

# Preparing for a FINRA Cycle Examination

This is another installment in our “What to Expect” webcast series on FINRA’s regulatory processes. In this one, we focus on what your firm can expect during a FINRA cycle examination.

FINRA conducts about twenty-three hundred cycle examinations each year to determine whether firms are in compliance with federal securities laws, rules and regulations. We understand that the arrival of FINRA examiners at your firm may cause some anxiety—especially if it’s your first examination, or if it has been a while since your last one.

In this webcast, we explain more of what you should expect from us as well as what we expect from you.

We also highlight some enhancements to our examination program in light of the consolidation of NASD and NYSE Regulation in 2007—which takes advantage of both organizations’ practices. And, for those firms previously registered with both FINRA and the NYSE, your sales practice and FINOP examinations will be conducted simultaneously by a single team of examiners now that we have a fully integrated Member Regulation examination program.

We hope you find this webcast helpful and that it takes some of the mystery out of FINRA’s examination process.

## Types of Exams

FINRA conducts more than two thousand cycle examinations each year. While we perform other types like cause exams, branch exams and market regulation trading and market making exams, it's our cycle examinations that comprise the bulk of our field work. These exams touch every firm. Here is a breakdown of FINRA exams:

<b>Cycle Exams</b>	Determine whether firms are in compliance with federal securities laws, rules and regulations
<b>Cause Exams</b>	Conducted in response to customer complaints, terminations for cause and other events
<b>Branch Exams</b>	Examine high-risk branches for compliance with federal securities laws, rules and regulations
<b>Market Regulation Exams</b>	Focus on compliance with rules related to trading, market making surveillance and market conduct
<b>Sweeps</b>	Coordinated sets of exams regarding practices, products or areas of interest that cut across the industry

## Exam Timing: Why My Firm?

FINRA's exam process is risk-based, which means that the approach for identifying firms for examination is based less on the calendar and more upon risk, scale and scope of firm operations. Based on an assessment of these factors, cycle examinations are performed periodically—on a one-, two- or four-year cycle. The risk assessment is performed annually, so it's possible that your firm's cycle may change from one year to the next.

Since exams are risk-based, their content and scope will vary firm-to-firm. For example, a cycle examination may primarily focus on a firm's financial and operational condition, or, alternatively, on its sales practices—but not necessarily both. In any case, it is important to know what to expect from your next exam.

## The Exam Process

### Preparing for an Exam

The assigned FINRA examiner will typically call your firm to alert you to an upcoming exam as much as 30 days before fieldwork begins, which doubles the 15 days advance notice previously provided for NASD exams. During that call, the examiner will inform you of the date examiners plan to arrive on site. Unfortunately, FINRA is unable to accommodate requests for the exam date to be pushed back since we need to schedule and conduct over twenty three hundred exams each year.

To minimize the time in your office and business disruption, your FINRA exam team conducts extensive pre-exam prep work of your firm and its activities before the onsite inspection. This also helps examiners focus their inquiries to best fit your firm’s business model. To conduct this phase, your assigned examiner will ask you for certain documents during the initial call. These requests vary, but can include your Written Supervisory Procedures, Business Continuity Plan, Anti-Money Laundering procedures and financial records. You will usually receive follow-up correspondence from the examiner to confirm your conversation.

Shortly after the call, your firm’s Chief Executive Officer will receive a Cycle Announcement Letter from FINRA by mail. This will be sent to your firm’s address on record in the FINRA contact system. It is the formal notice of the exam and will provide you with a brief process overview.

Soon after receiving this letter, your firm will be asked to review and update information on file with FINRA through a secure Web site, known as Web IR, which stands for Web Information Request. Your firm will use it to answer questions about its structure and business activities. Generally, you will be given 14 days from the time you receive the Web IR to complete and submit it.

FINRA examiners review the submitted information along with other documents like previously filed FOCUS reports, annual audits and other information that resides in regulatory systems.

Next, the examiner will prepare an Initial Records Request, which is a list of documents that must be available to the examiners when they arrive at your firm for the onsite inspection. This list—along with a cover letter explaining the request—will be sent to your firm by email. It is important for your firm to address this request as soon as it arrives so that you have the requested documents gathered and ready for the examiners on the first day of the onsite examination.

### Exam Preparation Tips

- ▶ Determine which employees at your firm will be responsible for each area of the exam and have them start gathering the requested information as quickly as possible.
- ▶ Make copies of specific records the examiner needs ahead of time. It is important to note that except under very limited circumstances the examiners will not remove original documents from your firm.
- ▶ Organize documentation in order of the request.
- ▶ If you run into difficulties making any requested documents available, contact your examiner as soon as possible to discuss a solution. Examiners will work with your firm to prioritize the production of the documents requested.

Part of our exam focusing includes reviewing your firm's most active areas of business—but this does not mean that the examiners will not look into other areas. FINRA is required to perform inspections to determine compliance with a wide range of federal securities laws, rules and regulations. Customer complaints, anti-money laundering, supervisory controls, net capital adequacy and customer asset protection are all areas of inquiry for virtually every examination. Also, the SEC requires FINRA to examine firms engaged in municipal securities business every two years. And sales of 529 plans are included in these exams since they are municipal securities. Firms should also periodically look at FINRA's Web site under “Improving Exam Results” for information about our examination priorities and ways to potentially avoid frequently found violations. These priorities are often areas of review on our cycle examinations.

### The Onsite Examination

When examiners arrive at your offices, you should first expect that they will schedule an initial meeting with your firm's key personnel. This will include firm personnel who will interact with the examiners, as well as senior staff with compliance and supervisory responsibilities. It may include executives up to your firm's CEO. This meeting will generally kick off your firm's onsite exam. There is also a FINRA Exam Manager assigned to every firm who supervises the exam team's work, that person may also attend.

This initial meeting will begin with introductions. The examiners will ask for the documents that were requested in advance and will explain the nature and scope of the exam, then ask you to identify your firm's key staff member and contact for each review area. The examiners will also identify which examiner will be the primary point of contact for the exam. He or she will ensure that there is effective communication between the examiners and the firm's personnel, and to prioritize document requests and other aspects of the exam.

To address document requests that may come up as the examination is conducted, FINRA staff will ask you for your preferred process for these requests while on site. The examiners will inform you of the anticipated length of the onsite exam and may request additional documentation or records that were not previously requested. FINRA staff may also ask for a tour of your offices. Finally, during this meeting, the examiners will usually review with you the process for closing out the exam.

Next, you should review logistics with the examiners—such as the location in your offices where the examiners will work, and if there is restricted access to the building or floor, or time constraints on getting into or out of your offices. Since examiners often need to keep copies of some records, please make a copying facility available for them to use. And, if you can provide someone to assist with copying, that will help speed up the exam.

During the initial meeting, be sure to ask your examiners any questions you may have about the process.

Cooperation and communication is key to a successful exam. So, please work with the examiners. If they find possible exceptions or potential violations, determine whether the firm can remediate the situation during the onsite exam.

It is important to note that while preliminary findings may be identified on site, examiners generally do not conclude during the onsite inspection whether violations have occurred. Rather, the onsite examination is focused on analyzing relevant information and obtaining any additional information deemed necessary, as well as making preliminary observations about compliance or if it is lacking.

Once the onsite review is complete, the examiner will conduct an Exit Meeting with key principals of your firm to review preliminary findings and any potential violations. An Exit Meeting Report will be prepared and provided to you. It describes the potential problems, open items, recommendations and other observations. The goal of the Exit Meeting is to quickly alert your firm to possible weaknesses so that you can gain immediate benefits from the onsite inspection and determine if corrective action is warranted. Your firm will be asked to sign the Exit Meeting Report to indicate receipt.

### Onsite Exam Tips

- ▶ Make a workspace available for the examiner.
- ▶ Make sure the examiner has access to a copier or copying facilities—and, if possible, assistance.
- ▶ Coordinate schedules of principals, supervisors and managers who may need to be interviewed.

## Completing the Exam

After the Exit Meeting, FINRA examiners return to their office and complete the exam. Examiners talk with the Exam Manager and sometimes with FINRA staff attorneys, and perform the research necessary to reach informed and supportable conclusions. The examiner will then prepare an Examination Report that is forwarded to FINRA management for review and approval. It includes a summary of what was reviewed during the course of the examination, as well as exceptions and recommendations.

Once approved, the Examination Report is final and will be sent to your firm’s CEO along with a cover letter. If no exceptions are found, the exam will be considered complete. However, if exceptions are found, the Examination Report will include these and your firm will be required to submit a formal written response to FINRA that identifies the corrective action the firm has either taken or planned. If FINRA finds the response or corrective action to be inadequate, FINRA will request a follow-up response.

How exceptions or potential violations are handled is determined by your FINRA examination team in consultation with FINRA management and our Enforcement Department. Once this occurs, an Examination Disposition Letter is sent to your firm. If there were any exceptions noted during the examination, this letter informs you of their disposition, which could include:

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| <b>No Further Action</b>     | No violations are being cited  |
| <b>Cautionary Action</b>     | A warning that similar violations in the future could result in a formal disciplinary action   |
| <b>Compliance Conference</b> | A more serious type of informal action that involves a meeting between FINRA management and representatives of your firm to discuss the violations noted during the examination. |

The vast majority of our examination exceptions are resolved through one of the disposition types just mentioned. Also, these informal dispositions are not reportable on Forms U4 or BD. That said, in some cases, exceptions may require a more formal resolution with referral to FINRA’s Enforcement Department for review.

## Resolving Differences

At times, differences may come up between examiners and member firms. You can always talk with your examiner about any questions or comments you may have. But understand that FINRA exam staff perform a critical regulatory and investor protection function and must make the final call on the timing, topics and scope of a particular exam.

If you have a difference that you cannot resolve directly with the examiner, contact the FINRA Exam Manager. He or she is charged with ensuring high standards of professionalism and accuracy, and will take all issues seriously and will respond promptly. It is FINRA policy that our Exam Managers contact the firm and the examiners during the course of the onsite examination to answer any questions or address any issues. As an additional step, you can also contact FINRA senior management. Another option is to contact FINRA's Office of the Ombudsman, which receives and addresses concerns and complaints from any source concerning the operations, enforcement, or other activities of FINRA.

## Benefits of an Exam

A FINRA exam is an excellent opportunity to take a thorough look at your internal policies and procedures, and to strengthen them. Most exceptions found during cycle exams are resolved through an informal disposition. This means that your firm can fix problem areas and improve procedures and internal controls without any disciplinary action or reportable event placed on its record. But, remember that repeat violations of even minor exceptions are taken seriously and may result in a formal disciplinary action.

So, when exceptions are noted, update your firm's written supervisory procedures and take any corrective action needed to make sure problem areas are addressed and do not recur.

Many firms also view an exam as an opportunity to educate employees on compliance and supervision—and, to clarify the distinction between these two functions. Also, concerns raised by the exam that relate to registered representative activity—like sales practice issues—should be addressed in your Continuing Education Needs Analysis and incorporated into your Firm Element Training Plan.

**Resources:**

**Letter Highlighting Exam Priorities**

[http://www.finra.org/web/groups/corp\\_comm/documents/home\\_page/p038169.pdf](http://www.finra.org/web/groups/corp_comm/documents/home_page/p038169.pdf)

**Written Supervisory Procedures Checklist**

<http://www.finra.org/WSPchecklist/>

**Improving Exam Results**

<http://www.finra.org/RulesRegulation/ComplianceTools/ImprovingExamResults/index.htm>