

To: Our Clients and Friends

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## SEC and FINRA Issue Guidance on Broker Dealer Branch Inspections

Broker-dealers who face inspections from regulators should take heed of recent guidance provided by the two principal securities regulatory agencies. The regulators are the Financial Industry Regulatory Authority (“FINRA”) and the SEC’s Office of Compliance Inspections and Examinations. Their jointly issued “National Examination Risk Alert”<sup>1/</sup> offers guidance on policies and procedures that broker-dealers should consider for branch office inspection programs. FINRA regulations require such inspections and there has been much literature and discussion among both regulators and the regulated as to the hallmarks of an effective program. The Alert identifies concepts from a series of prior cases and contains no new requirements, but it may signal a renewed focus in this area. In the past, regulators have sometimes issued such an alert as a precursor to a heightened focus on an activity, followed by investigations and, potentially, enforcement actions against those firms that allegedly have failed to meet those standards.

The Alert identifies practices that the regulators regard as sound and contrasts those with practices that they deem faulty. The list of sound practices emphasizes that the schedule for and substantive focus of branch office inspections must be risk-based (although supplemented with a random component so that not even well-run branch offices can get too comfortable). The Alert also emphasizes that a “significant percentage” of inspections should be on a “surprise” or “unannounced” basis. The list of practices identified as “sound” in the Alert is:

- A significant percentage of exams should be unannounced (identified through a combination of risk-based and random analyses);
- Firms should ensure that individuals conducting exams are sufficiently senior so as to understand the business and to have “gravitas”;
- Firms should establish policies to avoid conflicts of interest by examiners;
- Inspections should be tailored to the business conducted in the particular branch; and
- The schedule of inspections should be risk-based.

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<sup>1/</sup> (FINRA Regulatory Notice 11-54; SEC National Examination Risk Alert, Volume I, Issue 2 (November 30, 2011)).

One could question whether the standards as articulated in the Alert are sufficiently defined (what constitutes “gravitas,” for example?) or realistic (for a smaller office in a remote location, an unannounced inspection may result in a wasted trip if the representatives are out of the office on that day). Regardless, the standards represent a statement from the industry’s two primary regulators and firms would be well advised to consider whether their current practices comply with these suggestions (amorphous as they may be).

The “faulty” practices listed in the Alert are largely a function of omission – that is, what a firm is “not” doing. According to the Alert, firms with inadequate procedures typically:

- Do not tailor their inspection programs to the business of and risk factors represented by the branch office being inspected;
- Do not assign inspectors with sufficient experience and insight;
- Do not conduct a sufficient number of unannounced inspections; and
- Fail to have adequate policies and procedures and fail to implement heightened supervision of individuals with disciplinary histories.

Again, one could question whether such guidance truly is helpful as firms try to design and implement effective procedures. In our experience, weaknesses in compliance programs frequently are manifest only in hindsight. For example, as a practical matter, there are limited numbers of highly-experienced examiners who are willing to spend substantial amounts of their time traveling to inspect remote branch locations. Perhaps more importantly, when a firm is fortunate to have an established unit of such employees, the firm may conclude that those employees may be more effectively deployed performing higher level compliance and internal risk-controls functions.

Beyond the lists of sound and faulty practices, several statements in the Alert are particularly noteworthy. The regulators emphasized that risk assessment should be integral to decisions as to the schedule for inspecting branch offices, whether a particular inspection should be unannounced and the issues upon which the inspection should focus. As to how firms should assess risk, the Alert offers that “branch offices should be continuously monitored with respect to changes in the overall business, products, people and practices.” We understand the Alert, taking these statements together, as suggesting: (i) the importance of well-designed exception reports that focus on meaningful changes in the business activities of offices and individual representatives; and (ii) the desirability of an integrated program that relates inspections (and, presumably, other aspects of a compliance program, such as continuing education) to ongoing monitoring activities.

The Alert also identifies particular types of financial instruments and particular business practices that the regulators regard as representing higher risk, such as: structured or other complex products (including variable annuities), private placements, offices where representatives engage in outside business activities, and those offices where persons with prior disciplinary history may work.

The regulators emphasized that a firm’s risk assessment should be ongoing. This will, necessarily, change the cycle of certain branch examinations. The risks presented by different branch offices will not remain static and this should result in commensurate changes in the branch-inspection program. Firms are required, under NASD Conduct Rule 3010(c)(1), to conduct annual inspections of Offices of Supervisory Jurisdiction (OSJs) and non-OSJs that supervise non-branch locations. However, these are only the

minimal requirements. A firm may conclude that it must inspect certain offices on a more frequent basis than required under NASD Conduct Rule 3010. Whatever findings a firm makes as a part of its ongoing risk evaluation and subsequent decision-making should be documented.

In light of the Alert, we encourage firms to carefully consider the guidance, evaluate how best to reflect it within their compliance programs and implement such changes as appropriate. For example, firms might consider assigning more experienced compliance officials to periodically participate in inspections of branch offices not on an exclusive basis but as a way of supporting the inspection program (and, not incidentally, demonstrating to the regulators that the firm has, in fact, considered the guidance and taken steps to implement it). <http://www.finra.org/Industry/Regulation/Notices/2011/P125205>

For questions or further information, please speak to your Bryan Cave contact, a member of our [White Collar Defense and Investigations](#) or [Securities Litigation and Enforcement](#) groups, or the authors of this client alert:

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