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# KEY REGULATORY AND COMPLIANCE CONSIDERATIONS FOR SMALL AND REGIONAL BROKER/DEALERS

*In this article, the authors begin with suggestions for managing priorities with limited resources. They then turn to best practices for working with state regulators and tips for effective management of regulatory exams. They conclude that there are best practices that smaller and regional broker/dealers can adopt to mitigate regulatory risk, foster a firm-wide compliance culture, and build effective working relationships with regulators.*

By Paula D. Shaffner and Brandon M. Riley *

When the health inspector visits a restaurant, the kitchen staff scrambles to make sure every last crumb is gone from the counters and that the kitchen is spotless. Ideally, however, the restaurant was *always* compliant with the health code and the inspection – while nerve-wracking – should be a formality. Encounters with securities regulators are no different. Large and small firms alike must adhere to the same securities regulations, but small and regional firms must adapt to doing the same (or better) job with less – less in terms of resources and in terms of personnel. This article provides suggestions to small and regional broker/dealers for managing the multiple compliance priorities that leaner legal and compliance teams must navigate, as well as best practices when regulators arrive (and, like the health inspector, they most certainly will).

## SUGGESTIONS FOR MANAGING PRIORITIES WITH LIMITED RESOURCES

Where should firms focus their limited resources? More often than not, in smaller firms, the legal and compliance functions may overlap, and members of those teams may wear both hats, depending on the circumstance and the needs of the firm. Regardless, the ability to issue spot and identify regulatory risk is the most important aspect of the legal or compliance professional's role. Smaller teams should consider cross-training the business and compliance professionals to issue-spot within their functions, as appropriate. For example, the firm can (and should) train the business employees to identify and report compliance issues and assign a point person on the legal team to field those inquiries. The legal professional here is important to maintain the attorney-client privilege, as well as help identify and mitigate compliance risk. The legal team can also train the compliance professionals to conduct internal investigations and interviews so that more members of the team can handle regulatory issues when they arise. Regardless of the level of training or involvement of the compliance professionals, a legal professional must direct all investigative activity to preserve the firm's attorney-client and work product privileges.

Training, of course, takes time and money, but this is where regional firms would do well to leverage their relationships with outside counsel, which is a consistent refrain throughout this article. Few opportunities

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strengthen the relationship between the firm and outside counsel more than an invitation to train the business and compliance professionals on a compliance topic of interest to the firm and industry. Such an arrangement benefits the firm in that it receives insight and training from its trusted legal partners and allows outside counsel to gain valuable face time with members of the firm at no cost to the client.

Another way to stretch resources is to build a strong external network of like-minded legal and compliance professionals from other firms. Cultivating a small group of individuals to discuss industry and regulatory trends can assist a smaller firm in identifying regulatory risks and setting internal priorities to manage that risk. This informal network can also help identify trusted vendors and compliance consultants if there is a specific need or if there is a compliance function that can be outsourced.

Partnering with an internal IT team or outside IT vendors to design compliance and monitoring systems to enforce written supervisory procedures ("WSPs") can also assist with issue-spotting across the firm by automating the detection of "red flags" that require investigation. Again, it is important to design a communication channel and legal point person for IT to report any issues it identifies so that the communications and any ensuing investigatory documents are protected.

Finally, another difficult challenge that regional firms face is keeping track of and maintaining compliance with the ever-changing universe of industry rules and regulations. One important best practice here is to have a written plan and designate clear roles and responsibilities: Who will track proposals and final rule changes? Who will update WSPs and spearhead the design of compliance programs to ensure enforcement? Without a plan and clearly defined roles, firms unnecessarily elevate their risk exposure through inefficiency and the chance that something could slip through the cracks.

Communication, as always, is vital. The legal and compliance teams should be actively documenting decisions with respect to how new or revised regulations are implemented within the firm, as well as the rationale behind those decisions. The same applies to the individual compliance programs that the firm puts in place to enforce its WSPs. This is another opportunity to leverage outside counsel or consultants to help with both prioritizing internal resources and implementing compliance programs efficiently and as cost-effectively as possible.

## BEST PRACTICES FOR WORKING WITH STATE REGULATORS AND OTHER AUTHORITIES

The limited resources of small and regional firms are most stretched when a regulator pays a visit, either for a routine exam or with a specific inquiry. At best, a state or other regulator will be a compliance professional's neutral, fair-minded partner – there to ensure the firm crossed its t's and dotted its i's, and nothing more. At worst, the relationship can devolve into an adversarial confrontation, with the regulator going on an endless fishing expedition. The importance of avoiding a lengthy regulatory examination, inquiry, or enforcement action cannot be overstated: these exercises not only require an enormous amount of time and internal firm resources to address, but they are also extraordinarily costly in terms of compliance and legal fees. The combined effect can threaten to swallow up a smaller or regional firm if not appropriately managed from the outset.

There are several best practices; however, that can help position the relationship between the firm and the regulator(s) as one of cooperative trust and avoid the worst-case scenario.

## FOSTER WORKING RELATIONSHIPS WITH YOUR REGULATORS

Possibly the most overlooked dynamic between the securities industry and its regulators is it is not verboten to endeavor to get to know the firm's regulators before there is an issue. Many regulators would be happy to meet for lunch or a similar informal setting to get to know the firm and its legal and compliance team. An invitation to an internal event or to speak on an industry panel can also be a mutually beneficial relationship-builder. The point is to make an effort to get to know them so that there is an initial foundation for a working relationship.

More formal contact with regulators generally occurs either in the context of a specific inquiry or an examination of the firm's books and records. Both scenarios require the responding firm to walk a tightrope: the legal and compliance team is expected to be responsive, cooperative, and transparent while at the same time mindful of the firm's interests, internal communications, and the attorney-client privilege. That tension is a breeding ground for mutual mistrust, but being proactive and maintaining detailed internal records and documentation of the firm's communications with the regulator can go a long way toward successfully navigating the exam and protecting the firm should the regulator identify issues or concerns following the exam.

For example, when a regulatory request comes into the firm, making a list of the items that will not be difficult for the firm to locate and produce, and providing that list to the regulator is a good first step to show that the firm has a proactive compliance mindset. There are certain categories of documents – account information and statements, WSPs, branch office supervisory logs – that regulators (rightly or wrongly) expect the firm to be able to produce expeditiously, and the better a firm is at quickly providing that information, the more likely the working relationship with the regulator will get off to a good start.

Another important consideration is maintaining a detailed central electronic file of the regulatory inquiry or exam that serves as a repository for all the documentation concerning the firm's response. A firm can structure its legal and compliance functions in any number of ways, but one of the most important concerns from the outset of any regulatory inquiry is safeguarding the attorney-client privilege for communications and attorney work product protection for investigatory and response management materials. The best way to do that, as noted above, is to place an attorney in charge of the firm's response and any investigation that needs to be done to provide that response. The attorney can either be inside the firm or outside counsel, depending on the scope of the regulatory action, but in general, utilizing outside counsel in this scenario is the most effective way to safeguard privileges because the risk of commingling business advice with legal advice is minimized. Either way, the attorney should, in turn, supervise the collection and maintenance of the documentation in the central electronic file, which might consist of attorney notes, case management memoranda, interview memoranda, document collection, and production logs. Maintaining these detailed records is important for keeping the firm's response moving forward and on track, helps identify firm personnel who may have the relevant knowledge to answer questions the regulator has as the inquiry continues, and, importantly, gives the firm a foundation from which to negotiate a favorable resolution with the regulator.

The firm should also document all of its discussions and agreements with the regulator in an effort to both build trust with the regulator and protect the firm. It is important to maintain detailed notes of conversations with the regulator and reduce those notes to written communication, either by e-mail or letter. Any agreements reached with the regulator should also be documented in writing. Maintaining a detailed written record of the firm's communications and agreements keeps both sides honest should any disagreement regarding the scope of the inquiry or agreement be questioned in the future, which, in turn, further helps build mutual trust in the working relationship.

Finally, leveraging outside counsel is another way to be proactive and to help foster a working relationship of mutual trust and respect – especially when the inquiry comes from a state or other regulator with whom the firm does not have an established relationship. Outside counsel brings several advantages to the table: they can use their client relationships to gain insight into both the regulator and the nature of the inquiry, they may have a direct relationship with the regulator, and they may have the representational experience they can bring to bear to both influence the scope of the matter and help bring it to an amicable resolution.

## PUT YOURSELF IN THE REGULATORS' SHOES

Thinking about the examination or inquiry from the regulators' perspective can also help the firm put its best foot forward early in the process and highlight the firm's compliance-oriented culture. For example, the SEC and FINRA both publish their regulatory and exam priorities each year.[1] From the regulators' perspective, these are likely to be the focus of regulatory inquiries and routine examinations. Similarly, regulators will want to see that the firm is monitoring relevant enforcement actions and settlements, and internalizing the lessons of those matters to the extent applicable to the firm's business. (On this point, however, the firm also needs to make a legal and compliance judgment as to whether the SEC's or FINRA's position in the enforcement action was

[1] The SEC Division of Enforcement's Examination Priorities for 2023 are *available at* https://www.sec.gov/files/2023-exam-priorities.pdf. FINRA's 2023 Report on its Examination and Risk Monitoring Program is available at https://www.finra.org/rules-guidance/guidance/reports/2023-finras-examination-and-risk-monitoring-program.

consistent with relevant securities law, which could be the entire subject of another article.)

Regulators always want to see that the firm is maintaining up-to-date and relevant WSPs and, importantly, *enforcing* them as part of its compliance program. It is not sufficient for the firm's compliance personnel to merely draft and circulate WSPs and expect compliance across the firm from that point forward. Regulators instead want to see a robust continuing education and training program, as well as internal systems and workflows designed to detect noncompliance.

This is an area where, again, smaller or regional firms can leverage outside counsel to probe for the soft spots in the firm's compliance program before a regulator finds them. Outside counsel will have internalized the relevant enforcement priorities and enforcement actions, and will also be able to leverage their client relationships and experience to help with monitoring firm-wide compliance with WSPs. Using outside counsel also helps shield the process from review by regulators through attorney-client privilege and work product protections. Finally, outside counsel's eyes will mirror the regulator's, which will help the firm's compliance personnel develop those skills internally, in turn benefitting the firm's overall compliance culture.

## EFFECTIVE EXAM MANAGEMENT

When exam time arrives, there are multiple priorities to juggle, which is itself its own special challenge. The legal and compliance functions must balance the regulators' timeline while simultaneously making the case inside the firm that personnel needs to prioritize exam responses. Again, the best practice here is effective communication.

With the regulator, the goal should be to communicate that the firm stands ready to respond to reasonable requests, and the legal and compliance personnel should attempt to negotiate the scope of requests from the outset to the extent possible. Do not be afraid to ask clarifying questions to try to determine exactly what type of information or documents the regulator seeks. Effective negotiation and expectations-setting at the beginning should ensure that the firm can meet the internal exam deadlines. And responsiveness is key – there is probably no easier way to maintain and build a working relationship with a regulator during an exam than being responsive to phone calls and e-mails, and, conversely, no easier way to send the relationship in the opposite direction by failing to reply to e-mails or return phone calls.

Internally, the emphasis on communication is equally important, but the priorities are different. Firm personnel want to understand what the scope of the exam will be and how much of their time they can expect to spend collecting documents or assisting with responses. The legal and compliance functions also need to communicate the importance of the exam and, ideally, will align with high-level leaders to prioritize timely responses across the organization. And it bears repeating here that attorney-client privilege considerations are paramount, and the potential for issues multiplies exponentially, given the volume of internal communications during an exam. One best practice to Aconsider is identifying ahead of time the key internal employees who are most likely to be affected by the needs of the exam and to give those individuals a refresher on the contours of the attorney-client privilege, as well as the importance of maintaining confidentiality and not commingling legal communications with business communications. It is equally important for the internal employees to know that the legal department is in charge of responding to the exam and that they know from the outset with whom on the firm's legal team they are to communicate regarding the exam. Adhering to both of these best practices should go a long way toward safeguarding the attorney-client privilege during the exam.

## CONCLUSION

In summary, there are several best practices that smaller and regional broker/dealers can adopt to mitigate regulatory risk, foster a firm-wide compliance culture, and build effective working relationships with regulators, even with limited personnel and resources. Leaner compliance and legal teams should prioritize organization, communication, and relationship-building – internally, with outside counsel, and with the firm's regulators – to effectively build, maintain and promote the firm's compliance culture, and to put the firm's best foot forward when regulators inevitably come knocking on the door. ■