

# Today's Regulatory and Economic Environment Requires Firms to Take a Closer Look at the Overall Efficacy of Their Compliance Programs (... and It's Good Business)

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Many thought the economic and regulatory pressures were trying when the Enron fiasco occurred and the "tech bubble" burst. Then came Madoff's \$50 billion dollar ponzi scheme, the real estate mortgage crisis, and the financial meltdown of some of our nation's largest financial institutions. Most recently, the SEC released the Inspector General's 450-page report regarding the Madoff fraud and "the many missed opportunities to discover it." Simultaneously, the SEC released, "The Securities and Exchange Commission Post-Madoff Reforms," signaling that regulation is going to be tougher and more focused. Some of the SEC reforms include the following:

- revitalizing the Enforcement Division;
- revamping the handling of complaints and tips;
- conducting risk-based exams;
- improving fraud detection techniques for SEC examiners and recruiting staff with specialized experience;
- seeking more resources; and
- integrating broker-dealer and investment adviser examinations.

These developments have resulted in an aggressive regulatory environment. Regulators have zero tolerance for perceived misconduct, and investigations are being conducted at a much faster pace than in the past. This has led to an increasing number of enforcement actions and private actions, with stiff sanctions and awards.

Suffice it to say that investment firms are under extreme pressure to weed out the "bad apples" and prevent violations from occurring. Of course, firms are just as interested in getting rid of "bad apples" and preventing fraud as are the regulators. However the practical realities of running a business in tough

economic times make it difficult, at best, to accomplish these common goals. Nonetheless, if a firm is to thrive in the long run, it is imperative that it have a top-notch compliance program.

While firms cannot be guarantors against violations, a well tailored compliance program can go a long way to reduce the risk of illegal activity. Many firms have had the same basic compliance program for many years. Firms need to take a look at their overall programs to make sure their compliance fundamentals are solid and continue to be effective. Some of you may be thinking, "our fundamentals are strong ... we've got a compliance manual that's 8 inches thick!" While firms may have a manual the size of a telephone book (even one that is updated now and then), the same basic supervisory system may no longer be the optimal one for preventing supervisory failures.

There are 3 basic reasons firms are found liable for supervisory failures: 1) failure to *establish* adequate procedures; 2) failure to adequately *enforce* procedures; and 3) failure to *act* when faced with "red flag" warning signals. When economic times get tough, firms become vulnerable to problems in these areas. In this article I am going to address the fundamentals of a solid compliance program for investment advisers and broker-dealers and how to respond to a regulatory examination. ***The Fundamentals of a Strong Compliance Program***

Investment advisers and broker-dealers are well advised to convene a meeting with compliance staff to revisit the following critical questions:

- Has my firm established procedures *reasonably* designed to prevent and detect violation?
- Does my firm have an effective system for applying those procedures?

To answer these questions your firm needs to identify all compliance

factors (including conflicts) that create risk exposure and then make sure its procedures are designed to address those risks. For each category of prohibited activities relevant to your firm, you should ask 4 questions:

1. How could someone at my firm violate this rule or do this prohibited act?
2. What could signal that a violation or prohibited act is occurring?
3. Do my firm's procedures reasonably relate to the ways in which improper conduct could occur or manifest itself?
4. Are my firm's procedures clear enough to communicate to the supervisors what is expected of them and what they should do in response to indications of problems or irregularities?

## ***Understanding Key Compliance Concepts Is Essential to a Review of a Firm's Compliance Program***

Compliance Guidelines vs. Compliance Procedures. Every firm's manual contains *compliance guidelines* that state the applicable rules and policies that must be followed and describe specific activities that are prohibited. By comparison, *supervisory procedures* describe the supervisory system established to ensure that compliance guidelines are adhered to and to prevent and detect prohibited activities. For example, a compliance guideline might specifically prohibit price predictions in all investor communications and reference applicable rules. In contrast, a supervisory procedure instructs the supervisor on the steps necessary to prevent and detect non-compliant investor communications (e.g., review and initial all outgoing correspondence before it is sent). Supervisory procedures would also describe the action a supervisor should take if he/she identifies offensive correspondence.

Supervisory System vs. Written Supervisory Procedures. FINRA in

particular has made it a point to remind its members that there is a distinction between a supervisory system and written supervisory procedures (“WSPs”). See FINRA Notice to Members (“NTM”) 99-45 at [www.finra.org](http://www.finra.org). WSPs are an essential part of an overall supervisory system and document the system established by the firm. A supervisory system may include automated exception reports of frequent trading in customer accounts or email surveillance programs. The WSPs would instruct the supervisor on which reports are to be reviewed, how often the reports are to be reviewed, the steps to be taken if suspicious activity is identified, and how the supervisor is to document this oversight activity. WSPs should also clearly identify who has supervisory responsibility for a given area and must be periodically updated.

### ***The Nuts and Bolts of a Strong Compliance Program***

Both the SEC and FINRA have provided valuable guidance to investment advisers and broker-dealers describing the minimum standards for an adequate compliance program and the basic areas that must be covered. See NTM 99-45, cited above, and Advisers Act Rel. No. 2204 (Dec. 17, 2003) at [www.sec.gov/rules/final/ia-2204.htm](http://www.sec.gov/rules/final/ia-2204.htm). For investment advisers, the SEC has stated that they expect a firm’s policies and procedures to, at a minimum, address the following:

1. Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients’ investment objectives, disclosures by the adviser, and applicable regulatory restrictions;
2. Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services (e.g., soft dollar arrangements), and allocates aggregated trades among clients;
3. Proprietary trading of the adviser and personal trading activities of supervised persons;
4. Accuracy of disclosures made to investors, clients, and regulators, including account statements and

- advertisements;
5. Safeguarding of client assets from conversion or inappropriate use by advisory personnel;
6. Recordkeeping - The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;
7. Marketing advisory services, including the use of solicitors;
8. Processes to value client holdings and assess fees based on those valuations;
9. Safeguards for the privacy protection of client records and information; and
10. Business continuity plans.

Most of the foregoing applies to broker-dealers as well. FINRA has also provided the following guidance regarding the minimum requirements of an adequate supervisory system for broker-dealers. Most of these concepts also apply to investment adviser compliance programs.

*1. Compliance Programs Must Be Tailored.* There is no such thing as a “one-size-fits-all” compliance manual or WSPs. Firms invariably discover this when a regulator comes along and points out that certain (often unnecessary) procedures are not followed while other important procedures are not included in the manual. The key is to make sure your compliance program is tailored to your firm’s business model and addresses the activities of all advisers or brokers. For example, a firm that has many independent contractors will have different procedures than a firm whose representatives are all employees. Other factors include your firm’s product lines, customer base, firm size and locations, and your staff’s level of experience.

*2. Designating Principals Responsible For Supervision.* Firms must assign a specific individual who has ultimate responsibility for implementing the firm’s supervisory system and written procedures for each type of business it conducts. This individual must have sufficient knowledge and experience necessary to supervise the business.

*3. Designating Offices Of Supervisory Jurisdiction (“OSJs”).* Certain types of activities (e.g., order

execution) are sufficiently vested with regulatory significance that the locations where members conduct these types of activities require special recognition and attention. These offices are known as OSJs. A brokerage firm must review the types of activities that occur at each of its offices to determine whether it should be designated as an OSJ.

*4. Assigning Supervisors For Registered Representatives And Designating OSJ/Non-OSJ Branch Supervisors.* Each registered person must be assigned to at least one supervisor. Thus, it is irrelevant whether the person to be supervised is a registered representative, registered principal, or part of the senior management staff. Each registered person must have a supervisor.

*5. Determining Qualifications of Supervisory Personnel.* Firms must make reasonable efforts to determine that all supervisory personnel are qualified to fulfill their assigned responsibilities. At a minimum, the supervisor must be properly licensed to conduct the assigned responsibilities. However, passing the requisite licensing examination does not, in and of itself, qualify a supervisor. Members should determine that supervisors understand and can effectively discharge all of their responsibilities.

*6. Annual Compliance Meeting.* For FINRA firms, each registered representative must participate in an annual compliance meeting. This requirement provides an opportunity to discuss compliance issues and assists the firm in ensuring that representatives remain current on changing compliance requirements and changes in the firm.

*7. Internal Inspections.* It is important that firms conduct inspections to determine whether their supervisory systems and procedures are being followed. FINRA firms are required to annually review the businesses they conduct and each office. At a minimum, an OSJ must be reviewed every year, whereas branch offices are required to be reviewed in accordance with a stated cycle. In determining the inspection cycle for a branch office, a FINRA firm

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must consider the nature and complexity of the securities activity for which the branch office is responsible, the volume of business conducted at the office and the number of persons assigned to the office. Once a FINRA firm determines its inspection cycle, it must document the cycle in its WSPs.

***What to Do When Faced With a Regulatory Examination***

By applying the above-described fundamentals and augmenting the compliance program with features tailored to the firm's business, a firm can prepare itself ahead of time for any regulatory examination. The SEC and FINRA conduct "cause" examinations, "routine" examinations and "sweep" examinations of the firms over which they have jurisdiction.

A cause examination is conducted when the regulator has cause to believe there may be a problem or a violation. A cause exam can arise from a customer complaint, press article or tip. A routine examination is conducted on a cyclical basis and the regulators look for the firm's compliance with the law in a specified number of areas. Both the SEC and FINRA conduct their routine exams using a risk based approach. A sweep examination focuses on a narrow issue (e.g., sales of B shares) and seeks to determine how a sampling of firms are handling that issue.

There are a number of "Dos and Don'ts" practices that firms should observe when faced with any type of examination. In reverse order, they are as follows:

***Don'ts***

1. Do not treat a "routine" exam as routine. Don't "wing it" in responding to an inquiry or submitting to an interview. Give thoughtful responses or ask for more time so that you can provide a thoughtful and accurate response. (Remember, everything you say can and will be used against you.)
2. Do not lie to the regulators. Remember the old maxim, "the cover-up is often worse than the crime." Think Martha Stewart.
3. Do not behave in a manner that gives

the examiner the impression that you are causing delay or being disrespectful.

4. Do not let a deadline on a request letter pass, unless you have received an extension.
5. Do not volunteer information. Provide only the requested information and stay focused.

***Dos***

1. Be courteous.
2. Be aware of current regulatory rules and initiatives.
3. Review past deficiency letters.
4. Review the routine exam request list, ask the examiner for clarification if necessary and flag possible areas of concern for follow-up.
5. Provide the examiner(s) with appropriate workspace.
6. Designate a principal at your firm to interface with the examiner(s).
7. Maintain a log of documents requested and produced.
8. Address and correct any apparent miscommunications.
9. If there are any contested issues, address them before the fieldwork portion of the exam is concluded.

Following these "Dos and Don'ts" and having a strong compliance program should dramatically improve your firm's experience during the examination process and ready your firm for the SEC's Post-Madoff reforms and similar initiatives by FINRA.