



COMPLIANCE TIPS

Regulatory Examinations Be Prepared, Not Scared

With a little knowledge and preparation, a regulatory audit is nothing to fear. Knowing what you can expect removes a great deal of anxiety.

- Preparation Starts Now
 - Establish an effective compliance system.
 - Compliance must come from the top.
 - Establish adequate written compliance procedures designed to prevent, detect, and promptly correct violations of securities laws.
 - Conduct regular compliance reviews and risk assessments.
 - Respond to red flags and learn from mistakes.
 - Hire and train good people.
 - Organizational chart, clear assignment of duties, clear assignment of supervisors.
 - Observe record-keeping requirements. At all times, maintain current, neat, and organized files.
 - Annually go through the required records list and make sure you can produce everything in a timely manner.
- Prior to the Exam - Auditor Preparation includes reviewing:
 - Company web site.
 - Company filings (e.g. Form ADV, Parts 1 and 2).
 - Publicly available information, Press reports, Google.
 - Complaints, informants, other regulators.
 - Prior inspection reports.
 - Prior enforcement proceedings.
- Types of Exams
 - Routine.
 - For Cause.
 - Sweep examination focusing on a single particular issue.
 - As a matter of policy, an auditor will not tell you the reason for the exam.
- Notice of Exam
 - Range from no notice to a few weeks.
 - Larger firms may be given more notice as they have more prep work and need more time to get people together.
 - Smaller firms usually get a few days.
 - Usually get a phone call first.
 - An SEC request list is tailored to the adviser. CA request lists have been uniform.
- Length of Exam
 - 1 day to several weeks, depending on size, complexity, cooperation.
 - Several weeks for very large advisers or for in depth examination.

- End the Exam Quickly
 - Produce requested information quickly.
 - Be responsive, cooperative. The faster you get them the information, the quicker you may be able to bring the examination to a close and the more you demonstrate that your house is in order. Organization goes a long way.
 - Provide more easily retrieved documents first, then work on the more difficult to assemble information.
 - Ask for clarification of what is needed, especially if a request is particularly burdensome.
 - Pre-review of requested records must be quick.
 - DON'T ALTER OR BACKDATE YOUR DOCUMENTS.
- Control the Exam
 - Designate one contact person.
 - Review all documents prior to providing to auditors, remove irrelevant or privileged documents. Provide only the documents requested.
 - Keep a record of all documents provided to auditors (including oral statements). Make two copies of all records – one for audits, one for your files.
 - DON'T GIVE THEM ORIGINALS IF POSSIBLE.
 - Offer to make copies for them.
- Preserve Confidentiality
 - May request confidential treatment under the FOIA (Freedom of Information Act).
- Start of the Exam
 - Treat the auditor like a client – determine your client's expectations and then meet or exceed them.
 - Be prepared to explain complex business practices in a simplistic manner. Consider preparing a presentation for the entrance interview.
 - **First impressions are important. Demonstrate that you have a culture of compliance, and that compliance comes from the top.**
 - Give the auditors proper facilities. (Phone, electrical outlets, space to spread out papers; make photocopies for them)
 - Never refuse to produce or unreasonably delay the production of records that are subject to the auditor's inspection powers.
 - Cooperate with the auditors.
- Entrance Interview
 - Set tone for exam (don't be nervous or intimidated, be cordial). Let them know that you understand the regulations and take compliance seriously.
 - Management should not appear detached from supervisory responsibilities.
 - Try to determine reason for audit.
 - Ask for clarification, when necessary.
 - Find out approximately how long they anticipate being there, so you can clear your schedule.
 - Auditors are human beings.
- Focus of Exam (Legally limited to review of records advisors are required to keep)
 - What SEC is Looking For:
 - Step 1: Assess compliance environment.
 - Step 2: Weak compliance environment leads to detailed testing in many areas. Strong compliance controls lead to more limited sampling of books and

- records.
 - SEC looking for a culture of compliance that starts at the top.
 - SEC looking for an effective & comprehensive compliance system.
 - SEC looking for strong **internal controls** over areas of potential risk for clients.
- NASAA 2011 Top Deficiencies
 - The top five categories with the greatest number of deficiencies involved registration, books and records, unethical business practices, supervision, and advertising. The examinations revealed that:
 - The top registration deficiencies were inconsistencies between Parts 1 and 2 of Form ADV and failing to amend Form ADV in a timely manner.
 - In the area of preparing and maintaining current and accurate books and records, the top deficiencies included not maintaining client suitability information, not properly safeguarding client records and data, and not backing up data.
 - Unethical business practice deficiencies involved missing or no contracts and other contract-related issues, altered documentation and signing blank documents.
 - The most common supervision deficiencies were inadequate or no supervisory/compliance procedures, supervision over personal trades, and remote location supervision.
 - Common advertising deficiencies included issues involving websites, correspondence, business cards and the misuse of “RIA” (Registered Investment Adviser). Additionally, social media deficiencies are likely to increase in the future as more firms use these tools to advertise.
 - CA Specific Areas of Focus includes financial records and minimum financial requirements.
 - Deficiencies of Past Examinations.
- Interviews of Personnel
 - Determine scope of questioning prior to interview.
 - CCO or in-house counsel to take notes.
 - Every person interviewed should be prepared as if they were testifying in an SEC investigation.
 - DON'T LIE TO THE AUDITOR.
- During the Exam
 - Attempt to correct deficiencies identified during the exam before the auditors leave the office. Show documentation of corrective action taken.
 - Know the rules and regulations. Defend your actions.
 - Educate auditors.
 - Auditors can be wrong.
 - Ask to speak to the supervisor, if necessary.
 - Call the SEC Examination Hotline at 202-551-EXAM or send an email to: examhotline@sec.gov.
- Exit Interview
 - Now often taking place via conference call weeks after auditors have left the office.
 - Findings that will be included in the deficiency letter will be addressed here. Some items brought up throughout exam and during exit interview may not be in deficiency letter. SEC has stated that it will notify the Investment Adviser of all deficiencies to appear in letter before issuing the deficiency letter.

- Last opportunity to address findings and advocate your case with the auditors.
- Post Onsite Exam Work
 - Auditor may request more information.
 - 1 week in field leads to 2 weeks to write a detailed report & deficiency letter.
- Deficiency Letter & Response
 - Received weeks or months after conclusion of the exam. Usually within a couple weeks of exit interview.
 - ~85% of all advisors receive one. (~5% not action, ~5% oral notice of deficiencies, ~5% enforcement)
 - Call if you don't get a letter. You are still required to respond even if you don't receive it. (90 days)
 - Promptly reply to deficiency letter to either defend the legality of questioned practices or to emphasize that any violations are unintentional (and correct).
 - CA gives 15 days to respond, but an extension can be requested; SEC gives 30 days from date of their letter to respond on how you have corrected or intend to correct the deficiencies. You can still state your case if you don't agree that something is deficient.
 - Understand the deficiencies and be aggressive in the corrective action taken. Non-aggressive responders may go to enforcement. Most enforcement investigations result in enforcement action (civil lawsuit).
 - The SEC closes the book when they get an adequate response. Advisors are starting to receive notification when an examination has been closed.
 - Don't fight over details. Pick your battles.
- When to Expect an Examination
 - CA every 3 or more years.
 - SEC is conducting risk-based exams. Each Advisor is assigned a risk score based on Form ADV, history of past exams; you will not know what category you fall into.
 - New SEC Advisors may be examined within the first 6 to 12 months of first becoming SEC registered.
 - High-risk advisors may be examined every 1 or 2 years.
 - Very large and complex firms.
 - History of regulatory violations.
 - Significant deficiencies in prior inspections.
 - Poor compliance environment.

For assistance in managing your next regulatory audit, please contact:

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