CORE COMPLIANCE & LEGAL SERVICES, INC.
SOLUTIONS FOR TODAY'S BUSINESS

Risk Management Update
March 2012

BROKER-DEALER BRANCH OFFICE INSPECTIONS: A KEY PART TO SUPERVISION

Over the past year, FINRA has provided much guidance in the area of branch office inspections. Too often broker-dealers are relying on electronic or verbal affirmations from its remote offices and are not going onsite to determine whether the compliance program is being circumvented. Consequently, this month's Risk Management Update will focus on new guidance from FINRA based on its February 2012 Webinar entitled "*Branch Office Inspections*," which discussed common branch deficiencies and risk-based branch office inspection policies and procedures; Regulatory Notice 11-54 entitled "*Branch Office Inspections*," which was jointly issued by FINRA and the SEC's Office of Compliance Inspections and Examinations ("OCIE") in November 2011"[1]; and best practices to consider for your organization.

As the regulatory environment has changed during the past few years, so has the approach regulators are taking towards their examination process. Leaving behind the calendar cycle examination, the process is now a risk-based approach with the content varying from firm to firm. As part of this process, regulators now are performing branch office impact assessments in their annual exam planning. Consequently, a broker-dealer's branch office inspection program, too, should be risk-based and tailored to your business model, customers and counterparties. Consider, for example, whether a branch office sells structured products, complex products (including variable annuities) or private or unregistered offerings. If you have branch offices involved with these types of "high risk" sales offerings, or have branches with individuals who have a disciplinary history or who are under heightened supervision, these offices should be audited more frequently.

<u>Common Deficiencies Related to the Broker-Dealer's Supervision of Branch Offices</u>

Based on recent FINRA findings, consider the following areas which were cited as some of the most common deficiencies found within the broker-dealer's supervisory program for conducting branch office inspections:

- Failure to follow the firm's written supervisory procedures ("WSPs") for inspecting branch offices as required;
- Always announcing your exam schedule to the branch offices; and
- Failure to generate a written inspection report that includes the testing and verification of the firm's policies and procedures.

NASD Rule 3010(c)(1) requires firms to conduct a review, at least annually, of its Office of Supervisory Jurisdictions ("OSJs") and non-OSJ branches that supervise non-branch locations. In addition, all non-supervising branch offices must be inspected at least every three years and non-branch offices periodically.[2]

---

[1] *See generally,* FINRA Regulatory Notice 11-54, issued in November, 2011; Branch Office Inspections, FINRA and the SEC Joint Guidance on Effective Policies and Procedures for Broker-dealer, *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125204.pdf

[2] *See generally,* NASD Rule 3010(c), which governs "Internal Inspections," *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125204.pdf

What to Look for During Branch Office Audits

When developing your Branch Office Inspection Program (the "Inspection Program"), it is important to customize the audit program based upon the firm's structure, including the broker-dealer's product lines, business lines, outside business activities, customer type, and supervision models, such as on-site, remote or central. The Inspection Program should begin with an overall risk assessment of the firm and, if appropriate, a risk breakdown for each individual branch office. To assist you through this process consider the following:

- Target potential risk by reviewing with existing exception and surveillance reports;
- Create new exception or testing reports based on risk findings;
- Schedule the frequency and intensity of branch office inspections based on your risk assessment of the office;
- Engage in unannounced and announced exams and a random selection;
- Train your compliance exam staff to assure they understand the business;
- Encourage your compliance staff to challenge assumptions to ensure that risks are identified and effectively detected; and
- To the extent it is possible, eliminate conflicts of interest that may serve to undermine an effective Inspection Program.

Some of the most common areas for broker-dealers to inspect include the following areas, which the SEC and FINRA examiners also generally review:

- Supervisory protocols used by the branch to supervise customer accounts, including those of producing managers;
- Procedures used to handle money and securities physically received at the branch;
- Validation of changes in customer addresses and other account information in accounts serviced by the branch;
- Procedures related to transmittals of funds between customers and third parties, and between customers and registered representatives;
- Review of sales products, including:
  - Sale of structures products;
  - Private and unregistered offerings;
  - New issues
  - Mutual funds; and
  - Variable annuity sales and exchanges;
- Review of sales practices, including:
  - Verification of customer account information;
  - Compliance with broker-dealer procedures;
  - New account reviews and suitability of investments;
  - Unauthorized trading;
  - Churning;
  - Licensing of branch personnel; and
  - Training within the branch;
- Procedures used for branch office communications with the public, including advertisements, sales literature, emails and social media used with customers (and evidence of compliance approval);
- Review of branch office activities as evidenced by review of:

    - Customer files
    - Written marketing materials produced on the premises and at any satellite locations
    - Branch office appointment books, calendars, and CRM system records;
    - Email surveillance
- Procedures for handling of customer complaints;
- Review of bank accounts of the branch and affiliated entities, including review of third-party wire transfers, branch signatures guarantee log and consideration for unauthorized business activities; and
- Procedures used to uncover use of unauthorized computers or other electronic devices and/or social media.[3]

Conclusion

The key to any Inspection Program is to prevent and detect misconduct. As you embark on developing, reviewing or enhancing your existing Branch Office Inspection Program, consider the approach you are taking to risk assessment of each branch prior to the inspection. By developing a customized checklist approach, the broker-dealer may be able to determine if one office posses a higher risk than another office, which may necessitate either increased inspections or a more customized inspection based on the types of products or personnel within that branch. Once you have conducted the inspection, consider whether the findings are isolated or systemic. Ask your examination team to explore, as applicable, whether there is a supervisory breakdown, procedural deficiency, a recidivist finding or any customer harm detected. If systemic risk is detected, enhance WSPs as needed and provide additional training across the enterprise, as appropriate.

For more information, or to learn about how CCLS may be of assistance, please do not hesitate to contact us at (619) 278-0020.

Author: Kris Gruben, Sr. Compliance Consultant; Editor: Michelle L. Jacko, CEO, Core Compliance & Legal Services ("CCLS"). CCLS works extensively with investment advisers, broker-dealers, investment companies, hedge funds, private equity firms and banks on regulatory compliance issues. For more information, please contact us at (619) 278-0020, info@corecls.com or visit www.corecls.com.

---

[3] *See generally,* FINRA Regulatory Notice 11-54, issued in November, 2011; Branch Office Inspections, FINRA and the SEC Joint Guidance on Effective Policies and Procedures for Broker-dealer, *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125204.pdf