

Inspections of Broker-Dealers, Investment Advisers, and Other Regulated Firms

The SEC's Most Powerful Compliance Oversight Tool

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A. Introduction

The prevention and detection of regulatory violations is the most important challenge confronting a law enforcement agency like the SEC. Sometimes the SEC is able to detect fraud and other violations before they reach the news media through information received from such sources as state and local law enforcement agencies, disaffected employees, competitors or other incidental sources. Apart from these sources, the SEC's primary detection tool for violations by publicly held companies is examination and analysis of the financial and other disclosures in registration statements and reports required to be filed with the Commission.

To detect violations by broker dealers, investment advisers, investment companies, transfer agents clearing agencies and non-bank government and municipal securities dealers which are required to register with the Commission ("Regulated Firms"), the SEC has another even more powerful mechanism—the authority contained in the various federal securities statutes to conduct inspections of their books and records.¹ These statutes authorize the Commission to require that Regulated Firms make and maintain records relating to their business and authorize the Commission to inspect such records. The SEC has adopted rules which implement this statutory authority by specifying the documents and records which each of the Regulated Firms must maintain for this purpose.²

*With appreciation to Richard Marshall, formerly of K&L Gates, for his assistance.

1. See Section 17(b) of the Securities Exchange Act of 1934, as amended ("Exchange Act"), 15 USC 78o (2006); Section 204 of the Investment Advisers Act of 1940, as amended ("Advisers Act"), 15 USC 80b-4 (2006); and Section 31 of the Investment Company Act of 1940, as amended ("1940 Act"), 15 USC 80a-32 (2006).

2. Rules 17a-3 and 17a-4 of the Exchange Act, 17 C.F.R. §§ 240.17a-3, 240.17a-4 (2006). Rules 31a-1, 2, and 3 of the Investment Company Act, 17 C.F.R. §§ 270.31a-1, 2, 3 (2006). Rule 204-2 of the Advisers Act, 17 C.F.R. § 275.204-2 (2006).

Moreover, while the SEC's express statutory examination authority is limited to books and records, as a practical matter the SEC staff also can and does use its inspection authority to gather information through requests for written submissions and informal interviews of officers and employees. Any insistence by a firm on strict observance of the statutory limitations is likely only to result in a prompt issuance of a subpoena for sworn testimony before the SEC's Enforcement Division – in most circumstances a most undesirable escalation of a request for informal access to information.

The power to inspect enables the SEC to oversee not only compliance with applicable regulatory requirements by broker-dealers and other Regulated Firms but also the integrity of their representations to clients. Importantly, it also allows the Commission to evaluate their compliance controls and risk profiles with a view towards preventing future violations.³ It thus gives the SEC an ability to oversee the activities of Regulated Firms to a far greater extent than oversight that is exercised merely through examination of reports and other filings with the Commission.

The authority to examine broker-dealers is significantly augmented by the Exchange Act requirement that broker-dealers be members of a self regulatory organization ("SRO"), such as the National Association of Securities Dealers, Inc. ("NASD") or a national securities exchange. The SROs have the responsibility under the Exchange Act to enforce the federal securities laws as well as their own regulations applicable to their members.⁴ The SEC generally defers to the SROs as the primary inspection agencies for broker-dealers and largely limits its own examinations of broker-dealers to "cause" inspections and those necessary for oversight of SRO examinations. Other Regulated Firms, including investment advisers and investment companies, are not required to be members of an SRO and accordingly, only the SEC conducts inspections of their operations.

All Regulated Firms can expect to experience periodic SEC and/or in the case of broker-dealers SRO inspections. During 2006, the SEC's Office of Compliance Inspections and Examinations ("OCIE") completed over 2400 inspections and reviews of investment advisers, investment companies and hedge and other private funds.⁵ A large number of broker-dealer inspections also were conducted by the NASD and other SROs. Moreover, inspections give rise to more enforcement investigations and actions against Regulated Firms than any other source. Accord-

3. For further discussions of the purposes of the SEC's inspection power, *see e.g.*, SEC 2006 Performance and Accountability Report at 11, available at <http://www.sec.gov/about/secpar/secpar2006.pdf> ("2006 SEC Accountability Report"); Lori Richards, Director, OCIE Speech at 9th Annual IA Compliance Best Practices Summit 2007, IA Week and Investment Adviser Association: SEC's Compliance Examinations in the Protection of Investors (Mar. 23, 2007), available at www.sec.gov/news/speech/2007/spch032307lar.htm; keynote address at the National Regulatory Services, 17th Annual Spring Conference: Furthering Good Compliance: Current Areas of Focus in SEC Examinations (Apr. 8, 2002), available at <http://sec.gov/news/speech/spch548.htm> and Speech, "Meet the Regulators," Mid-Atlantic Securities Forum, Philadelphia, Pennsylvania (Mar. 21, 2002), available at <http://sec.gov/news/speech/spch545.htm>.

4. *See* Section 15A of the Exchange Act. *See* Chapter 9 *infra* for further information regarding SRO inspection programs. While an SRO as a non-government authority has inspection powers that are broader in some respects than those of the SEC, many aspects of the SEC's inspection process described herein also apply to SRO inspections.

5. 2006 SEC Accountability Report at 12, *supra* note 3.

ingly, a thorough understanding of the inspection process is critically important for those who represent or are associated with Regulated Firms. Not only can such an understanding assist in avoiding enforcement investigations and possible prosecution, it also can assist a Regulated Firm to be classified as “low-risk” and obtain the benefit of less frequent, less intrusive and shorter inspections. Thus, effective preparation for and management of the inspection process is an indispensable prerequisite to the ability of a Regulated Firm to remain in good standing with its regulatory authorities.

B. OCIE and the Inspection Program

Historically, the SEC’s inspection power was exercised through examination staffs attached to the SEC’s Division of Investment Management (investment advisers and investment companies) and Division of Market Regulation (broker-dealers, transfer agents, clearing agencies, non-bank government and municipal securities dealers and SROs) located in the Washington D.C. headquarters and through regional office examination staffs overseen by the Investment Management and Market Regulation Divisions.⁶ On May 1, 1995, OCIE was created to centralize the oversight of all SEC inspection activities in the Washington, D.C. office and the various regional and district offices. Inspection staffs from the two Divisions were transferred to OCIE, and the inspection program was further augmented by additional management and legal staff to coordinate and support the SEC’s inspection program on a nationwide basis. Most of the examiners are attached to the regional offices. Although they report administratively to the heads of those offices, their activities are overseen, and to a significant extent directed, by officials of OCIE. The result has been a much better trained, coordinated and supervised inspection staff which has as its primary mission not only the detection of fraud and other violations of the federal securities laws but also the fostering of pro-active private sector compliance.”⁷

To achieve its purposes, the SEC relies heavily on a “routine” examination process which conducts inspections on a schedule which is determined not only by the passage of time since a firm has last been examined but most importantly

6. At present, the SEC has 11 regional offices, including six offices that until recently were designated district offices and reported to regional offices.

7. See Lori Richards, Director, OCIE, Remarks at the 9th Annual IA Compliance Best Practices Summit 2007, IA Week and the Investment Advisor Association: SEC’s Compliance Examinations in the Protection of Investors (Mar. 23, 2007), available at <http://www.sec.gov/news/speech/2007/spch032307lar.htm>; and keynote address at the National Regulatory Services, 17th Annual Spring Conference: Furthering Good Compliance: Current Areas of Focus in SEC Examinations (Apr. 8, 2002), available at <http://www.sec.gov/news/speech/spch548.htm>.

in recent years by the “risk profile” of the firm, *i.e.*, its compliance record, size and the staff’s perception of the compliance culture. In 2006, almost two-thirds of the routine examinations of investment advisers were targeted at higher risk firms, and the rest were directed at randomly selected firms with low-risk profiles.⁸ Gene Gohlke, Associate Director of OCIE, has described the routine examination process for investment advisers and investment companies as follows:

“As part of each routine exam, exam staff also inspects all registered funds and the books and records of private funds managed by the adviser. Examiners review and evaluate the effectiveness of compliance policies and procedures and interact with adviser and fund CCOs. Examiners focus their attention on areas within these firms where they perceive the existence of significant conflicts of interest. Examiners also conduct forensic tests in critical areas, those areas of the firm in which there are significant conflicts of interest or where hidden schemes and arrangements might flourish. One of the outcomes of these routine exams is an updated risk rating of the adviser and any registered funds it advises. These exam-based risk ratings are developed based primarily upon our evaluation of the advisers/funds’ compliance program and compliance culture.”⁹

Thus, OCIE seeks to focus its necessarily limited resources on firms that it identifies as posing the greatest compliance risk. Moreover, routine examinations are not all encompassing. The examiners instead tend to focus on operational areas that are perceived at the time as posing the greatest compliance risk not only within the industry but also within the particular firm being examined. Many of the current industry-wide areas can be readily identified from recent speeches of Director Richards and other OCIE officials as well as from recent SEC enforcement actions.¹⁰ Routine examinations represent the vast majority of SEC inspections.

OCIE also conducts so-called “cause” examinations which are focused on potential specific violations. They are usually initiated on the basis of an investor complaint, employee or competitor tip, press report, review of the firm’s Commission filings or other source which indicates a possibility of ongoing violations. Cause examinations tend to be highly focused on the particular problem or problems which led to the examination. Unlike routine examinations, which are scheduled in advance and are usually preceded by notice, cause examinations are generally unannounced. Cause examinations, in particular, require a careful response because of the potential for a referral to enforcement. They should not

8. The SEC reported that in 2006 OCIE completed routine inspections of 650 advisers with higher risk profiles and 328 advisers with lower risk profiles. Such advisers accounted for approximately 40 percent of adviser assets under management as of the beginning of 2006. Examiners also conducted inspections of 368 advisers that appeared to have specific issues requiring additional scrutiny or that were part of a risk-targeted examination sweep. 2006 SEC Accountability Report at 11-12, *supra* note 3.

9. Remarks before the Fund of Funds Forum (Nov. 14, 2005), available at <http://sec.gov/news/speech/spch111405>.

10. See *e.g.*, Lori Richards, Director, OCIE, Remarks at the 9th Annual IA Compliance Best Policies Summit 2007, IA Week and the Investment Advisor Association: SEC’s Compliance Examinations in the Protection of Investors (Mar. 23, 2007), available at <http://www.sec.gov/news/speech/2007/spch032707lar.htm>; and speech before the National Membership Meeting of the National Society of Compliance Professionals (Oct. 19, 2006), available at <http://sec.gov/news/speech/2006/spch101906lar.htm>.

be dismissed as a “fishing expedition,” but handled in close consultation with experienced enforcement counsel.

A third type of examination that has been used increasingly in recent years are “sweep” examinations. Such examinations generally involve either requests for information, or visits to the firm preceded or supplemented by requests for information that seek to determine whether the manner in which a sample of the industry is handling a particular regulatory compliance issue is cause for regulatory concern and possible further investigation. Sweep examinations vary in scope and intensity but commonly require the collection and analysis of relatively large quantities of information within relatively short time frames. Sweep examinations also require a careful response with a view towards precluding further inquiry. The increased volume of sweep examinations in recent years has subjected the SEC to severe industry criticism of an unnecessarily burdensome inspection program. Most likely, OCIE will respond to this criticism by making less use of the sweep examination mechanism in the future.

The SEC also conducts oversight examinations of broker-dealers, both to test the effectiveness of SRO oversight and to uncover undiscovered violations and inefficiencies. SRO oversight inspections complement the SEC’s compliance examinations of the NASD and other national securities exchanges to determine whether they are properly fulfilling their self-regulating responsibilities. While oversight examinations are primarily intended to evaluate SRO performance, a key indicia of such performance is the existence of previously undiscovered violations.¹¹ Accordingly, broker-dealers should treat such inspections with the utmost seriousness.

C. The Inspection Process

1. Selection of Inspection Targets

The selection of targets for SEC inspections has not always been risk-based. The SEC’s earliest inspections focused on individual investment advisers, individual investment companies and broker-dealers. They examined each individual firm, one at a time, as if it were a stand alone entity. During the 1970’s, in an attempt to adapt to a changing industry, the SEC took a “systems” approach and, for example, examined mutual funds together as part of a complex that generally shared the same investment adviser and compliance systems. In 1998, after

11. Lori A. Richards & John H. Walsh, *Compliance Inspections and Examinations by the Securities and Exchange Commission*, 52. BUS. LAW. 119, 136 (1996).

the National Securities Markets Improvement Act redistributed regulatory responsibility for investment advisers between the state and federal regulators, SEC examinations of investment advisers and mutual fund complexes were based on cycles that the SEC anticipated would occur approximately every five years, with more frequent reviews as circumstances warranted and SEC resources allowed.

The SEC's current risk-based approach was introduced in 2003 and now drives the selection of inspection targets as a function of a firm's risk profile. To set examination priorities and goals, SEC examiners generally identify what they believe to be the most significant risks to investors, other registrants and the securities markets. Similarly, the examination itself focuses on the firm's risk management compliance culture and internal control processes.

In OCIE's view, risk-based examinations facilitate the SEC's investor protection objectives through evaluations of both the investment advisory firms themselves and the conduct most likely to pose harm to investors. OCIE approaches its risk-based methodology for determining examination targets from several perspectives and processes. OCIE asks examiners nationwide to identify what in their view are the most significant risks to investors, registrants and the markets.¹² OCIE senior management uses this information to assist in setting examination program goals and priorities for individual firms, as well as to determine whether to conduct sweep examinations on specific activities. OCIE's determination of firms to examine also is based on its analysis of "significant findings" from its prior examinations. OCIE also monitors news, new products and activities of firms, recurrent problems, trends and academic studies in determining target firms and conduct to examine. OCIE considers information it gathers from other SEC offices, including the Divisions of Enforcement, Investment Management, Market Regulation and Corporation Finance, and the Offices of Economic Analysis and Investor Education and Assistance (which receives and analyzes investor complaints). It also consults with bank, insurance and state securities regulators to better understand the most significant risks to investors and thus to set exam priorities.

2. Conduct of the Inspection

SEC inspections typically begin with a telephone call or letter from a regional office that specifies the date the examination is to begin and notifies the firm of documents that it must make available for inspection. There is generally no way of knowing when the SEC will notify a firm of the examination. The examiners generally choose the date at random or based on their own schedule. Since the SEC is

12. Mary Ann Gadziala, Associate Director, OCIE, Remarks at the SIA Compliance and Legal Division June Monthly Luncheon: Regulatory Examination Programs—Focus and Significant Findings (June 22, 2006), available at <http://www.sec.gov/news/speech/2006/spch062206mag.htm>.

not obligated to provide prior notice to a firm, the inspection can begin with a surprise visit by the examiners, although this is not typical for routine examinations.

The examination itself consists of several phases. It is conducted both at the firm's and the SEC's offices. The on-site portion of the examination, known as the "fieldwork," generally begins on the date specified in the notice of the examination. SEC staff will request an "entrance interview" with the firm's personnel, typically the chief compliance officer and possibly other officials of the firm. While on-site, the examiners review the requested records and interview firm personnel. These interviews may consist of questions about the documents produced, specific policies and procedures, and conduct at the firm generally. These interviews can play a critical role in the examiners' assessment of the firm's controls and risk environment.

The examination continues off-site at the SEC's offices, where the examiners continue to review the documents and other information they have received from the firm. The examiners may make follow-up telephone calls to ask questions, request additional documents and request written responses to certain questions to support the firm's responses. These requests for additional records may occur many weeks after the examiners complete the on-site portion of the examination. The examiners may use computer technology to analyze large volumes of data that the firm has produced. They also may consult with supervisors as well as OCIE and other SEC headquarters staff, such as the Division of Investment Management. Weeks or months can pass before the examiners complete their off-site review.

When the SEC's off-site review is complete, the examiners typically request the firm to participate in an "exit interview," generally with senior management of the firm. These interviews can be conducted in person or by telephone, generally as determined by the SEC staff. In the exit interviews, the examiners discuss their preliminary findings. For this reason, the exit interview is critically important. It provides the firm an opportunity to react quickly to adverse findings either by attempting to correct the examiners' perception of the facts and/or applicable law or by taking prompt corrective action to remedy problems.

The SEC staff also may contact firms between on-site examinations to ask questions by phone and/or request additional documents or written responses to questions on an expedited basis on specific issues, such as for a sweep examination. This facilitates the SEC's management and prioritization of sweep examinations and enables it to better focus on-site examinations.

3. The Inspection Outcomes

SEC examinations can result in several possible outcomes that range from no adverse findings at all to referrals to the SEC's Division of Enforcement for further action. In the vast majority of examinations, however, the outcome is the middle of the spectrum, in which the examined firm receives a deficiency letter. For example, the SEC examined 1600 investment advisers and registered investment companies in 2006. The vast majority—80 per cent—received deficiency

letters. Six per cent were referred to Division of Enforcement staff for further review.¹³

a. Deficiency Letters

Deficiency letters detail the examiners' findings regarding the firm's violations of laws and/or regulations, supervisory deficiencies and control weaknesses. These letters generally require the firm to respond to the SEC within 30 days of the firm's receipt of the letter with a detailed explanation of the steps the firm intends to take to address the issues that are identified in the deficiency letter. In general, the firm's response should, as appropriate, discuss in detail the reasons why the firm believes that the examiner's findings are erroneous, the explanations for any acknowledged deficiencies and most importantly, the steps the firm has taken or is taking to correct the deficiencies. The 30-day deadline is not inflexible, and firms should not hesitate to request an extension, if needed, since it is more important to respond adequately than quickly.

b. Letters Closing the Examination

Where the examiners make no findings regarding the firm's practices, policies and procedures or otherwise, the examiners send the firm a letter that concludes the examination and states that no findings were made. This is obviously an exceedingly good but rare outcome. As noted earlier, it happens only in a small percentage of the examinations.

c. Enforcement Referral

When examiners make a determination that the conduct, lack of supervision, policies or procedures or any other aspect of the firm's business may warrant further action by the SEC Division of Enforcement, OCIE will make an "enforcement referral." This determination is subjective and is made on a case-by-case basis, generally in consultation with the Division of Enforcement staff and the appropriate operating division. The decision may be reviewed by a committee of SEC staff from various divisions to determine whether a referral is appropriate given the facts and the applicable law. Conduct most likely to result in an enforcement referral includes violations that involve fraud, customer abuse, intentional wrongdoing and significant investor losses.

13. 2006 SEC Accountability Report at 12, *supra* note 3.

An enforcement referral is likely to result in an enforcement investigation. Although in egregious cases such referral may occur promptly after or even before the close of the inspection, in most cases it occurs only after review of the firm's response to the deficiency letter. To reduce the potential of such a referral, it is critically important to respond to any of the concerns expressed by the examiners during the exit interview if possible, and to respond thoroughly to the deficiency letter.

D. Handling the Inspection

1. The Essential Prerequisite: An Effective Compliance Program

Preparation for a positive SEC inspection must begin long before the commencement of the examination. Indeed, the preparation begins with the establishment of a strong compliance culture at the firm.

An effective compliance program lies at the heart of a strong compliance culture. Such a program includes (i) oversight of compliance not only by compliance personnel, but also supervisory business personnel, management oversight committees, and boards of directors; (ii) compliance standards, policies and procedures, including a code of ethics or code of conduct; (iii) exercise of due diligence in delegating responsibilities; (iv) communication, education and training; (v) monitoring and auditing; (vi) response, prevention and evaluation; and (vii) enforcement and discipline.¹⁴ The firm's policies and procedures should address at a minimum portfolio management processes, trading practices for proprietary and employee personal trading, disclosures, safeguarding client assets, recordkeeping responsibilities, fee assessments, privacy and business continuity plans. Investment companies' compliance programs should also include pricing of portfolio securities and fund shares, processing of fund shares, identification of and policies with respect to transactions with affiliated persons, protection of nonpublic information, market timing and fund governance requirements. Firms also should stay abreast of issues that the SEC considers "hot issues" and periodically review and update their compliance programs to the extent they have not adequately addressed these issues.

14. See e.g., Lori Richards, Director, OCIE, Speech before the National Membership Meeting of the National Society of Compliance Professionals (Oct. 19, 2006), available at www.sec.gov/news/speech/2006/spch101906lar.htm.

a. Tone at the Top

A firm's culture emanates from the top. As such, senior management has a critically important role in establishing and maintaining a strong compliance culture by making compliance a priority for the firm. This can be accomplished in a variety of ways, including allocating appropriate resources for compliance operations and internal reviews and establishing and effectively communicating the consequences of violating policies and procedures.

b. Qualified CCO

A highly qualified CCO is *sine qua non* of a firm's compliance program. Qualifications to be considered include the individual's (i) level of experience, especially relevant to the risk, size and complexity profiles of the firm; and (ii) ability to establish, maintain and review the firm's compliance program, conduct mock examinations with the assistance of outside compliance consultants and law firms, and effectively manage relationships with regulators and firm management. As discussed in more detail below, the CCO should have the stature necessary to effectively coordinate firm personnel for the SEC examination, and to be the primary interface with the SEC examiners during the inspection.

c. Effective Reporting and Documentation

Effective recordkeeping is essential to an effective compliance program. It is also critical to a positive outcome of a SEC examination. At a minimum, the firm must comply with applicable SEC and SRO recordkeeping requirements. In addition, the SEC examiners will expect the firm to promptly provide the records requested initially and throughout the examination. The firm's ability to meet the examiners' requests quickly and with ease will help establish a positive first impression with the examiners and help demonstrate that the firm maintains effective control of its operations. Conversely, disorganized recordkeeping, inability to respond promptly to examiners' requests for documents and/or recordkeeping violations, even if minor, can create a negative impression regarding the firm's overall compliance. A comprehensive recordkeeping matrix that identifies the regulatory records and other records that the firm otherwise maintains to support its business and the respective locations of the records will facilitate timely productions of the requested records.

d. Address Prior Deficiencies

The SEC will expect firms to address deficiencies that were raised in prior examinations. These issues may be the first areas to be examined, particularly if they

are associated with potential harm to investors, the markets, or the firm's business. The possibility of enforcement action is significantly enhanced if a firm fails to address prior criticism, particularly if the criticism has been raised in multiple examinations.

2. Managing the Process

Once the SEC examiners arrive at the firm, it is essential that the firm effectively manage the interactions with the examiners, production of records and responses to their questions. The examination will run more smoothly, and the firm will have better control over the process, if it designates a single contact for the examiners. In addition, setting the right tone and evidencing a strong compliance culture from the outset will serve the firm well throughout the examination and ultimately could affect the outcome. In this regard, the firm's senior management can help demonstrate the priority it places on compliance by being available to meet with the examiners at the initial entrance interview, even if the SEC has not requested that they be present.

a. Designate the Right Exam Coordinator

The person responsible for coordinating the examination for the firm should be someone who understands the examination process, the firm's compliance program and potential consequences of a mishandled examination. The person's stature at the firm should be sufficiently senior so as to further evidence to the examiners the seriousness with which the firm considers the examination and compliance generally. This person frequently will be the firm's CCO or general counsel or a senior member of their staffs.

i. Exam Set-up

At the outset of the examination, the firm's coordinator should introduce him or herself to the examiners and indicate to them that all requests for information, including requests to speak with the firm's personnel, should be made to the coordinator.

It also is important to designate a specific office or conference room where the examiners can perform their work. The workspace should be well-lit and have adequate space for the examiners to do their work. This will serve the dual purpose of making the examiners comfortable and limiting their access to employees. All employees in the vicinity of the examiners' work room should be informed of the presence of the examination staff and that it is imperative that all conversations be conducted in offices and not in hallways.

ii. Exam Type and Focus

At the beginning of the examination, it is important for the coordinator to ask the examination staff about the type of exam (regular, for cause or sweep exam) if this is not already known. Often, the initial notice and/or request for documents before the examination begins will provide this information, but if not, it is important to find out at its inception.

Similarly, the coordinator should inquire about the focus of the examination. Although this may be evident from the initial document request, fully understanding the areas that the examiners will cover can be helpful to handling responses to the examination staff. If the firm has any cause for concern about areas that the examination will cover, the coordinator should inform the CCO (if the CCO is not the coordinator) and possibly the firm's legal counsel. Consideration should be given to identifying any problem areas to the examiners before they find them on their own.

b. Prompt Responses to Requests

Cooperation with the examination staff is key to a successful examination. Responding promptly to examiners' requests is essential.

The coordinator should be responsible for overseeing the gathering, review and copying of all documents that the examiners request. All documents should be reviewed before they are turned over to the examiners to ensure that privileged and irrelevant materials are not provided. The coordinator should confer with counsel before producing any documents if the coordinator or anyone else at the firm has any questions about the scope of the document request, including whether some of the documents may be privileged. Documents and other information to be furnished also should be thoroughly examined prior to production from the viewpoint of a regulator's perception and consideration given as to whether any information that may raise questions should be accompanied with appropriate explanations. Copies and/or records should be made of all documents that are produced, and careful notes should be taken of all interviews that are conducted. In other words, the firm should create an adequate record of the entire examination so as to be able to reconstruct the information that was provided to the examiners both in written form and orally.

Although a flat refusal to produce records to which the examination staff has a right to review is not wise, one should not hesitate to seek clarification of the scope of a request if the document request is unclear or will require production of an excessive number of documents. Often the examination staff has no idea of the extent of documents that will be responsive to its request and can be persuaded to narrow it after being informed of the number of documents involved. In any event, such a discussion can be invaluable in shedding light on the purpose of the staff's request.

c. Preparation of Interviewees

Thorough preparation of employees who the examiners seek to interview is critical to successfully managing the examination. Well-prepared employees will be less nervous and better able to respond effectively to examiner questioning. The coordinator should also be the focal point for requests for interviews and preparing firm personnel who will be interviewed. Prior to any interview, the firm's CCO and/or legal counsel should meet with the employee to explain the interview process, offer guidance on what to expect and how to respond. The person should be prepared for the interview as if testifying at an SEC investigation. The employee to be interviewed should understand the importance of being honest, calm, polite and cooperative. It is essential that employees understand that although they should be responsive to the examiner's questions, employees should not volunteer information that is not requested and never guess at an answer. All interviews of firm employees should be attended by someone from either the legal or compliance department to protect the employee's rights and to prevent the disclosure of irrelevant or privileged information. This will also assist the firm's understanding of the focus of the examination, enable it to assess potential issues or preliminary findings and to consider taking prompt remedial action during the pendency of the examination. Careful notes should be taken during the interview or immediately afterward to maintain a record of the substance of the interview.

3. Relating to the Examiners

As noted above, establishing a cooperative rapport with the examination staff is key to handling an examination successfully. So, too is facilitating an efficient process. Both the firm and the examination staff will benefit from an examination that runs efficiently. The sooner the examiners leave the firm's premises, the sooner the firm can resume business as usual. The examination staff has its own schedule to keep and it is to the firm's benefit to enable the staff to keep to it. The longer the examiners remain at the firm's premises, the greater the likelihood of their uncovering something that might not have been a focus of the examination and that could be the subject of a deficiency letter. Accordingly, the firm should do whatever it can to enable the SEC staff to conclude the inspection as quickly as possible.

Responding promptly to the examiners' requests for information is a first step. In addition to moving the process quickly, prompt responses can leave the positive impression that the firm is well-organized, has recordkeeping under control and is otherwise well managed. The firm should provide affected personnel and any outside counsel with notice of an upcoming examination and the likelihood that they will be requested to review documents or be available for interviews on short notice so that there is no time lost in waiting.

4. The Importance of Candor

The importance of truthfulness cannot be over-emphasized. False or misleading statements to an examiner not only undermine the firm's credibility, but they are also a federal criminal offense if deliberately made.¹⁵ Several steps will enable the firm to maintain its candor with the examination staff.

All personnel should be honest with the examiners at all times. Regulatory problems can only become more serious if personnel are not truthful about the firm's activities. Moreover, when faced with document requests that relate to a troublesome matter, it often is wise to call the examiners' attention to it before they find it themselves. In this regard, the examiners tend to be more understanding of conduct that constitutes a violation of the rules when firms inform the examiners that the firm has discovered such conduct and the steps the firm has taken to correct it. Such disclosures should only be made, however, after careful consideration with experienced enforcement counsel.

Commitments made to the SEC, particularly those made in response to deficiency letters, should be fulfilled. Failure to correct conduct cited in a deficiency letter can leave the staff with a variety of negative impressions, including that the firm does not consider compliance a priority, that the firm does not deliver on its commitments generally, and/or that the firm is disorganized and does not remember commitments that it makes. Repeated failures to correct adequately a cited deficiency can lead to an enforcement action, even where the conduct did not lead to any identifiable harm to clients.¹⁶

5. Maintaining Confidentiality

Information that the firm produces in the context of an SEC inspection is likely to include confidential business information, such as client names, strategies, product information and compensation information. The information can be subject to disclosure to numerous sources, including competitors and the press, pursuant to Freedom of Information Act (FOIA) requests. It is therefore essential for the firm to take precautions to minimize the likelihood of any such disclosures.

15. 18 U.S.C. § 1001 (2006).

16. Indeed a failure to correct prior deficiencies led to the first enforcement action under the new Advisers Act Compliance Rule, Rule 206(4)-7. *See* CapitalWorks Inv. Partners, LLC and Mark J. Correnti, Inv. Advisers Act Release 2520, 2006 SEC LEXIS 1306 (June 6, 2006). *See also*, for example, Gofen and Glossberg, Inc., Advisers Act Release No. 1400, 1994 SEC LEXIS 99 (Jan. 11, 1994) (custody violations); Howard M. Borris & Co., Inc., Advisers Act Release No. 1460, 1995 SEC LEXIS 31 (Jan. 9, 1995) (books and records, custody and reporting violations); Louis E. Sharp, Admin. Proc. No. 3-8590, 1995 SEC LEXIS 35 (Jan. 11, 1995) (books and records, reporting and cash solicitation rule violations); and Stephen C. Schulmerich, et al., Advisers Act Release No. 1358, 1993 SEC LEXIS 22 (Jan. 4, 1993) (books and records and reporting violations).

The firm can request confidential treatment under FOIA. The SEC has established procedures for requests for confidential treatment.¹⁷ The procedure generally affords the party who produced the documents to object to their disclosure if they are requested pursuant to FOIA.

The firm also can request that produced documents be returned. Although the SEC retains some documents that are produced during an inspection, it frequently does not need to keep all of them. The firm's request for return of documents should be made in writing.

E. The Limits of the SEC's Inspection Powers

Although the SEC has broad powers to conduct inspections and examinations of Regulated Firms, its authority is not without its limits. For the vast majority of firms, however, a detailed discussion of these limitations is more theoretical than real because the primary objective in handling an SEC examination is not to win an argument. Rather, it is to do whatever is appropriate to demonstrate a "low risk" profile in order to limit the length of the current inspection and to enlarge as much as possible the period before the next inspection. This cannot be accomplished by stubbornly contesting the SEC's authority. Such a contest should be reserved for those few cases where it seems likely that the inspection will end with a recommendation for an enforcement investigation, and it is necessary to assume a defensive posture during the inspection process.

Nevertheless, a general awareness of the limits of the SEC's inspection authority is helpful to managing the process in a way that minimizes its burdens. Any discussion of the legal limitations on the SEC's power of inspection should start with the Fourth Amendment to the Constitution.¹⁸ The SEC's statutory authority to conduct examinations of books and records of broker-dealers, investment advisers, investment companies and other Regulated Firms is a judicially created exception to the restrictions against unreasonable search and seizure imposed by the Fourth Amendment. Thus, the courts have held that power of an administrative agency to inspect books and records is consistent with the Fourth Amendment prohibitions as long as (1) the inspection pertains to a commercial business operating in a regulated industry; (2) the examination is relevant to the regulatory purposes; (3) its scope is clearly defined and limited and (4) it is known to the regulated firms.¹⁹ On

17. Confidential Treatment Procedures under the Freedom of Information Act, 17 C.F.R. § 200.83 (2006).

18. The Fourth Amendment provides in pertinent part: "The right of the people to be secure in their persons, houses, papers and effects against unreasonable searches and seizures, shall not be violated."

19. *Colonnade Catering Corp. v. United States*, 410 F.2d 197, 202 (2d Cir. 1969) rev'd on other grounds, 397 U.S. 72 (1970). *See also*, *United States v. Biswell*, 406 U.S. 311 (1972), where the Supreme Court upheld statutory authority to conduct surprise inspections of firearms dealers. *But see*, *Marshall v. Barlow's Inc.*, 436 U.S. 307 (1978), holding that Fourth Amendment prohibited an OSHA inspection without a search warrant.

this basis, the Court of Appeals for the Second Circuit has specifically upheld the SEC's power to inspect the records of a registered investment adviser against a Fourth Amendment challenge.²⁰ The court justified its decision on the basis of legislative history that indicated a Congressional finding that the availability of investment adviser records for inspection was necessary for effective regulation so that the records were deemed "characteristic of quasi-public documents and their disclosure may be compelled without violating the Fourth Amendment."²¹

At one time, the SEC's inspection powers were limited to books and records required to be kept under agency rules. In 1975, however, the relevant statutes were amended to authorize the SEC to examine all records maintained by Regulated Firms, and the SEC now takes the position that its examination authority is unconditional and unlimited except for the requirement that any such examination be "reasonable."²² Armed with this broad grant of authority, the SEC has not hesitated to seek the assistance of the courts to prevent a Regulated Firm from interfering with the SEC's right of inspection²³ and later to take disciplinary action against the defendant for violation of SEC rules mandating availability of records for inspection.²⁴

Moreover, the courts have made clear that various constitutional rights are unavailable during an SEC inspection. These include the privilege against self-incrimination by an individual or sole proprietorship registered with the SEC as an investment adviser and the right to representation by counsel, although as a practical matter, the SEC staff does not object to such representation. In addition, the self-evaluation privilege in all likelihood, would not be recognized.

Notwithstanding the SEC's broad examination powers and the concern over inciting an enforcement referral by contesting an OCIE information request, firms should not hesitate to question the request in a professional and non-contentious manner if it appears excessively burdensome or otherwise appears to exceed the limits of the SEC's inspection authority. In this connection, the Fourth Amendment requirement of "reasonableness" is the most important limitation on the SEC's authority, and one that the SEC itself readily concedes, at least in theory. In the context of an enforcement investigation, the courts have on rare occasion refused to enforce a subpoena that is unreasonably broad in scope.²⁵

20. SEC v. Olsen, 354 F.2d 166, 170 (2nd Cir. 1965)

21. *Id.*

22. Lori Richards and John Walsh, *Compliance Inspections and Examinations by the Securities and Exchange Commission*, 52 BUS. LAW. 119 (1996)

23. See, SEC v. Barr Fin. Group, Inc., SEC Litig. Release No. 16159, 1999 SEC LEXIS 1047 (May 24, 1999); SEC v. Hammon Capital Mgmt. Corp., SEC Litig. Release No. 8580, 1978 SEC LEXIS 427 (Oct. 17, 1978).

24. In re Hammon Capital Mgmt. Corp., 47 SEC 426 (Jan. 8, 1981) (registrant suspended for 90 days for failure to make its records available for inspection)

25. See e.g., SEC v. Sange, 513 F.2d 188 (7th Cir. 1975) (subpoena enforcement denied because it required "mass removal of business records").

It is important to note that the aggressiveness of the examination staff in exercising the inspection power appears to vary somewhat with the prevailing regulatory climate. For example, in the year following exposure of mutual fund market timing issues with the September 2003 filing of the Canary Partners complaint by the New York Attorney General, SEC examiners were particularly aggressive in making exceedingly broad demands for almost immediate production of emails and other documents. Since that time, the staff's aggressiveness has moderated considerably but the legacy of that year seems to linger on, particularly with respect to exceedingly broad requests for email production. At the same time, OCIE, particularly its top management, generally recognizes the need to accommodate legitimate objections to scope of information requests and the time allowed to comply with such requests.

Accordingly, it is entirely appropriate for an investment adviser or broker-dealer faced with information requests that are exceedingly difficult or impossible to comply with to seek to negotiate more reasonable bounds to the request and if necessary, to escalate the matter within the examining staff. Such efforts, however, must recognize that the courts have been reluctant to curb the inspection powers of regulatory agencies. In any event, care should be exercised to raise questions concerning burdensome information requests in a manner that does not lead to a staff perception of bad faith in responding to their requests or that the firm is unable to do so.

In addition to staying within the bounds of reasonableness, the SEC and its staff cannot pursue a course of conduct designed to mislead a firm during an inspection. Thus, in one case, a court of appeals refused to enforce an SEC subpoena based on information obtained under circumstances where SEC staff members pretended to be seeking general background on industry practices when in fact they were conducting an informal enforcement investigation.²⁶

Finally, it should be noted that the Privacy Act of 1974 requires that SEC requests for information in connection with an investigation be preceded or accompanied by notification of (1) the authority and purpose of the request, (2) the routine uses to be made of the information requested, (3) the voluntary or mandatory nature of the request and (4) the consequences, if any, of a failure to produce the information. The Privacy Act requirements serve the important purpose of preventing the SEC from conducting undercover or sting operations under the guise of an inspection. It does so by requiring that the SEC staff disclose whether it is seeking information pursuant to its inspection or its law enforcement powers.

26. SEC v. ESM Gov't Sec., Inc., 645 F.2d 310 (5th Cir. 1981).

F. The Current State of the SEC's Inspection Program

Needless to say, despite a seemingly robust inspection program, the SEC was seriously embarrassed by the fact that widespread market timing and late trading abuses in the mutual fund industry were first exposed by New York Attorney General Spitzer's filing of the Canary Partners complaint in September 2003. That failure led to a suggestion by one SEC Commissioner that the Commission should consider abolishing OCIE and reintegrating the inspection program into the operating Divisions of the SEC primarily responsible for the regulation of the investment management and the broker-dealer industries.²⁷ Such action would be based on the theory that the integration would provide for better interaction with the day-to-day "front line" experience of the Commission's regulatory personnel. Legislation to this effect has been introduced in the Congress but thus far not seriously considered by the Congress, reflecting the dominant view both inside and outside the Commission that more moderate measures might be taken to improve coordination between OCIE and the operating divisions and to enhance the ability of OCIE to detect previously unrecognized compliance abuses.

Much of the criticism of OCIE's inspection program arising from the mutual fund market timing abuses reflects the wisdom of 20/20 hindsight vision. While market timing was considered a low-risk compliance issue by OCIE, it also was largely below the regulatory radar of the Division of Investment Management. Moreover, for the most part, the "sticky asset" deals that characterized some of the market timing scandals were largely unnoticed by the industry compliance and legal counsel outside the Commission. They sometimes viewed the prevention of market timing as offering a difficult policing challenge, but never as one that involved the active complicity of marketing and other personnel within their organizations.

Nevertheless, the lessons learned from the market timing debacle has led to substantial changes in the focus of the SEC's inspection program. First, OCIE and the examination and enforcement staffs will never again ignore email communications. Indeed, the ability to retain and retrieve electronic communications in response to broad ranging email requests has emerged as an important challenge to all firms subject to SEC regulation. Second, OCIE, in constructing its risk-based examination priorities has responded to criticisms of a GAO study,²⁸ by focusing

27. Paul Atkins, Commissioner, SEC, Remarks before SEC Speaks in 2005 (Mar. 4, 2005), <http://sec.gov/news/speech/spch030405psa.htm>.

28. "Mutual Fund Trading Abuses: Lessons Can Be Learned from SEC Not Having Detected Violations at an Earlier Stage," GAO-05-313 (Apr. 2005), available at: <http://www.gao.gov/new.items/d05313.pdf>. See also "SEC Mutual Fund Oversight: Positive Actions Are Being Taken, but Regulatory Challenges Remain," GAO 05-692T (June 7, 2005), available at: <http://www.gao.gov/new.items/d05692t.pdf>.

much more intently on potential conflicts of interest as perceived not only by its staff but also those appearing in academic studies. Some of these studies had warned of large scale market timing within the mutual fund industry before the filing of the Canary Partners complaint. Third, in another attempt to “stay ahead of the curve” OCIE has relied since 2003 extensively on sweep exams which seek to identify potential problems before they become widespread industry scandals. Fourth, and most importantly, OCIE is placing great emphasis on the implementation of the SEC’s Compliance Rule,²⁹ by seeking to interact extensively with the Chief Compliance Officers for mutual fund complexes and investment advisers, and by reviewing periodic CCO reports to fund board of directors.

OCIE’S new tactics are not without controversy. Industry critics have been complaining of the growing burden and intrusiveness of SEC information requests in connection with inspections. They also have complained of intolerance on the part of the examiners over delays and errors in the production of information as well as the use of inspections to encourage if not mandate compliance practices that are not required by SEC rules. There also is a concern that information is being gathered for enforcement purposes without the procedural protections incident to an enforcement investigation. In addition, firms have complained of the stridency of OCIE deficiency letters which frequently levy charges of serious violations based on a faulty understanding of the facts or an unwarranted application of regulatory requirements. This stridency is particularly disturbing because the deficiency letters often have to be disclosed to existing and potential institutional clients and to auditors.

Many of these criticisms reflect an industry reaction to the SEC staff’s initial response to the market timing debacle. With the passage of time, OCIE and the examination staff have curbed somewhat its aggressive demands for document production, indicated it would limit the use of sweep inspections, moderated the tone of its deficiency letters and often offered the registrant opportunities to discuss issues with examiners before they draft their inspection report and issue the deficiency letter. Nevertheless, despite the recent signs of moderation, the impact of the market timing scandal has left a seemingly indelible mark on the SEC inspection program. It has raised the burden and risks of an SEC inspection to levels that far exceed pre-2003 levels.

SEC inspections of broker-dealers, investment advisers and investment companies, and other regulated entities provide the most frequent occasions for interaction between these entities and the SEC. They are also the most frequent sources of enforcement investigations against these entities. Indeed, it is virtually certain that every broker-dealer, investment adviser, and investment company will be inspected by the SEC and that, on occasion, these inspections will detect serious deficiencies.

29. Advisers Act Rule 206(4)-7, 1940 Act Rule 38a-1 (2006).

Given the frequency and potential importance of SEC inspections, it is essential for entities that are subject to SEC inspection powers to understand the inspection process. As explained below, SEC inspections are governed by somewhat different legal constraints than those that apply to investigations typically conducted by the Division of Enforcement.