review which targets a single issue throughout multiple firms. Sweep audits focus on a pre-determined regulatory policy or concern or some other wide-ranging industry issue.

Cause are initiated to address a specific issue at a firm. They may be prompted by a customer complaint or other red flag.

- **Outcomes**

An audit can have one of three possible outcomes: (1) issuance of a no findings letter indicating that no problems were found; (2) issuance of a deficiency letter explaining the deficiencies discovered and requiring corrective action, or (3) referral to SEC Enforcement, state regulator, or SRO.⁷

Deficiency letter:

A deficiency letter is issued in approximately ninety-one percent (91%) of all examinations.⁸ The goal is to provide the firm with a deficiency letter within ninety (90) days of completion of the audit and the firm has thirty (30) days to respond to the findings.⁹ The SEC will generally provide a deficiency letter even if the SEC makes an enforcement referral to allow the firm to take immediate remedial action.¹⁰ Deficiency letters summarize the relevant rule or standard of conduct, outline the facts found, and indicate the ways in which the conduct found during the exam deviates from the standard.¹¹

If the firm agrees to take corrective action, which will be reviewed during the next examination, the examination is completed.¹² If the firm disagrees with the findings or does not agree to implement the recommended remedial action, a second deficiency letter which will clarify the examination staff's position may be provided.¹³ The examining

⁷ *Id.*

⁸ *Id.*

⁹ SEC Audit No. 364, *supra*.

¹⁰ Lori Richards, Director, OCIE, *Keynote Address by SEC Staff: Furthering Good Compliance: Current Areas of Focus in SEC Examinations*, presented at National Regulatory Services, 17th Annual Spring Compliance Conference (Apr. 8, 2002), <http://www.sec.gov/news/speech/spch548.htm>

¹¹ Lori Richards, Director, OCIE, *Speech by SEC Staff: Remarks before the National Society of Compliance Professionals National Membership Meeting* (Oct. 25, 2005), <http://www.sec.gov/news/speech/spch102605lr.htm>

¹² SEC Audit No. 364, *supra*.

¹³ *Id.*

staff may also seek to meet with or otherwise communicate with the firm to attempt to resolve the disagreement, or ultimately refer the matter to enforcement.¹⁴

Enforcement Referral:

The SEC's Enforcement Division will pick up where the OCIE leaves off in the case of an enforcement referral. The commencement of an enforcement investigation brings the SEC's full powers to bear and the review is far more inclusive than during an audit. The enforcement division may subpoena the production of documents and elicit testimony from witnesses, including firm employees and principals. Depending on the results of the investigation, civil or criminal actions may be brought against the offending firm or associated persons.

2. Know Your Rights

- During an audit, a regulator's powers are not limitless and it is essential that broker-dealers be aware of certain rights and protections when confronted with a regulatory audit.
- The regulators do not need a search warrant to enter the firm's premises, and a firm cannot refuse to produce records and information based on the Fifth Amendment.
- Although there is no constitutional right to be represented by counsel during an audit, practically speaking, the examiners normally do not object to an attorney being present.
- The SEC does not recognize the self-evaluation privilege. This may become an issue if and when the regulators request firm internal audits or investigative reports.
- Federal privacy laws, including the Privacy Act of 1974, afford some protection to broker-dealers:
 - The SEC examiners must disclose whether they are gathering information pursuant to their audit powers or law enforcement powers. If law enforcement, the firm may take the appropriate measures (e.g., retain counsel) to protect itself, and
 - The examiners cannot mislead the firm during the audit. *See, e.g., SEC v. ESM Gov. Sec. Inc.*, 645 F.2d 310 (5th Cir. 1981) (holding that fraud, deceit, or trickery are grounds for denying enforcement of an administrative subpoena).

¹⁴ *Id.*

3. Set the Stage – Projecting a Culture of Compliance

In any audit, the firm must demonstrate three things to the regulator:

- They have a system of supervision tailored to its business.
 - They implement the system.
 - They document the implementation
-
- At beginning of audit, the examiners will most likely conduct an in depth review of the firm’s compliance system and procedures and focus on any weaknesses in internal controls. The SEC considers the foundation of an effective compliance program to be “an overarching compliance culture at the firm.”¹⁵ Projecting this “culture of compliance” is essential to establishing a good first impression with examiners. Inadequate controls, although violations in and of themselves, may lead examiners to violations.¹⁶ Examiners may raise their concerns with the CCO and critique the program.¹⁷
-
- The examination of the firm’s compliance program will go beyond what is on paper in the firm’s manuals and will likely involve an assessment of how the system has actually been employed to test its capacity to confront real problems.¹⁸ It is therefore essential that the firm not only have a comprehensive program in place, but that it maintain detailed records and accounts about how it has been effectively implemented.¹⁹

4. Get Involved in the Direction and Scope of the Audit

- The firm should designate a contact person who is responsible for responding to the examiners’ requests and gathering all requested information. A senior compliance person or the chief compliance officer is preferable.

¹⁵ Mary Ann Gadziala, Associate Director OCIE, *Speech by SEC Staff: Integrating Audit and Compliance Disciplines within the Risk Management Framework*, presented at Compliance ’05 USA, Operational Risk and Risk Magazine (Nov. 30, 2005), <http://www.sec.gov/news/speech/spch113005mag.htm>

¹⁶ *Id.*

¹⁷ Lori Richards, (Oct. 25, 2005), *supra*.

¹⁸ Mary Ann Gadziala, (Nov. 30, 2005), *supra*.

¹⁹ *Id.*

- To the extent possible, all requested information should be reviewed for relevance and possible privilege prior to production to the examiners.
- The contact person should also keep a record of all information that has been requested and produced to the auditors. This measure may help to ascertain the scope and focus of the audit if the staff has been unwilling to discuss it with the firm.

5. **Let the People Speak - Employee Interviews**

- Unlike under its enforcement powers, the SEC only has the power to compel access to a firm's records and cannot compel employees to submit to interviews during an audit. Of course, that does not mean that a firm should refuse to allow its employees to be interviewed if requested. Refusal to provide interviews or documents may simply lead to the matter being referred to the enforcement division, where documents and information can be compelled by subpoena.
- Form 1661 describes the obligation to provide "mandatory" information pertaining to the books and records requirements contained in sections 17(a) and (b) of the Securities Exchange Act of 1934. Any information outside what is considered "mandatory" is therefore "voluntary." SEC examiners generally do not request voluntary employee interviews during examinations.
- If an examiner insists upon conducting an employee interview, the firm arguably has the right to insist that counsel or another representative be present. *See* Rule 102(b) of the SEC Rules of Practice; NYSE Rule 476(h); and Rule 9141 of the NASD Code of Procedure.
- At a minimum, the designated contact person should insist that all requests for employee interviews are first directed through the contact person, and the contact should try to ascertain the scope of questioning. This will allow the firm to discuss the issue with the employee, offer the opportunity to make counsel available, and generally prepare the employee for the interview. This will also enable the firm to identify whether there are privilege issues that may arise during the interview and if so, how to protect them.
- If an employee interview is conducted, a firm representative should be present to take notes.

6. Keep Lines of Communication Open and Honest

- The SEC has emphasized that open lines of communication are essential to the examination process.²⁰ The firm's ability to deliver quality information to the examiners has a profound impact on how they will respond. It is a good policy to be candid and complete when communicating with the examiners because they have a "duty" to be suspicious. A forthright and thorough explanation may help to alleviate some of those suspicions.
- The firm and its contact person should try to maintain an open, ongoing dialogue with the examiners. The extent to which the examiners are willing to communicate depends primarily upon the individual examiner and the nature of the audit.
- One primary benefit of open communication is that an issue of concern to an examiner may be resolved before it becomes a recommendation. The examiner may have a misunderstanding or misperception of a certain issue that can be cleared up with an explanation from the firm. Additionally, there may be mitigating circumstances of which the examiner is unaware.
- The firm may inquire (but may not receive a response) about how long the audit will last, and what areas will be the subject of the information (clues as to this issue may also be gleaned from information requests).
- Remember that examinations are often conducted by junior staff whose findings will be reviewed by senior staff. It is not uncommon for junior staff to have concluded that a problem existed, only to have senior personnel reverse that finding (of course, the converse is also true). At any rate, this is one more reason to carefully respond to the examiners' questions and concerns.
- Finally, information and document requests are often deliberately drafted in broad terms. The contact person should try to clarify any questions regarding the requests and also attempt to limit their scope, if necessary.

7. Assert Your Position

- Cooperate with the examiners. A refusal to cooperate may raise the examiners' suspicion or lead directly to an enforcement referral. Appearance and behavior are important during audits; be assertive, not defensive. An obstructive or combative attitude may prompt unwanted scrutiny and sour future relations. Remember, they will be back. Developing a history of honest and reliable dealings is essential.
- The firm should be ready to argue its case to the examiners. For example, the firm may have to explain why its acts were legal, inadvertent, or

²⁰ Lori Richards, (Oct. 25, 2005), *supra*.

isolated. However, the firm should be careful in knowing when to pick its fights. There is no need to argue insignificant issues.

- Examiners may conduct an exit interview in order to discuss their preliminary findings with the firm. The exit interview is a good opportunity for the firm to advocate its position and present its initial response or to offer clarification to the concerns of the examiners.

8. Try to End the Audit as Quickly as Possible

- Of course, the length of an audit is largely determined by the examiners, but there are measures the firm can take to shorten the audit's duration:
- produce requested information quickly;
- provide the staff with adequate workspace; and
- promptly review all materials before producing them to the examiners.
- As mentioned earlier, the longer the examiners are on the premises, the more likely it becomes that they will find violations.

9. Preserve the Confidentiality of all Materials

- For SEC examinations, the firm should request confidential treatment for all materials in writing pursuant to FOIA. The FOIA provisions require that confidential documents produced to the SEC contain the label “confidential treatment requested by [name of person or entity producing the documents].” *See* 17 C.F.R. § 200.83. Although neither the NASD nor the NYSE rules provide for the confidential treatment of materials, it is good practice to request such treatment and label any produced documents accordingly.
- Request the return of all documents. The examiners will often agree to return sensitive materials at the end of an audit.

10. Overview

- Keep control
- Put examiners in a nice, spacious room to work. Do not let them wander
- Have a liaison, preferably the CCO
- Have them put all requests in writing
- Respond quickly and truthfully

- Getting them out fast is a good idea
- Keep a detailed log of documents provided
- Keep copies of everything you give them
- Mark confidential
- Advocate your case
- Do not give up privileged information
- Request return of documents in writing
- Request an exit interview

B. SEC Examination Priorities and Selected NASD Enforcement Actions

1. Top Areas of Focus for SEC Examinations by OCIE in 2006²¹

- **Sales Practice – Retail**

Financial Planners – salespersons vs. advisors

Suitability

Controls on Recommendations

New Products – What Compliance Procedures has the firm put in place to vet new products that are introduced. Has the firm conducted sufficient due diligence on products?

Variable Annuity Sales

Mutual Fund Sales – calculations of breakpoints and sales charges

Revenue Sharing

Fee Based Accounts

Firms that target specific investor groups

1. Military Personnel
2. Period Payment Plans
3. Senior Citizens – “Free Lunch” seminars

- **Supervision – Producing Sales Managers – Failure to follow firm’s procedures**

- **Internal Controls**

Risk Management

Credit

Trading

- **Net Capital Requirements / Customer Reserves**

- **Trading Issues**

Order Handling

²¹ Lori Richard's "Top Ten" presented at SIA's Spring 2006 Conference.

Erroneous Trades
Misuse of Customer Trading Information
a. Review information flow at firms

Best Execution
a. Conflicts of Interest
b. Payment for Order Flow

Fixed Income Issues
a. Excessive Mark-Ups
b. Pricing/Best Execution
c. Timely Reporting

Anti-Money Laundering
a. Deficiencies found at half of B/Ds visited

Information Security
Reg SP
Identity Theft
Misappropriation Controls

Business Continuity/Business Recovery Plans

Selected Recent NASD Enforcement Actions

- **529 Plans**

NASD recently conducted a fact-finding sweep to review the sales practices and supervisory systems of firms selling 529 college savings plans. Afterward, the NASD announced it had fined a member firm \$500,000 for supervisory violations in connection with the sale of 529 plans and ordered the firm to reimburse customers \$750,000.²² In that case, over a three year period, the member firm sold over \$1.1 billion of 529 plans, without adequate procedures in place to ensure sales were suitable. Among other issues, the firm did not have adequate procedures to take into account state income tax benefits when determining the suitability of 529 sales. The result: customers purchasing plans who were not able to utilize state income tax benefits.

- **Mutual Fund Share Sales Practices**

As with prior years, mutual fund share sales practices continue to be an NASD examination priority. In 2005, the NASD's Class B and C share enforcement actions

²² NASD Press Release, Oct. 26, 2005,
http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_015319

resulted in an exchange or refund offer to 79,000 households.²³ NASD continuously reminds members of the need “to have conducted an analysis of the effects of the fee structure on the investor's return and to recommend the share class that is most advantageous for the customer.”²⁴ Because NASD requires member firms to have adequate supervisory procedures and controls with respect to breakpoints, “examiners will review mutual fund transactions to determine if recommendations of specific share classes are suitable and to determine if customers received the appropriate sales charge.”²⁵

In December 2005, NASD announced that it had fined several member firms \$19.4 million for share class violations.²⁶ The violations included recommendation of Class B and/or Class C shares to customers without considering or adequately disclosing that Class A shares would generally have been more advantageous to those customers. The firms’ supervisory and compliance procedures were also deficient.

- **Variable Insurance Products**

Because of the complexity of variable insurance products and a series of recent sales practice violations, NASD has made the review of sales procedures and supervision of variable insurance products an examination priority.²⁷ “Examiners will scrutinize variable product replacement sales, overselling of enhanced riders, supervision of hypothetical illustrations, variable products within qualified plans, and market timing of sub-accounts.”²⁸

In March 2006, NASD announced an action against a member firm which failed to comply with state insurance regulations, requiring pre-investment disclosures to investors in connection with replacement sales of variable life insurance and variable annuities.²⁹ It suspended the firm from conducting new business in variable annuities for thirty-days, fined it \$400,000, and also fined and suspended two of the firm’s principals.

²³ NASD News Release, Dec. 19, 2005,
http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_015753

²⁴ NASD: Improving Examination Results, September 2005,
http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_015101

²⁵ *Id.*

²⁶ NASD News Release, Dec. 19, 2005, *supra*.

²⁷ *Id.*

²⁸ *Id.*

²⁹ NASD News Release, Mar. 2, 2006,
http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_016103