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## Preparing for, and Surviving, a Regulatory Examination

### I. INTRODUCTION

With the changes from Dodd Frank still rippling through the financial services industry, the question is not will you get audited, but when will you get audited and by whom. Whether you are registered with the U.S. Securities and Exchange Commission (SEC) or a State Regulatory Authority (SRA), you need to be prepared for a regulatory examination.

If you are the Chief Compliance Officer (CCO) or Compliance Officer, and you have not been through a regulatory examination, the dreaded phone call, or the unannounced visit, from your regulator frequently passes through your mind. The best way to alleviate that anxiety is to be prepared. This article is intended to achieve four results: 1) explain the types of examinations regulators engage in and the risk assessment process regulators go through; 2) help you prepare for a regulatory examination; 3) help you manage the examination; and 4) help put the examination in perspective and take away some of the anxiety of a regulatory examination.

### II. TYPES OF EXAMINATIONS

Before we discuss preparing for an examination, let's touch briefly on the different types of examinations. Regulators, both on the Federal and State level, typically engage in one of four types of examinations: 1) sweep examinations; 2) cause examinations; 3) routine examinations; and 4) "desk" examinations.

Sweep examinations are narrowly focused exams, normally utilized by the SEC and now by some states, and meant to gather information about specific industry practices. Sweep examinations typically focus on a segment of the portfolio management or trading process investment advisers engage in, but can also include a specific type of registered investment adviser. Some examples of sweep examinations would include soft dollar practices, valuation practices, anti-money laundering, and advisers to private equity funds. These examinations can be done on or off site, but are typically conducted through the mail to a large population of advisers and then a sub-group may be identified for onsite follow-up. You should be able to identify a sweep examination from the request list, which will be focused on a select aspect of your business. However, a sweep examination can quickly turn into a full (or routine) examination if the examiners find material or numerous deficiencies related to the sweep topic. Any examination may result in a deficiency letter or an enforcement referral (more on that in Section V), but your best

chance of a "no findings" result comes from a narrow sweep examination.

Cause examinations are on the upswing due to the SEC's (and many SRAs) enhanced customer complaint systems. Whether it's a disgruntled ex-employee or an unhappy client, if the SEC receives a complaint they will follow-up (thank you Mr. Madoff). The states are also paying more attention to complaints they receive to identify onsite examinations. Whether the complaint is viable or not, this allows the SEC or SRA to narrow the focus of their exams. These exams are typically done onsite and the majority of them are unannounced, meaning you will simply get a knock on the door. These exams can take anywhere from a few days to a full week. Your business may be interrupted while you work to provide the documents a regulator wants and needs. In addition, the request list will be very specific and geared to a product, a client or an employee. Depending on the findings, you may receive a deficiency letter related to minor issues and no comment on issues that may be referred to Enforcement.

Routine examinations are the most prevalent at both the Federal and State level and both are risk based. Your firm's risk level (low, medium, high) is determined initially by the answers on your Form ADV Part 1 and, if you have been examined previously, the past examination results. Your initial risk rating will depend on whether your Form ADV Part 1 indicates that you have custody of client assets, utilize an affiliated broker-dealer, manage private funds, utilize soft dollar arrangements, engage in principal or cross trades, or utilize solicitors, among other things. Another major component is your Assets Under Management (AUM). Many firm's that could not maintain Federal registration because they only had \$85 million in AUM, now find themselves a big fish in a smaller pond at the State level and their risk rating will correspond to this. Conversely, if you have \$120 million in AUM, the SEC is not going to be as concerned with you as the private funds with a couple hundred million or several billion in AUM that are new to their regulatory oversight. A routine examination request list will generally be much longer than a sweep or cause examination request list and touch on every aspect of your business (e.g., corporate information, portfolio management, trading, marketing, compliance, valuation, etc.). These exams typically take up to a week or longer to complete and often there are additional requests for documents after the onsite portion of the exam is complete. As we discuss in Section IV, the end result of a routine examination is typically a deficiency letter, but if you have been audited before and the results of the exam are similar, you may be in for more than a deficiency letter.

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The last type of examination is being used more by the SEC than the SRAs at the moment, but that may increase as the efficiency of it becomes more apparent. Desk level examinations are a type of routine examination; i.e. your name popped up as low risk or you are a relatively new registrant. The SEC has been contacting registrants on the phone and faxing shorter request lists focused on the firm's policies and procedures, corporate information, brochure disclosures, and marketing materials. The idea is to look at enough materials to determine if an onsite review is necessary while decreasing the amount of time necessary to conduct a review. Theoretically, this allows the SEC to "touch" more registrants while still identifying those firms that need a more thorough onsite review. As with routine examinations, the end result of a desk examination is also typically a deficiency letter.

### III. PREPARING FOR A REGULATORY EXAMINATION

Now that you can identify the type of examination you may be presented with, how do you prepare? One basic skill will get you three-fourths of the way there – ORGANIZATION! If you are organized you are more than half-way home, if you are disorganized, get organized – Now!

The Examiner has a job to do and is human (really), so the easier you make their job, the greater level of comfort the examiner will have with your business. If you can turn requests around quickly, know what the examiner is asking for, and provide easy to review documents or files, it tells the examiner that you have your act together, that you take compliance seriously, and this generally puts them at ease. If you are fumbling through files, continually asking for more time, providing half responses to requests, and generally in disorder, the examiner's antenna will go up, and they will be less likely to give you the benefit of the doubt. To them disorganization is like smoke, and they will have a responsibility to make sure that there is no fire where they see that smoke, generally lengthening the examination and making it a more painful experience.

A good way to get organized is to review and understand your "required" books and records. Google the applicable books and records Rule and read the text –it's not that long (i.e., SEC Rule 204-2 or SRA equivalent). You should also be able to find sample SEC examination request lists (and some SRAs) on the Web. Use that as a starting point – make sure you understand what those records are, if they apply to your business, and where or how in your office they are maintained.

Whether you are Federal or State registered adviser, you should have written compliance policies and procedures that address your specific business model. If you have an off-the-shelf manual

that you have not touched since you purchased it, you are asking for trouble. Take the time to review that manual and understand the procedures you have adopted, at least annually, to keep up with changes to your business practice and changes to applicable regulations. Three of the standard items that the SEC request are: 1) All compliance policies and procedures that were in effect during the review period; 2) A current inventory of the Adviser's compliance risks that forms the basis for its policies and procedures; and 3) Information relating to the firm's compliance testing, including any compliance reviews, quality control analyses, surveillance, and/or forensic or transactional test performed by the firm. Not only must you have policies and procedures, you will be held to what is in them; therefore, it is vital that they are customized and accurately reflect your business processes and reviews. In addition, you must be able to show that you test for proper implementation of your policies and procedures. This does not have to be overly burdensome or complicated. For example, when you review a client's account, pull the whole file and make sure that the advisory agreement is in the file and properly executed, document that you are still managing the account in line with the client's investment objectives, reconcile the fee charged for one quarter back to the advisory agreement, review the accuracy of the invoice you sent to the client (if applicable), and confirm the address on the custodial statement to your internal records. Create notes or a checklist to evidence these reviews. You just tested aspects of your policies and procedures related to books and records, adherence to client investment objectives, advisory fee calculations, and custody. While this is only a portion of the testing or reviews you should be doing, something is better than nothing, especially if your resources are scarce.

Another area to nail down is your Code of Ethics, any examiner will review this aspect of your Compliance Program, and it is very easy to stay on top of if you are organized. Make sure you have a list of access persons, get each access person to complete an annual holdings report, make sure you are receiving each person's brokerage statements, and have them acknowledge their receipt and understanding of the Code of Ethics. This is low hanging fruit for an examiner, so if you can show them that you are organized and on top of it, it will give them a better feeling for your overall Compliance Program.

### IV. MANAGING THE EXAMINATION

OK, now that you are organized, what do you do if a regulator calls or shows up on your doorstep? Typically you will receive some lead time (about a week, two if you are lucky) to prepare for the examination and they will send you a request list in advance. There are a few basic tenants to keep in mind when going through an

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examination: 1) choose one contact person to be your primary contact with the examiners; 2) show senior management involvement; 3) keep your responses to the point; and 4) discuss all real and potential deficiencies while the examiners are onsite.

You should identify in advance who is going to be the main contact and gatekeeper during the examination. This should be the CCO (or a senior Compliance Officer if you have a larger staff). It is important to designate one point of contact in order to make document requests and responses to questions more efficient and under your control. If too many people are interacting with the examiners the chance of miscommunications go up, and miscommunications make you look disorganized and raise unnecessary questions in the mind of the examiner. In addition, in the digital age, it is easier to make full copies of the documents you have provided to the regulator and I would encourage you to follow their number sequence, it makes it much easier to resolve any future questions about production.

In order to show that your firm encourages a “culture of compliance” it is important to have some senior management interaction with the examiners. This can typically be done in the initial meeting and/or the exit interview. You do not need to “coach” your President or CEO, but it is important that they get across your authority as the CCO to implement the firm’s policies and procedures, the importance of a sound Compliance Program (as evidenced by the time and financial resources put into hiring appropriate staff or outside service providers), and their basic understanding of the applicable securities laws. While the President or CEO does not need to cite chapter and verse from the Compliance Manual, they should be able to act like they read through it once.

Most examinations will include at least two examiners and when they conduct interviews, one will ask questions and the other will take notes. You should do the same thing. Anytime you or someone from your firm speaks with the examiner someone should take notes to ensure that everyone knows what was said should a question arise later on. You are not trying to catch the examiner in a “Gotcha” moment; it is simply a sound practice. In addition, it is also a sound practice to keep conversations with the examiners “on topic.” Responses should be direct and to the point, this can be especially relevant for CEO and VP of Marketing that like to “show” the examiners how compliant or vigilant they are or just like to talk. A harmless conversation about the great golf course you played last weekend with your rep from Fidelity could result in twenty questions about gifts and gratuities. Furthermore, if you do not know the answer to a question, simply say that you need to check on that and you will get back to them as soon as

possible. Many people are nervous when dealing with an examiner for the first time and in an effort to get through the conversation will respond with a half-truth or half-answer. When the examiner has to clarify your response or follow-up with additional questions you come across either as unprepared or hiding something, in either case the examiner is now forced to dig into that issue to make sure there really is no fire where he now sees smoke.

As you progress through the examination, the examiners should be bringing real or potential deficiencies to your attention. If there is something you can fix, do it while they are onsite and you may be able to keep the item out of the deficiency letter, or at least receive credit for your immediate rectification noted in the letter. If the examiner is not bringing anything to your attention, make sure you ask how things are going and request an exit interview. The examiner may not be able to review everything while onsite, but you always want to be able to defend yourself in person for issues that they have identified onsite. This makes it much more likely that you can resolve the issue before it gets into the deficiency letter. Worst case, a non-violation will be in the deficiency letter, and you will have to explain in your response why it should not be considered a deficiency. Also, if you do not understand or agree with the examiners’ interpretation of a Rule, ask them to clarify it for you and/or walk through the language of the Rule with you. The best way to approach this interaction is as an educational experience, “I believe we are meeting the Rule’s requirements; can you show me where I am off.” Examiners make mistakes and may not understand the full picture, so it is important that you understand exactly why you are being cited for a deficiency. However, if you believe an examiner has made a mistake, try to identify the procedure, the rule, the violation or whatever it might be so you can quickly be able to defend yourself should it be necessary.

### V. THE “BIG PICTURE”

It is also important for you and your Senior Management to understand that the examiners will find deficiencies. It’s the examiner’s job to find deficiencies. No matter how well you prepare, the chances of the examiner finding no deficiencies is extremely limited. It is important to keep the “big picture” in mind, your worst case scenario from any examination is that it gets referred to Enforcement and you get sued or fined. However, the SEC examinations that get referred to Enforcement generally include one or more of the following issues: 1) outright fraud (e.g., misappropriation of client funds, altering documents, lying to examiners, customer harm, etc.); 2) material undisclosed compensation leading to customer harm (e.g., failing to disclose the \$150,000 revenue sharing arrangement the Adviser has in

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place with a mutual fund carrier); and/or 3) multiple minor deficiencies resulting from systemic internal control failures (e.g., you completely ignored the findings from the last exam, you cannot produce required books and records, failure to even attempt to implement a Compliance Program, etc.).<sup>1</sup>

That said, the materiality of a deficiency and it resulting in an Enforcement referral does differ between the SEC and the SRAs. A recent trend on the State level has been fines (\$2,500 - \$10,000) resulting from deficiencies that do not typically rise to the customer harm type of issues described above. Especially if you have been audited previously, make sure you have implemented all the necessary changes previously outlined in the previous deficiency letter. If you choose to ignore, fail to implement or fail to make necessary changes based on the SRAs recommendations, they are much more likely to seek a fine for non-compliance. For State registered advisers I would suggest paying close attention to your home state investment advisory contract requirements and the suitability information obtained when opening an account. Certain SRAs are more likely to treat multiple books and records violations, especially inadequate agreements or lack of suitability documentation, as an opportunity to fine the firm. I have seen an uptick in SRAs taking issue with deficiencies in these areas resulting in small fines. The problem becomes two-fold; you have to pay a fine, and you are likely required to disclose the fine on your Form ADV, unlike with a deficiency letter. Once you have been fined by a SRA, you are much more likely to be on the SRA's "radar" for a return examination. Those who have been fined often find a regulator back in their office within a year to determine whether the Adviser has complied with the SRA's "cease and desist" order.

If the items described above do not apply, you will simply receive a deficiency letter (granted, it may be tersely worded). It is also important to note that certain clientele may request to read or obtain a summary of the results of your last examination. Therefore, the goal should be to have no deficiencies or a brief deficiency letter, but it is not the end of the world and should be viewed as a learning experience to improve your Compliance Program.

## VI. CONCLUSION

There is no getting around it, a lot of responsibility comes with the title or role of Chief Compliance Officer or Compliance Officer and you will get examined at some point. Therefore, it is in your best interest to take compliance seriously and come up with a plan to

prepare for a regulatory examination – understand your books and records requirements, familiarize yourself with the documents and questions the regulators will typically ask, create a well-organized system to track and maintain your required books and records, and most importantly customize, review and test your compliance policies and procedures. While the specter of an examination can seem daunting, preparation and organization will have you ready to treat the examination as you should – a way to improve your Compliance Program.

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<sup>1</sup> Any Enforcement referral or cited deficiency is based on specific facts and circumstances that may fall outside of the guidelines described in this Article.