IGNITES
A Financial Times Service

Print | Close Window

Surprise! The SEC Revives Unannounced Exams

By Jill Gregorie August 25, 2017

For roughly the past year, SEC examiners in Boston have been showing up at advisors' doorsteps unannounced to ensure shops don't do any last-minute prep work before their regulatory inspections.

By catching firms off guard, the Securities and Exchange Commission can gain a better perspective on how a firm operates when it thinks nobody is watching, Kevin Kelcourse, the SEC's associate director for examinations in the Boston regional office, told *ACA Insight* last week.

"There is anecdotal evidence to support the contention that some firms are cleaning up a bit after we announce exams, but before we arrive," Kelcourse told *ACA Insight.*

Traditionally, SEC staff initiate exams by sending a document request list and specifying when they plan to arrive on-site for inspections, says Danielle Joseph, director of the ACA Compliance Group.

As recently as mid-July, though, Boston-based inspectors have instead been appearing in advisors' lobbies and asking to meet with the fund company's chief compliance officer, a lawyer told *ACA Insight*.

Reports of unexpected visits have been distressing to many Boston-area advisors, "particularly since it's the summer and some employees are on vacation," the lawyer said.

Summer or not, roughly a quarter of managers believe they would flunk if they were to face a sudden exam, according to results of a separate survey.

Similarly, about a third of executives at broker-dealers and 43% of executives at alternative managers lack confidence in their firms' ability to meet examiners' expectations, according to the results of an online survey of 204 C-suite leaders conducted by Cipperman Compliance Services between July 18 and August 3.

One reason firms may feel ill-prepared is that SEC exams have become more narrow in focus. Adding to that pressure, the new administration has not yet made clear which risk areas it intends to target, says Kathleen Malone, an attorney and managing director in **Duff & Phelps**'s compliance and regulatory consulting practice.

"Usually we get more specific guidance from the SEC in the beginning of the year, but Mary Jo White was leaving right after the exam priorities came out, so we've been seeing different kinds of sweeps," she says.

The exam priorities that the SEC did put out were also very broad, Malone notes.

One way for shops to ensure they are not caught off guard is to seek a document request list assigned to a firm in the past, and then run through the steps of procuring each item with staff, ACA's Joseph says. Similarly, firms should seek an overview of questions that SEC examiners typically ask during one-on-one interviews with staffers, and rehearse answering those.

It's important to prep every employee, since "you may have a general idea of who the SEC exam staff is going to interview, but there is the possibility that they can talk to anyone at the firm," Joseph says.

Shops should also run tests to ensure the written policies match what they do in practice, and correct one or another if they are out of sync, since examiners are increasingly checking on such discrepancies, says David Rishel, partner and COO at **Hardin Compliance Consulting**.

These assessments can reveal the "ticky-tacky things they should be doing" but may overlook because they've already confirmed they comply with larger, more obvious concerns such as preventing negligence and fraud, Rishel says.

Routine testing can also help firms undergoing examinations by uncovering concrete proof that policies and procedures are working in case examiners question them, says Don Andrews, a partner and global practice leader of the Risk and Compliance Group at **Reed Smith**.

"If you say you have policies and procedures that are adequate to perform this or that function, you need to provide testing that backs that up from an evidentiary standpoint," he says.

Firms should keep records of every compliance test and risk assessment, since "the SEC doesn't believe anything happened unless they see it in writing," Rishel adds.

Firms should also understand that compliance cannot be tackled in "one fell swoop," since procedures need to adapt to evolving regulatory demands, as well as new requirements that may apply when the business launches new products or enters a new business line, says Bill Mulligan, CEO of Cordium.

One effective approach to making a compliance program both comprehensive and up-to-date is fixing batches of problems they identify and and then immediately moving on to the next set, he says.

"If the SEC goes into a shop and they have a lot of broken windows, or a lot of little problems, the regulator will change their posture and assume, 'Wow, this is a shop that just doesn't take their regulatory requirements seriously,' and will end up doing a much more intensive exam," Mulligan says.

While the sight of an SEC examiner may be jarring, routine internal testing and incremental efforts to address compliance gaps can put firms in the best position for an exam — even if they're unlikely to ace it, says Amy Lynch, founder and president of FrontLine Compliance.

And statistically, not many firms do. Across all regions, about 70% of exams result in deficiency letters, and roughly 10% are referred to the enforcement division, Peter Driscoll, acting director of the Office of Compliance Inspections and Examinations, said at an ICI regulatory conference in March.

"No one ever feels 100% ready for an exam, but most firms get through it — I wouldn't say unscathed, because when you look at the percentages, most firms get deficiency letters — but they won't get fined or sent to enforcement, and that's OK," Lynch says.