



## Risk Management Update January 2009

### THEY'RE COMING: PREPARING FOR YOUR NEXT REGULATORY EXAMINATION

With the public scrutiny facing regulators of the financial services industry, the Securities & Exchange Commission ("SEC") and the Financial Industry Regulatory Authority ("FINRA") have commenced wide-ranging inspections and examinations of some CCLS client firms in the Pacific Region. In this Risk Management Update we shall discuss the current regulatory examination process and the issues of concern as CCLS is seeing brought forth in these recent examinations.

#### Examination Process Recap

For some firms who have not been examined by the regulators for several years, the examination process has evolved into a risk-based approach. The typical examination proceeds through the following steps and adequate preparation for each will greatly improve your examination experience.

**Notice** — Depending on the reason for the particular examination, regulators may or may not provide advance notice of their arrival on-site. Advance notice, if given, may range from a few days to a few weeks. However, examiners may not provide notice and may arrive unannounced in an effort to get a candid look at the firm's operations. As one Commission staff member has advised, "assume you will be examined. View regulatory examinations as a regular part of your business as a responsible regulated firm."<sup>1</sup>

**Request List** — Upon announcement of the examination, the regulator will send the firm a request letter containing a list of certain information or documents required to be provided in either paper or electronic form to the regulators prior to the examination. If it is unannounced, a request list will be provided upon arrival.<sup>2</sup> Examiners will review these books and records to determine that they are accurate, current, and in sufficient detail. Although the specific documents requested will vary depending on the nature of the examination, often the requests relate to documents regarding the firm's sales materials and advertising practices, investment activities, and relationships and agreements with clients and affiliates.

**Day of the Examination** — Once the regulatory staff arrives, the firm should identify the firm's primary point of contact and commence the initial firm interview. During the interview process, it is important to explain the firm's current business model, describe any changes in management or internal controls since the regulator's last visit and expand upon new product lines/services so that the staff has a good understanding of the firm's business prior to conducting the on-site examination. In an unannounced visit, during this interview the examiners will direct the firm on what documents they wish to review and which firm personnel they wish to interview. Typically, the staff may request a tour of the facilities to better understand the firm's organizational structure and view safeguards for protecting confidential client information. Throughout the examination, the regulatory staff may conduct interviews with other firm personnel, including senior management, telephonically or in-person and request e-mails from particular individuals. In addition, the staff may request supplemental documents, including documents from third parties that may have a "material impact on the firm."<sup>3</sup> Dependent upon the staff member, an exit interview may be conducted on the last day of the on-site visit in which outstanding items are addressed.

<sup>1</sup> Lori Richards, Director, SEC Office of Compliance Inspections and Examinations, Frequently Asked Questions About SEC Examinations (Jan. 17, 2008), available at <http://www.sec.gov/news/speech/2008/spch011708lar.htm>.

<sup>2</sup> SEC Office of Compliance Inspections and Examinations, *Examination Information for Broker-Dealers, Transfer Agents, Clearing Agencies, Investment Advisers, and Investment Companies*, [http://www.sec.gov/about/offices/ocie/ocie\\_exambrochure.pdf](http://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf).

<sup>3</sup> Id.

If you wish to have an exit interview, be sure to pro-actively request this if one is not offered as this setting provides a good opportunity for the firm to discuss any issues identified by the staff and perhaps clarify its internal processes by supplying additional supporting materials or information.

**After the Examination** — Generally, 120 days after the completion of the on-site visit, the firm will receive a written letter from the regulator stating the findings of its examination. While the letter may state that no apparent deficiencies were noted during the examination, this finding is rare. If there were any noted deficiencies, the letter (commonly known as a “deficiency letter”) will outline such information and request that the firm responds to its letter by providing the corrective action taken to address the deficiency. If the staff deems the findings to warrant further investigation, the regulator may escalate and refer the findings to its enforcement division or the appropriate authority or governmental agency. Therefore, many firms work with its legal counsel and/or compliance consultant throughout the examination process to best prepare for the examination and respond to any noted deficiencies.

### **Preparing for Current Regulatory Focus Areas**

In preparing for a regulatory visit, there are several particular areas which examiners will be focusing on and firms should take time to carefully evaluate their compliance in these areas. Since compliance should be considered as everyone’s responsibility throughout the organization, this begins by setting a “tone at the top” reflecting an understanding of the importance of maintaining compliance with all regulatory requirements. Prior to the exam, review with personnel the following focus areas.

1. **Risk Management** – As a general matter, firms should have in place sufficient internal controls to effectively manage risk. This includes the overall obligation to maintain up-to-date, comprehensive compliance, supervisory and corporate governance procedures. Examiners will look to these areas as an indication of a firm’s adherence to other compliance requirements. Thus, it is critical for firms to conduct an inventory of their internal controls and test their effectiveness.
2. **Safeguarding Client Information** – Examiners will continue to look at firms’ compliance with Regulation S-P and whether firms have effective policies and procedures for safeguarding their customers’ information and protecting against theft, loss, and misuse. Firms must take precautions to make sure that they have in place sufficient safeguards to prevent the misuse of, or unauthorized access to, nonpublic personal information relating to customers and that all other provisions of Regulation S-P have been complied with.
3. **Books and Records** – As pressure to improve transparency in the financial services industry increases, an important concern for the regulators is the adequacy of a firm’s compliance with applicable books and records requirements. Having accurate, up-to-date books and records in compliance with all regulatory requirements will make for a much smoother examination process. Particularly, firms should focus on how they are utilizing technology, such as electronic trade blotters, electronic communications (such as e-mails, instant messaging and texting) and surveillance systems and how they are fulfilling storage, retrieval and supervisory requirements.
4. **Disclosure** – Every firm’s client disclosure documents should be carefully reviewed for any potential inaccuracies or omissions. The importance of full and complete disclosure is always critical but perhaps even more magnified in times of unprecedented market conditions. Examiners will closely look at the content of these disclosures as well as the extent to which a firm’s practices are consistent with its disclosures. In particular, regulatory staff will focus on whether securities recommended and investments made are consistent the client’s investment objectives and noted portfolio guidelines and investment restrictions.

5. ***Fair Price and Valuation*** – Providing accurate valuations can be challenging in turbulent markets, but the obligation to provide investors with the most accurate pricing remains paramount. Firms should make sure that sources on which they are relying for valuation are reliable and are based on objective notions of fair value. Requiring multiple sources of pricing information can be an effective means to ensure compliance in this area. Be sure to regularly monitor, test and update controls over valuation procedures.
6. ***Anti-Money Laundering*** – Firms must understand and ensure compliance with their obligations to have effective policies and procedures to detect and deter money-laundering activities under the securities laws, the Patriot Act and Bank Secrecy Act. In this regard, regulators may look to the firm’s AML policies and procedures, whether these policies and procedures are regularly tested, and whether the policies and procedures are followed in practice.

Remember that as you preparing for your upcoming examination consider the above guidance and take the time to gather all supporting information which supports the adequacy and strength of your existing compliance program. For more information, please contact us at (619) 278-0020.

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