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PREPARING FOR AND ENDURING A FINRA EXAM

A broker-dealer preparing for a FINRA exam needs to address FINRA's current examination priorities, including identified deficiencies in prior exams, high risk areas of its business, written supervisory procedures, and compliance staff training, among other things. The authors discuss these and other aspects of the exam process, including the on-site visit, for the various types of FINRA exams.

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FINRA's Departments of Member Regulation and Market Regulation carry out an extensive and systematic program for examining FINRA's broker-dealer members. FINRA conducts so-called "cycle" exams of member firms on a regular schedule and conducts industry "sweep" and "cause" examinations on more of an ad hoc basis. FINRA can address findings from any of these exams through informal or formal disciplinary action. Although the nature of FINRA's disciplinary action ultimately turns on the strength of the findings and evidentiary support for them, FINRA's actions also can be influenced by the way in which the firm handles the examination: its preparation for the examination; the documentation and other evidence of the quality of its compliance and supervision program that it presents to examiners; its ability to foresee possible issues; and the timeliness of its responses to FINRA. A broker-dealer's counsel can play a very useful role in the firm's preparation for and responses to FINRA exams.

This article will provide specific advice for firms and their counsel facing a FINRA cycle exam, Trading and

Market Making Surveillance ("TMMS") exam, or sweep investigation. Of course, the best protection against FINRA findings is having perfect procedures and employees who operate consistently within the requirements of the FINRA and SEC regulatory schemes. However, in the real world, we must look to risk-based decisions and documentation of those decisions to satisfy FINRA's oversight imperatives. This article will not attempt to provide more than a peripheral description of best procedures, but instead will operate on the assumption that many findings of defects in a firm's procedures and practices can be mitigated by proper handling of an exam.

GENERAL THEMES

Dealing with a regulator requires some degree of flexibility, because FINRA's examination and disciplinary focus is often a moving target. FINRA needs to be able to address developing industry trends, and demonstrate to other regulators and the investing public that it is addressing all current issues that could be

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the source of investor harm. Consequently, FINRA resets its examination priorities each year – they are announced in an Annual Examination Priorities letter at the start of each year – and in real time as publicized events occur in the market.

FINRA’s success is often defined by its ability to identify and address deficiencies. It is rare that an exam does not discover some deficiencies in a firm’s policies, procedures, or practices; however, it is potentially within the firm’s powers to influence FINRA’s view as to the seriousness with which it views these violations.

While this article is intended to help firms and their counsel thoroughly plan for an exam, firms should keep in mind that sometimes it is the one out of 20 items that it failed to deal with that ends up going wrong and leads to a FINRA finding. Nevertheless, if a firm makes rational and informed risk-based decisions about where to focus its resources and documents those decisions, it will then be much more difficult for FINRA to play “gotcha” when it finds a defect. In addition, if a firm identifies a needed fix to its procedures in the course of its preparation for an exam (or, indeed, at any other time), it should remediate the problem immediately or, at the very least, develop a concrete plan for doing so. It is never too late to adopt new procedures or make other changes before an exam. A firm avoids fixing the identified problem at its peril, since it only makes matters worse if, having identified the defect, it chose to do nothing about it. Moreover, when a firm identifies a possible defect, it is advisable to consider reporting it and the firm’s remediation plan to FINRA immediately. FINRA is more approachable on every level than a firm might think; a stand-offish attitude with respect to the regulator can be counter-productive.

Finally, the best way for a firm to show FINRA that it has considered its business plan, its areas of risk, and industry-wide imperatives in implementing its systems and procedures, is to document all those considerations. FINRA understands that broker-dealers cannot adopt procedures designed to detect and prevent all possible problems; given the economics of a firm and its available resources, a firm must make risk-based determinations. A firm’s documentation of its assessments of risk and resulting decisions enables

FINRA to understand why any violations might have passed through the firm’s safety net and to choose to take no disciplinary action on it. Firms also should document all tests of their procedures, all training provided to their associated persons, and any decisions to change a procedure.

To increase the efficiency and effectiveness of its exams, FINRA has enhanced its procedures to allow it to gain a better understanding of the firms before the exams begin. FINRA asks firms to complete a Risk Control Assessment, which is an annual survey FINRA uses to better understand a member firm’s business and to help examiners prioritize the underlying risks associated with that business. While the survey is voluntary, most firms have been completing it since it was implemented in 2011.

IDENTIFYING SPECIFIC AREAS OF FOCUS

In preparing for an exam, the best rule is to try to mirror the preparations that the examiners and, indeed, FINRA itself in its entire examination program, go through to prepare for the exam. On a broad level, FINRA prepares by identifying issues of focus for the year, based on identified risks.

As a general matter, FINRA’s regularly scheduled cycle exams cover the following parts of the firm’s business: financial condition; supervisory procedures; internal controls; AML; sales practice; and business continuity planning.

Year to year, FINRA focusses on different priorities for those exams. In preparing for an exam, the firm should inform itself about the likely areas of focus by keeping up to date on FINRA’s numerous communications with the industry. A firm’s compliance officer and counsel should read FINRA’s Annual Examination Priorities Letters for the last several years – these are usually issued shortly after the beginning of the year and are available on FINRA’s website;¹ review FINRA Regulatory Guidance as it is issued and catch up on other FINRA notices on a regular basis; be familiar

¹ www.finra.org.

with FINRA sweeps, which can be identified on FINRA's website under "Targeted Examination Letters;" and be familiar with recent significant FINRA disciplinary actions, which can be another indication of FINRA priorities and possible unannounced sweeps. These are addressed later in this article.

For example, based on these sources, it is clear that the priority areas of FINRA's current (and recent) exams include structured products, private placements, anti-money laundering procedures, e-mail retention and review, conflicts of interest, and information barriers. A broker-dealer might experience separate priorities depending upon the examiners' district office of origin. For example, many municipal bond cases are handled out of the New York office, while the Boca Raton examiners may focus on AML matters.

Focusing on FINRA's current and perennial exam priorities will enable a firm to ensure that its policies and procedures are adequate to ensure that the relevant parts of its business are adequately supervised.

GETTING THE FIRM'S HOUSE IN ORDER

Specific Reviews

In addition to understanding FINRA's substantive priorities, a firm needs to devote time before an exam to ensuring that its house is in order, that is, that it has remedied any identified deficiencies, has brought its systems and procedures up to date, and satisfied all of its periodic obligations.

The best place to start preparing for this year's exam is by reviewing the report from last year's exam – as well as exam reports going back several years – and ensuring that all the findings and deficiencies have been addressed. It is likely that the firm provided a written response to FINRA in response to any previous findings and that the firm made representations about remedial steps that it had taken and planned to take. The firm should make sure that it has satisfied those representations. In addition, because FINRA had already identified the area as one for concern, it is likely that it will scrutinize that area on its next exam, so the firm should do a top-to-bottom review of that part of its business to ensure that it is compliant; the risk has already been identified.

In addition to prior exam findings, the firm should look at any formal disciplinary proceedings involving the firm over the last several years. As part of any resolution of those proceedings, did the firm commit to any remediation or other procedural changes? Did it

follow through? Even more serious than repeat exam findings is a repeat finding of a violation.

To further mirror the FINRA examiner's preparation for the exam, the firm should consider the nature of its business, to see whether the business is covered by FINRA's current priorities; for example, does the firm sell a high proportion of "complex products"? If the firm's products and services appear to put the firm squarely in FINRA's sights, review FINRA's guidance in each of these areas and make sure that the firm's procedures line up with FINRA's recommendations. A broker-dealer's business focus can change over time; does the firm's Form BD and Membership Agreement reflect the firm's current business? In evaluating the firm's business, the firm should identify risk areas – such as a high volume of complex products or indicia of AML risk, including foreign customers or significant penny stock activity – and make sure that the firm's procedures are designed to mitigate those risks.

Of paramount importance is determining whether the firm's written supervisory procedures adequately cover the firm's current business, that is, the firm's products and services, and organizational structure and staff. As to the former, the procedures should be tested. As to the latter, the firms should make sure that the correct officers and employees are identified in the procedures and that their contact information is up to date.²

Training

The firm should make sure that all compliance staff and other associated persons are up to date with their training and that the training is relevant to their positions and documented. In keeping with the theme of "better late than never," it is better to present catch-up training during the month leading up to the exam than to face examiners with no record of training during the last year or so.

THE EXAM

Typically, a firm receives about 30 days' notice of the start date of an exam. (On rare occasions, FINRA might conduct an unannounced exam for cause.) At that point, the firm will be asked to review and update information

² See, e.g., *Enforcement v. Stonegate Partners and Brian Bernier*, Disciplinary Proceeding No. E112005002003 (May 15, 2008) (The firm's procedures had not been tailored to the firm. Among other things, the firm identified as the designated compliance principal someone not associated with the firm; his name was on the template used by another firm. The case resulted in a lengthy suspension and a significant fine).

on file with FINRA about the firm's structure and business activities through the FINRA Gateway (which has replaced Web IR, that is, Web Information Request). FINRA examiners review the submitted information along with other documents, such as previously filed FOCUS reports, annual audits, and other information that resides in regulatory systems. The examiner next provides an Initial Records Request, which is a list of documents that must be available to the examiners when they arrive at the firm for the on-site inspection. Those documents typically include internal audit reports, internal testing results, etc. Note that on sales practice exams, FINRA is doing much more review off-site before the exam begins, and will request extensive information about transactions, P&L, customer complaints, and other electronically stored information.

When the day comes and examiners arrive to begin the exam, it is worth treating the arriving exam staff with respect and courtesy, and to arrange to put the firm's best foot forward. We recommend holding an introductory conference between the exam staff and senior firm personnel. It will be a sign of good faith and indicate that the firm is taking the exam seriously. Use the opportunity to provide an overview of the business and feature the improvements that have been put in place, including responses to the previous exam. Take care to make the exam work more convenient for the staff, such as by designating a primary contact for the examiners and providing a dedicated area for them, with internet access and photocopying facilities.

At the same time, we recommend that the firm keep in mind that the exam may be FINRA's opportunity to gather facts that could potentially become evidence in a formal disciplinary proceeding. Accordingly, the firm should treat it with an appropriate degree of precision and put protections in place to avoid misunderstandings. For example, ask the examiners to put all requests in writing, so you can keep track of them. Keep a duplicate set of any documents provided to examiners. If a request by the examiners appears to be unclear, overbroad, or irrelevant, make sure to discuss it with examiners and reach an understanding as to its meaning. If exam staff asks to interview any associated persons, treat such interviews as fact-gathering events, analogous to litigation discovery. We recommend that the firm cooperate with the request, but also make sure to learn the subject matter of the interview ahead of time, prepare the associated person for the interview, have a member of the firm's compliance or legal staff attend all such interviews, and make sure that the interview is limited to the designated topic and to matters within the employee's understanding.

To avoid any surprises, it is a good idea to maintain close contact with exam staff or their supervisors, such as scheduling a regular – preferably daily – meeting with them. Remain alert to any particular interest that exam staff shows in any parts of the business when they, for example, ask follow-up questions or involve FINRA enforcement staff in the inquiry.

After an examination concludes, FINRA's examination staff provides the results to the firm in several stages, with several opportunities for the firm to respond. Right at the end of the exam, the examiners hold an exit meeting and present the firm with an exit meeting report, which provides the findings without indicating whether they will be treated informally or will rise to the level of formal action. The firm can respond to those findings orally and/or in writing, and following the exam, the staff will generate a Report of Examination that takes into consideration the firm's responses. The firm will have an additional opportunity to respond to that more formal report. Finally, the Examination Disposition Letter lists what actions were taken in response to the findings and the firm's responses, that is, whether examination staff recommended no further action, informal action, or a referral to the Department of Enforcement for possible formal disciplinary action.

OTHER EXAMS

TMMS Exams

FINRA conducts exams in specialized focused areas outside of sales practice. The most common type of other exam is the TMMS exam.³ The TMMS exam is typically a yearly exam by FINRA of a FINRA member's market-making and trading operations.

Similar to cycle and sales practice exams, the TMMS exam requires the same devotion of time to preparation prior to its initiation by FINRA. The exam usually occurs at the same time each year, so the firm should not be surprised by its timing. In addition, the firm will receive an e-mail or a call from the FINRA examiner one month before the exam. The examiner will make an initial request for information at that time and set up a schedule for the on-site portion of the exam. The examiner will also provide a questionnaire. Although the information is provided to the FINRA staff on a

³ The Chicago Board of Options Exchange currently conducts an independent TMMS exam for its members. It is possible that a member of both the Chicago Board of Options Exchange and FINRA can receive an exam from both regulators.

rolling basis, most documentation in connection with the exam is due one week before the examiners' on-site visit.

The documentation requested may consist of the firm's organizational charts, written supervisory procedures, firm policies, order tickets, trading confirmations, and other electronic communications. These are the regularly requested documents, but the requests can vary from year to year based on FINRA priorities. Trade-related documentation is usually requested for a two- to three-day period.

After the documentation is provided, FINRA conducts an on-site exam in which the production is discussed and the firm provides an overview of its trading operations. The on-site portion of the exam also includes a tour of the trading facilities. The entire on-site exam usually lasts a day or two. The firm should be prepared for this portion of the exam and be able to answer questions regarding the trading systems. Although the regulatory staff spends this time at the firm, the majority of the analysis for the exam findings is conducted at the regulator's offices. After the on-site portion of the exam, the conclusion of the review can take from three to six months, depending on the size of the firm being examined and further requests for information.

The subject matter covered on the exam usually includes Regulation SHO, order entry and execution, best execution, Section 31 fees (fees paid by the SROs to the SEC, charged to the broker-dealers), firm policies and procedures, NMS Rules 605 and 606, books and records, and other exchange activity. Specific topics of interest noted from year to year include market access, professional customer order marking, information barriers, error accounts, Alternative Trading Systems compliance, and compliance surrounding Retail Liquidity Providers.

After the exam is complete, FINRA will send the firm a preliminary finding letter. The firm has the opportunity to discuss and respond to the findings through written communications. The TMMS exam for options historically does not have an exit interview like the equity TMMS exam. This will probably change when the equities and options TMMS exams are combined at FINRA, expected for 2014.

FINRA's examiners typically close the matter by issuing, in order of increasing severity, a "No Further Action letter," a Cautionary Action Letter, an Acceptance, Waiver, and Consent document ("AWC") resolving a matter before a formal proceeding is

initiated, or a Complaint commencing a formal disciplinary proceeding.

Preparing for Other Exams

As discussed above, and consistent with sales practice exams, the firm should continue to update and maintain any written supervisory procedures throughout the year, paying specific attention to any findings in past exams or regulatory matters at the firm. The firm should have a document that can define all trading systems and be certain that the compliance department is familiar with each of the systems. Firm representatives speaking to FINRA will need to know how the different departments interact when executing an order and what systems are used by the firm during the life of an order.

The legal and compliance departments should be very knowledgeable about the firm's systems and procedures prior to the exam. The presence of informed legal and compliance representatives can be the most effective way to handle the exam. FINRA will primarily be discussing its questions with those representatives, and if they do not have readily available answers, the staff may take exception.

One other point to note is the management of staff expectations on timeliness. The firm should avoid over-promising and under-delivering, particularly around e-mail and other hard-to-provide documentation that may have already been sent to your firm's central storage. On the e-mail point in particular, most firms are aware that e-mail production is a time-consuming, tedious, and expensive task given the size of the typical request and the process for pulling e-mail. In addition, pulling e-mails may involve outside vendors. Depending on the request, it is not unusual in a large firm to take several weeks and even months to search, capture, review for relevance and privilege its trove of e-mails in response to requests. The firm should prepare its regulator for this process to avoid any appearance that it is not producing data on a timely basis.

TARGETED EXAMINATIONS

As noted earlier in the article, over the last few years, FINRA has been increasing its use of targeted exams, known as sweeps. Regulators use sweep letters to target their reviews to certain firms and activities. This practice enables the regulators to focus on some of the firms likely to be most involved in the targeted activities and to send a broad message to the industry. The regulator will choose specific firms based on participation in the sweep area of practice, regulatory history, and other exam findings, to name a few factors.

In the last 12 months, FINRA has issued sweep letters in the following areas: high frequency trading; risk management and controls; social media communications; alternative trading systems; business continuity plans; order protection disclosure practices; and nontraded REIT communications

The sweep letters often are the result of a market event or other regulatory action that may affect the market as a whole. For example, the recent matters involving certain firms' algorithmic trading activity may have led FINRA to issue sweep letters to other firms regarding high frequency trading.⁴ In that sweep, FINRA is reviewing the controls that firms have in place when developing, testing, monitoring, and rolling out new high frequency trading algorithms. FINRA continues to review procedures at firms surrounding these algorithms.⁵ Firms should continue to monitor the

news releases and other regulatory channels to be prepared for any sweep exams that may be coming their way.

CONCLUSION

Diligent preparation is the key to a successful exam, whether it is a cycle exam, a TMMS exam, or other targeted exam by the regulator. In addition, an open dialogue with the staff and informed compliance and legal personnel will increase your firm's chances of a positive outcome on your exam. There are no guarantees of a completely clean exam bill of health; however, knowing what to be ready for year after year will help ensure that the right information is provided to the regulators in a timely manner and will only help the regulators and their perception of the firm. ■

⁴ See Goldman's Options Error Shows Peril Persists after Knight, www.bloomberg.com/news/2013-08-21/goldman-options-error-shows-peril-persists-one-year-after-knight.html.

⁵ A copy of this letter can be found on FINRA's website at www.finra.org/industry/regulation/guidance/targetedexaminationletters/.