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Dress Rehearsals for the Real Thing

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MOCK EXAMS

Dress Rehearsals for the Real Thing

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One of the most stressful parts of being an advisory firm's chief compliance officer (CCO) is the unknown. This includes concern that you have misinterpreted a regulation, an employee is not following procedures (knowingly or unknowingly), or that operational or trading errors are occurring and not being caught, to name a few. CCOs are required to conduct ongoing forensic testing of their compliance programs to help monitor most of these risk areas ahead of the ultimate test—a regulatory exam. To help prepare for this regulatory examination of a compliance program, many firms will conduct a mock exam. The mock exam will help a CCO assess the compliance program's preparedness, the compliance-related functions, and the firm as a whole. Like a real exam, a mock exam can be time-consuming for both the compliance team and the firm. A mock exam also only examines the firm during a set period of time, whereas ongoing testing allows for processes and behaviors to be modified over time to be brought into compliance. There are many things to think about when contemplating undertaking a mock exam: what type of exam to do, who should create and conduct the exam, and what to do with the results. This article lays out options and ideas on the aforementioned decisions, as well as some tips for conducting a mock exam.

Key areas of a mock exam are document requests, document content review and evaluation, and interviews. A full exam would entail all three areas, but depending on your goals you may decide to conduct interviews only or focus on one aspect of the business (e.g., trading).

MOCK EXAM GOALS

Once you have determined that your firm will benefit from conducting a mock exam, several decisions need to be made. First and foremost is determining the goals of the exam. Do you want to test only parts of the compliance program or the entire program? Do you want to see how employees react and respond—both to document requests and to being interviewed? The goals for the mock exam are critical in the creation of the mock exam.

The next topic to think about is the maturity level of your firm and the key players in your firm. Is the firm relatively newly registered or never examined? Have you done a mock exam previously? Has your firm been through a regulatory exam before? These questions can help you scope the depth and breadth of your mock exam. New or never before examined firms may want to focus on the overall program to ensure all of the typically covered exam areas are assessed. More mature firms may benefit from a dialed-in mock exam that focuses only on certain areas that were issues in a prior mock exam, actual exam, or ongoing testing. Also important to note is that you should think about your compliance team's experience with exams, as well as the experience of key firm employees. If your firm is more mature and has been through exams before, but has a director of a critical function who has never been through an exam, putting this director through the paces on document collection and an interview would serve the firm very well.

After deciding your mock exam goals and assessing the maturity level of your firm and key players, you should have a good idea of the kind of mock exam you'd like to conduct. Key areas of a mock exam are document requests, document content review and evaluation, and interviews. A full exam would entail all three areas, but depending on your goals you may decide to conduct interviews only or focus on one aspect of the business (e.g., trading).

The document request portion of your exam is important for several reasons. It allows you to determine the best contact in various areas (e.g., perhaps it's a finance employee who should be contacted instead of the chief financial officer for billing documents). Knowing who your go-to is for each content area typically covered in an exam is also

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helpful when creating a playbook for exams. Finally, you will gain knowledge into how quickly typical requests can be turned around. It's certainly better to identify issues in reporting or documentation in a mock exam rather than during a real exam. Once the requested documents come in, you or whoever is conducting your mock exam needs to pore over the information looking for errors, issues, inconsistencies (e.g., one quarter's report has five columns of data, but the next quarter's report has six), and finally deciding if policies in your compliance manual are not being followed. Employee interviews always are an interesting portion of a mock exam. Employees may dutifully sign off on the code of ethics and compliance manual, but how familiar are they with their responsibilities and do they know where to find the documentation on your firm's intranet? Do some staff provide much more information than asked for, or embellish and answer with what they think the interviewer wants to hear rather than sticking to business practice? Finally, do certain employees react aggressively or present negatively regarding certain topics or specific lines of questioning?

CHOOSING THE MOCK EXAMINER

Next, you need to consider who will conduct the exam. There are pros and cons to all of the options. The most cost-effective option is to run the entire mock exam internally. Besides cost savings, pros include that you know your firm and its strengths and weaknesses so you know where to look to uncover possible issues. Cons are that running an entire exam yourself (not to mention designing it and writing up results) will be time-consuming for the compliance team. Another con is that if you've possibly missed something through your testing, you may continue to miss it in a mock exam.

The next option is to have an outside consultant run your mock exam. Pros are that most consultants have run mock exams at firms (both as compliance officers and consultants) and can offer fresh eyes and ideas. Having an outside consultant involved in either all or a portion of the planning, execution, and results phases means that your compliance team also will be less burdened time-wise. However, depending on the level of discretion given to the outside consultants in designing the mock exam, your compliance team still will spend significant time on the mock exam, but it will be spent on activities directly correlated to what they would be doing during an actual exam. Cons include cost and having a final report that may be discoverable by a regulator. Seasoned consultants have remarked that although this is a risk area, self-discovery and remediation can be viewed as a successfully functioning compliance program. A solution to findings of material conflicts or areas of non-compliance being discoverable would be to have your outside counsel work directly with the consultants conducting the exam to address viable next-step efforts to remediate the issues.

The third option is to have your outside counsel or another law firm conduct the mock exam, which is the costliest solution. Attorneys are well-versed in the laws and regulations in the industry, but they typically are not as well-versed in the operational aspects of an advisor. However, one advantage of using a law firm is the protection of privileged communications.

If you choose to use a consultant or law firm to conduct your mock exam, you will need to decide how involved you will be in the design and preparation of the exam and how you want findings communicated (verbally or written).

PLANNING THE MOCK EXAM

Next, you need to think about the overarching parameters of the mock exam: when to do it, what internal resources will be required, and what topics or areas should be included. The amount of time required for your compliance team will depend on whether you are running the exam yourself or bringing in outside help. Either way, you may need additional internal support, because any exam—mock or actual—is administratively time-consuming. Files need to be logged and saved; emails need to be sent and logged. Many firms will use executive or administrative assistants to help with these organizational tasks. As previously mentioned, you also want to think about who will be a point of contact for each area of the business (for document collection) and who will be interviewed. Another area to think about is the time of year to run a mock exam. We all know that there is no ideal time to do it, but you can be strategic in finding a time that may minimize impact across the firm. First, look at your compliance calendar to identify and avoid times of the year when compliance resources are more heavily utilized (e.g., quarterly reporting, regulatory filings, annual testing) or more hectic for your operations, finance, and investment teams. Timing of the mock exam also will depend on how broad the exam is. If only one or two areas are being examined it should be a bit easier to find a time period that works. You also may consider doing the mock exam throughout the year—perhaps operations during quarter one, investments during quarter two, etc.

After the timing and resources have been evaluated, the next determination is identifying which topics to focus on during the mock exam. In deciding this you should review several external and internal sources. The list below is a good starting point, but depending on your business lines you may want to modify the list.

- External Sources
  - Review U.S. Securities and Exchange Commission (SEC) exam priorities, risk alerts, speeches, no-action letters, cases: Do any areas relate to the firm's current or planned business practices?
  - Recent SEC exam document request lists: What areas are relevant to your business practices?

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- Review any recent or upcoming regulatory changes that did or could impact the firm: Are there any gaps (i.e., new policy required) or enhancements required based on the regulatory changes?

- Internal Sources
  - Review the most recent risk assessment: Are there any medium to high-risk areas?
  - Review the most recent forensic testing: Is there adequate documentation and any noted findings? What areas required remediation?
  - Review the most recent annual review report: What areas required remediation?
  - Review internal error/breach logs and remediation logs: Are there areas that warranted further testing/review or had their risk rating increase?
  - Identify recent or upcoming internal firm changes that did or could impact the compliance program: Were there any key personnel turnover, changes in business strategy, new products?

MOCK EXAM FRAMEWORK

The next step is to design the exam framework. One of the most important items is the document request list. As a starting point, you can use one of the more recent SEC document request lists that are made public from time-to-time on different websites. You will want to amend this list based on the research of external and internal resources done during the preparation phase. You want to make sure that the requests are clear, which can be done in one of two ways: Leave the request in "SEC speak" then clarify when you send the request email, or modify the language to simplify the request. A second important item to create is the list of interview questions you will ask the key firm staff. Included in each interviewee's question list should be questions asking employees to explain their roles in the compliance program and where they can find the firm's compliance manual and code of ethics.

As you develop these lists you also need to decide: (1) who should be interviewed, (2) who will be the point of contact for the various areas of the document request list, and (3) which staff members will be responsible for reviewing which documents. Typically, members of the C-suite and heads of departments will be interviewed but, depending on your firm's situation, you may want to broaden or modify this list. For example, if there have been client billing issues you may want to include a billing manager and not just the chief financial officer. Choosing a point of contact for each business area typically should be straightforward. As part of a firm's annual compliance testing you already should have a go-to person in each area. Each point of contact should be able to manage any data or document collection in their area and should be senior enough to review information before it is sent to compliance. As for assignments within the compliance team, similar to the point of contact in each business area, you already may have resident experts in many areas who do the annual testing. If this is not the case, then it is up to the CCO how best to divide and conquer. One modification to think about is that if you are doing the mock exam in-house, the assigned compliance team member will be reviewing the document for appropriateness with regard to the request.

The tracking of information will allow you to see how long different pieces of information took to be turned in. It also will provide insight into how many times it may have taken for the correct information to be provided.

TRACKING AND EVALUATION

Next, you need to develop how to track and evaluate the information received. Both the tracking and evaluation of information received are important in the analysis of how a firm reacted and met the expectation of the mock exam. The tracking of information will allow you to see how long different pieces of information took to be turned in. It also will provide insight into how many times it may have taken for the correct information to be provided. We will discuss what these data points mean when analyzing the mock exam. Similarly, a tracking tool for the interview process should be developed. This is important in order to give feedback to interviewees and to determine if there are similarities—positive or negative—in interview responses. Also, a remediation tool is needed to track the life cycle of any remediation that comes out of the mock exam. All these tools are important whether or not you are conducting the mock exam yourself or having an outside party do it. Finally, one tip for those conducting their own mock exams is to have an email address created for all correspondence regarding the exam. We have found that SECexam@advisorname.com usually catches peoples' attention.

CONDUCT THE MOCK EXAM

Thus far, we have discussed the kinds of mock exams you can run, who should conduct the mock exam, and how to prepare and design a mock exam. Now it is time to execute the exam. Because this is a mock exam and not the real thing, it's helpful to hold an all-hands meeting ahead of time to inform staff that the mock exam is happening and emphasize the purpose and importance of the exam. You can leave out the date it will begin to keep some of the element of surprise. Once the exam has officially kicked off with a flurry of emails requesting documents and setting up interviews, the compliance team (or other assigned employees) will begin the process of checking documents in and

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saving them to the appropriate folders. Whether the mock exam is being conducted by in-house employees or not, there needs to be an internal review conducted by the compliance team to evaluate documents for relevance versus the request. The CCO also should have regularly scheduled meetings with the compliance team to stay on top of how the mock exam is going (again, regardless of whether it's being run internally or externally).

ANALYSIS

As documents come in and interviews are conducted, analysis can begin. When reviewing documents, there are several things to evaluate, whether you are conducting the mock exam internally or not. First, did the produced documents meet expectations (i.e., were the correct types of documents turned in)? Were the documents complete (time periods, number of samples, etc.) or did they contain red flags—incomplete files or reports, errors not corrected, documents not following written procedures, etc.? Try to think like an examiner. If you find issues or outliers and are running the exam internally, request additional documents to see if there is, in fact, a pattern emerging. If the mock exam is being run externally, you may be asked for additional documents as well. As for interviews, review your notes and tracking spreadsheet. For externally run mock exams you should be sitting in the room, as if it were a real exam. Did any of the interviewees stand out—in a good or bad way? Were there any trends in answers? What feedback or coaching may help interviewees for next time?

As you run through the analysis of the documents and interviews it is important to keep a running list of remediation needed. If you already maintain a remediation log or list you can add to it. If it's something you haven't used before it should be created. This remediation log will give you a road map of updates to your program—compliance manual changes, internal procedures updates, employee training needed, reporting modifications, etc. Some of these projects may be underway already if issues were discovered previously.

REPORTING

As your mock exam wraps up and results are formulated, a CCO must decide how to report the findings to management. This challenge comes to firms doing their own mock exams as well as those who outsource the exercise. Some firms are wary of a written report becoming "discoverable" during an actual exam and acting as a "road map of deficiencies" for a regulator. There are three ways to deal with this. The first option is that the whole point of doing the mock exam is that you are testing the firm and plan to make changes to the program based on your findings.

The second way to approach reporting results is to provide a high-level summary and communicate further details verbally. In other words, keep the written portion of the results simple.

Therefore, you shouldn't be concerned with a regulator seeing your mock exam results; as long as your remediation is done in an expedient manner, you are working to correct the deficiencies. The second way to approach reporting results is to provide a high-level summary and communicate further details verbally. In other words, keep the written portion of the results simple. A third approach, for those firms not conducting their own exams, is having a law firm administer the mock exam or having a law firm hire a consultant to run the exam, where the consultant only communicates results with the law firm. This should create privileged communication regarding findings if the only written results are shared between the consultant and law firm. This should keep any findings from being discoverable.

CONCLUSION

As the SEC continuously reminds the industry, a compliance program should never be a "set it and forget it" function. Successful compliance programs are ever changing in order to take into account the business practices of the firm, regulatory changes, and industry norms. As we discussed at the beginning of this article, a mock exam is a great way to assess the preparedness of the compliance program, the compliance-related functions, and the firm as a whole. But, even though the mock exam will give you an idea of where your firm stands at a particular time, your ongoing testing and remediation, updating of compliance program documents, and employee training are critical to keeping your program healthy and ready for an exam. Remember, no firm is ever truly ready for a regulatory exam. But if you are always preparing by continuously evaluating your program, training the firm's employees, and conducting mock exams, you can better build, grow, optimize, and protect your advisory practice.

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