If You Give a Regulator a Record …
(How to Handle Requests for Information from Regulators)

by Cheryl L. Haas-Goldstein and Gregory S. Amoroso

While recently assisting a client with a regulatory investigation, we reviewed a multi-page follow-up request letter and it reminded us of a children’s book we have read. In the book, *If You Give a Mouse a Cookie* by Laura Joffe Numeroff, a young boy gives a mouse a cookie which leads the mouse to request some milk to go with it, which leads the mouse to request a napkin, which leads to a series of other requests ending with the mouse requesting a second glass of milk, the house a disastrous mess and the boy simply exhausted.

Much like the mouse in the story, the SEC, self-regulatory organizations and state securities regulators (collectively, the “regulators”) are rarely satisfied with a simple one-time request. Instead, each request tends to lead to additional requests with subsequent requests often more demanding than the previous. To make things even worse, it appears the regulators are no longer satisfied with requesting just those records required to be maintained pursuant to SEC Rule 17a-3. Instead, the expectation has grown from firms providing those required records to creating customized reports often requiring manual coding at the regulator’s request. This approach by the regulators became more apparent with the Breakpoint Assessment in 2003. Since then, all of the regulatory agencies are seemingly emboldened with the authority to request special reports. These requests have led to increasing demands on an already overburdened compliance and technology staff leaving firms, at best like the boy in Numeroff’s story, exhausted. Given that these reports are often used against the firm as “Exhibit A” in some type of formal action, exhaustion may be the least of a firm’s worries. In effect, firms are performing the work of the examiner – conducting the investigation – and submitting the findings to determine the penalty. Accordingly, firms must be very careful in how they respond to these complicated requests from regulators.

Books and Records Rule

The SEC’s books and records rules, Rule 17a-3 and Rule 17a-4 under the Securities Exchange Act of 1934 (hereinafter the “Books and Records Rules”), specify records that broker-dealers must generate, and how long those records and other documents relating to a broker-dealer’s business must be kept. One of the main purposes of the Books and Records Rules is to allow the regulators to conduct effective examinations of broker-dealers.

Regulatory Trend
Breakpoint Initiative

In 2003, the SEC, NASD (now FINRA) and NYSE examined a limited number of firms that offered front-end loaded mutual funds to determine if customers were receiving the sales discounts disclosed in the fund prospectuses. The regulators discovered that in many cases, broker-dealers were not providing customers who purchased Class A share mutual funds with proper sales discounts, either because the dealers were not calculating the discounts correctly or because they were not properly linking related accounts for the purposes of obtaining the discount. As a result of those examinations, the regulators initiated what came to be known as the Breakpoint Initiative/Assessment Survey. As

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part of the survey, the entire broker-dealer community was required to do an analysis for the regulators rather than simply producing books and records. In conducting the self-assessment, the regulators specified requirements for performing the reviews and reporting the data to the regulators.

NASD took these self-assessments and without any additional substantive investigation or inquiry proceeded to sanction firms based on the results of their own self-assessment. NASD issued Letters of Caution to scores of firms and in its signature case ordered 15 firms to pay over $21.5 million in penalties to settle charges brought by the SEC and NASD.

Sweep Examinations

Based on the apparent success of the breakpoint initiative, at least in the eyes of the regulators, regulators sent an entire series of “Sweep Letters” requesting firms provide certain data in a uniform fashion dictated by the regulators. The interesting thing about these requests were, as noted previously, that the regulators did not limit their request to documents required to be made or preserved pursuant to SEC Rules 17a-3 or 17a-4. Instead, the regulators expected firms to create the very report which the regulators used as an exhibit to a complaint if any action was brought against the firm. Previously, regulators would request required records and conduct their own investigation and create their own “uniform” spreadsheets to compare responses. It appears those days are gone. Regulators now ask firms to conduct the investigation for them and to provide them with the results for the purpose of imposing a sanction. To add insult to injury, the regulators even dictate to firms the program or format in which the information must be provided.

Routine Exam Requests

What started as a breakpoint initiative and then spread to sweep exams has slowly crept into requests for routine examinations. For example, the “Document Request List” that started a routine examination of one firm was 12 pages long and requested over 150 production items. This list did not include the plethora of documents requested during the on-site portion of the inspection. Furthermore, the request provided a sample purchase and sales blotter and advised the firm that its records should include the same fields of information and be in a similar format. Ironically, some of the items required in its sample purchase and sales blotter are items not required by SEC Rule 17a-3. In addition, this request specified the computer software, Microsoft Excel format, and production medium “either a 3.5 inch diskette or compact discs.”

Frequently Requested Documents

In addition to the more burdensome exam requests, the nature of requests during investigations has changed as well. Some examples of common requests for records outside the standard required records are:

• Spreadsheets or Data Lists

In these instances the regulators will usually request that the firm take data from various sources and create a spreadsheet or list typically in Excel format. In most cases, the data is not stored in Excel format in the ordinary course (or otherwise searchable or sortable medium) and must be converted to comply with the request.

• Electronic Communications

Most firms are familiar with Rule 17a-4’s requirement to preserve e-mails. Firms should be aware that the regulators are specifically requesting not only e-mails but any type of electronic communications, such as instant messaging, text messaging, Bloomberg messaging, and digital-voice messaging. In addition, regulators are now asking for electronic communications in native format. In providing electronic communications in native format, firms should understand that they are providing a whole host of information about the communications in addition to the message itself, known as metadata. Metadata reveals such information as when the communication was produced, by whom it was edited and, where it was sent.

• Searchable Documents

Often, regulators are now requesting that documents be produced in a format that is searchable. As a result, firms are forced to take hard copy documents and scan them so that they may be searched. In some cases, however, the documents are not easily transferred to a searchable document.

• Public Documents

One of the most frustrating requests are requests for public documents, such as prospectuses and annual reports. Firms are forced to incur additional production costs, which at times are significant, to gather data otherwise accessible to the regulators.

As with all productions, firms should maintain an exact duplicate of what they produce to regulators. Ideally firms should bates-label...
their production as well. While Bates labeling is not possible for documents required to be produced in native format, firms should consider Bates labeling a hard copy of the same file to maintain a record of what is being produced.

Production Concerns

Providing the records required by SEC Rule 17a-3 is generally not a problem for firms. It is the creation of documents that causes the most aggravation to firms and their compliance staff. It is not that most broker-dealers do not want to provide regulators with the information they have requested, rather it is the impression by the regulator that the firm only needs “to push a button” to produce the requested document(s). Often, it appears the regulators do not appreciate the time and expense it takes firms to create these customized reports. For the firm, there are two main concerns when responding to these particular requests. The first is the time and expense in creating such reports, and the second is the possibility of creating inaccurate or faulty data.

For most firms, creating these customized reports involves extracting certain pieces of data from various data bases and compiling them in a requested format in a requested program. This almost always involves working with the firm’s Information and Technology (IT) department as most compliance professionals are not technologically savvy enough to extract this data themselves. Unfortunately, most IT departments are swamped with their own day-to-day responsibilities, and thus the demand to create additional reports causes great angst among the compliance staff requesting the documents and the technology staff preparing them. Preparing such reports comes at a high price to the firm in personnel costs as well as actual out-of-pocket expenses. The personnel costs are both tangible (additional or overtime salaries) and intangible in the stress created in the staff to meet these demands on top of their already full days. The out-of-pocket expenses can include additional computers or software or programming costs and/or paper/copying costs.

Another concern that firms face is whether the data they are providing is accurate. As previously mentioned, the requests often involve gathering data from different databases and combining several pieces of data from several different data bases into one spreadsheet. Easier said then done. Although simple or small requests can easily be reviewed for accuracy, most requests for custom reports are for spreadsheets that are hundreds, if not thousands, of lines long and incorporate data from several different sources. The regulators clearly do not appreciate the hurdles firms jump over to generate these reports. In many cases, the regulators lose their patience when it takes significant time to prepare the report or when the reports contain internal errors. FINRA has fined firms for flawed and untimely data. In the recent Oppenheimer settlement, for example, the firm agreed to settle with FINRA for one million dollars based on allegations that it produced, flawed, incomplete and untimely data in the breakpoint self-assessment.3

To further complicate matters, the requests by regulators are often unclear and firms have to follow up and seek clarification. At times, even after seeking clarification, firms find out what was asked for is not really what was wanted. Firms then have to create another report to give regulators what they wanted from the start, but did not know how to ask for it. In one recent request to a firm, in which the regulators had prior document requests and on the record testimony, the regulator requested additional specific information about an event and then advised the firm “You do not have to limit your response to the questions that follow.” In other words, “please produce whatever else you think may be relevant.” This approach is extremely problematic – if the firm fulfills the specific requests and ignores the general request for “give me everything you think is relevant,” will the regulator fine the firm for failing to produce complete information?

So What is a Firm to Do?

Seek Clarification

The first thing a firm should consider is asking for clarification as to what information the regulator is seeking. Obviously, for required records or very simple requests for customized reports there is no need to contact the regulator, however, if response to the request will be burdensome the firms should know exactly what the regulators are looking for before attempting to produce the records or create a report. By communicating with the regulators, firms may be able to help the regulator focus on what it is they are seeking and prevent follow up requests. If the document request asks for a large number of documents or is large in scope, try explaining the firm’s concerns and see if the regulator will agree

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to limit the request or suspend additional production, at least while they review the initial production. If the request appears overly broad, firms should consider asking the regulator to limit the time period or ask to provide a sample of the requested data with the agreement that more will be provided if needed. Often, regulators are overinclusive in their requests and can get a sufficient understanding from a smaller sample. Firms should avoid producing documents that were not requested, in an attempt to be helpful, as this often only serves to either raise additional questions or lead to a new line of investigation.

Negotiate

If a firm receives clarification and the request still is overburdensome, it should consider negotiating specific items in the request. Whether to negotiate with the regulator or just produce what is requested can be a very sensitive matter and one which firms should take very seriously. If the records are required under SEC Rule 17a-3 or if the firm can easily create a requested report, the firm should comply. Opposing requests should be considered when the request is so burdensome that it puts undue pressure on either the firm’s personnel or its financial resources.

In most cases, a firm can push back on two fronts—the scope of the document request or the time allotted to produce the documents. Most regulators routinely give firms two weeks from the date of the request letter to produce the information, but most regulators will negotiate the due date if the difficulty in providing the documents by

the due date is explained. If the regulator has requested numerous documents, a request to make a rolling production, in which some information is provided by the due date and the additional documents are produced as they become available, is generally acceptable.

When negotiating consider explaining to the regulator the cost, personnel and/or system difficulties. Often, explaining that the firm wants to cooperate, but is severely compromised by resources is helpful. Suggesting another available record or other data could at times satisfy the regulators as well.

What happens when negotiations fail?

If a firm is unable to come to some agreement with the regulators, the firm ultimately must choose one of two options: either acquiesce and produce the documents and reports, or make a carefully considered decision not to produce the documents requested. In deciding whether or not to produce the documents and reports, the firm should consider asking whether there is a rule or interpretation requiring the creation or maintenance of the requested item.

If there is not a specific requirement and the firm decides not to produce the document/report(s), the firm should be prepared for the consequences. Most regulators have subpoena power or rules requiring production of requested records and failure to produce those records can have grave consequences. Therefore, one cannot lightly disregard these requests. In almost all cases it is advisable to produce the information if possible. There may be extreme situations, however, where firms consider drawing the line in the sand. In those cases, firms will want to include counsel and senior management in determining how best to proceed and evaluate the litigation risks of this course of action.

Conclusion

Pursuant to the provisions of SEC Rule 17a-3, firms are required to maintain certain records which must be produced to regulators when requested. Ensure that the firm is preparing all of the records required under SEC Rule 17a-3 and that they are kept for the time period and in the format required by SEC Rule 17a-4.

When requests for documentation from regulators are received, the firm likely wants to review the request and ensure that it understands exactly what the regulators are asking for and when unsure consider seeking clarification. The regulators generally do not appreciate the difficulties firms have generating these customized reports. If the request is overly broad or burdensome, a firm may want to contact the regulators and attempt to negotiate the documents requested or at a minimum the amount of time the firm has to produce the documents. Remember that what a firm produces can be (and recently often is) held against it so care in the production of records is crucial.

2. The authors are not sure who in 2008 still uses 3.5 inch diskettes.
3. See Oppenheimer & Co., Inc. and Albert Grinsfelder Lowenthal, NASD Case No. 2005000316701 (October 30, 2007)
NSCP 2009 Meeting Dates

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Chicago - April 20th
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