BRANCH-OFFICE INSPECTION BEST PRACTICES

By Dan Butterfield
Senior Account Executive
Smart Pros Ltd. Financial Campus
www.financialcampus.com

January 2015

About the Author: *Dan Butterfield has 25 years experience in financial services and has helped design compliance systems and online learning platforms for the industry. Dan is currently responsible for SmartPros' Audit Management Solutions (AMS) business development in the western USA.*

"What we've got here is failure to supervise." [1]

With apologies to fans of the film classic Cool Hand Luke, *failure to supervise* is a common penalty-flag thrown on member firms and compliance officers who've been held to account. Other regulatory gotcha phrases include '*failed to identify'* and the dumbfounding *'should have known.'* It is not simply what the firm (supervisors, et. al.) did not know, but rather what they should have known. The very core of effective supervisory procedures is a good branch-office inspection program. Well-conceived systems and inspection processes means never having to hear or read: *failed to supervise*… *failed to identify*… or, *should have known*.

Reading the CARDS, 'Risk' Trumps

It has been three years since the SEC's Office of Compliance Inspections and Examinations (OCIE) and the Financial Industry Regulatory Authority (FINRA) jointly issued guidance[2] on branch-office inspection best practices. There have only been a few adjustments to branch inspection guidelines[3] since then, but firms must not be lulled into complacency. Maintaining old processes can prove costly. Particularly reliance on dated audit systems that have not kept pace with risk-based principles. The 'risk' pot only gets bigger with FINRA's push to implement their Comprehensive Automated Risk Data System (CARDS).[4] The next time a designated examining authority drops by for a chat, don't be surprised when they arrive with a list of 'targeted' branch -offices and reps that will be subjected to special scrutiny.

Best Practices

Below is a summary of best practices many firms now use to comply with branch-office inspection requirements, and properly track and remedy any 'found' issues. No doubt a number of good ideas have been missed here, and comments are welcome.

1. Establish an Independent Audit Group:

Audit systems and workflows vary widely and are affected by a firm's size, resources and scope of business. Yet FINRA encourages all firms[5] to:

- Use risk analysis to determine frequency of branch inspections;
- Employ surveillance reports and current technology to help identify risk;
- Use checklists that incorporate previous inspection findings and trends from internal reports;
- Track action that is taken; and,
- Elevate the frequency and/or scope of branch inspections when necessary.

At risk of stating the obvious, firms must establish an independent audit group.[6] One of the quickest ways to run afoul of the rules is to engage an auditor or audit supervisor with a conflict of interest (i.e. *a financial interest in, or in some other way 'affected by' a particular outcome*) on any inspection they conduct or oversee.

2. **Develop a Training Program for Branch Auditors:**

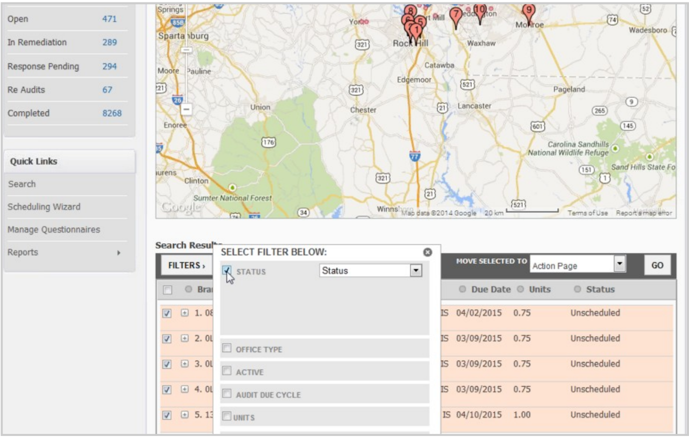
   "Tag you're it" will not work for those performing branch-office inspections. Train your auditors and clearly define the auditor role and inspection protocols. It is also a good practice (if firm size and staffing levels allow), to not utilize the *same* auditor in the *same* branch on consecutive audits (i.e. change auditors on the next inspection cycle).

   Note also the SEC and FINRA admonishment: Firms with significant deficiencies[5] in their branch inspection programs, typically:

   - Use generic examination procedures for all branch offices;
   - Leverage novice or unseasoned branch office examiners;
   - Perform the inspection in a "check the box" fashion; and,
   - Devote minimal time to each exam.

3. **Employ a Master Audit-Calendar:**

   Many large firms (250+ branches) now use web-based calendars, dedicated to an audit system, to create, publish and manage branch inspection schedules. The more advanced audit-calendars have limited 'view permissions' whereby staff/ auditors can only see and interact with their own audit assignments. Many firms also use e-mail notifications and mapping technology integrated into the audit-calendar.



   Map tools allow a firm to quickly identify a grouping of branches by zip-code or via zoom-in/zoom-out tools. This allows an audit manager to assign branch inspections by proximity, minimize travel distances and make the best use of auditors' time in the field.

4. **Develop an automated Audit Survey/Form**:

   The majority of web-based systems make use of an electronically assigned survey or 'audit form' (an e-form) which a branch manger or person-in-charge (PIC) must complete. The audit form covers all inspection items with responses thoroughly vetted by the auditor once they are onsite. A number of these e-forms have the ability to capture an expanded response (i.e. a detailed explanation versus a simple 'yes' or 'no' checkbox). This is especially important for 'exception' items. Once the onsite review is complete, the auditor (depending on firm's chosen workflow) will submit the e-form for tracking and review by the firm's Audit or "QA" Group.

5. **Distribute a Pre-audit Survey**:

   (used *only* for 'scheduled' versus unannounced audits) A handful of firms have realized substantial time/cost savings by way of a pre-audit survey. This 'preliminary' branch inspection e-form is presented to a branch-manager or person-in-charge two to ten (2 to 10) days before a scheduled audit. The survey highlights each inspection item (e.g. signage display, reps' correspondence files, reps' use of *only* authorized computers/devices, etc.) and requires the branch manager verify ('yes' or 'no') whether they have reviewed each item prior to the scheduled audit. The pre-audit survey prompts branch staff to better prepare for the forthcoming inspection. Getting 'ducks in a row' so to speak, can also save the auditor substantial time.

6. **Use Notifications/Alerts:**

   The majority of web-based audit systems and their associated e-forms, are integrated with e-mail notifications (alerts) that serve as prompts or calls to action. Unless you are creating an unannounced inspection, using e-mail notifications is a 'best practice.'

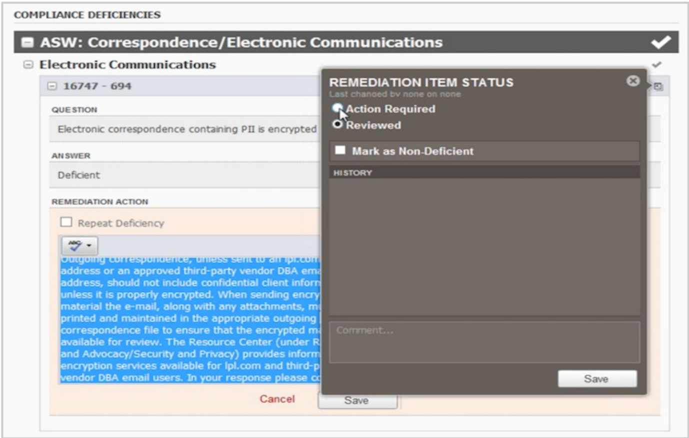
7. **Perform a Quality Assurance 'QA' Review**:

   Many firms will have a 'first pass' review (*before* issuance of any deficiency or remediation letter) of all submitted audits, with special attention to 'exceptions' and the associated explanation/ documentation. An audit supervisor can then, if necessary, return the audit (a particular e-form) for further data input or schedule a follow-up branch inspection. Identified deficiencies ('exceptions') are commonly highlighted during the remediation process as outlined below.

8. Take Remediation Actions:

Any sub-standard branch issue (i.e. an 'exception') must be reviewed by a Compliance Principal (CP) or appropriately designated and experienced member of the Audit Group. The CP should then identify corrective (remediation) steps and put them in writing. This is often done via an audit exception letter (aka deficiency letter). Many audit systems use e-forms and notifications (e-mail alerts) to facilitate remediation workflows. If/when deemed necessary, the CP can schedule a follow-up onsite audit to verify all corrective actions have been taken.

"Inspect what you expect."[7] As a best practice, multiple supervisory level 'QA' reviews may be necessary to ensure remediation actions have been taken before the audit can be 'finalized' in the system.



9. Track Trends:

"Big things have small beginnings."[8] Even a small exception item can uncover or grow into something big; particularly if the exception persists or repeats. Audit systems should be able to track and 'report on' repeated deficiencies. The greater the number of exceptions, or delay in remediation, the higher the risk to the firm. Branches (and reps within) with greater risk need to be inspected more often or slated for secondary unannounced (aka 'surprise') audits.

10. Conduct Unannounced ('surprise') Audits:

Do them! Target branches that have a higher 'risk exposure,' such as those with a high volume of customer complaints, previous audit exception items or inadequate remediation. When a branch is slated for an unannounced audit, Compliance and Audit must exercise care to ensure that no 'heads up' (no advance warning) is provided to the affected branch manager or reps/personnel therein.

11. Heightened Supervision:

While not always identified with a branch audit system, it is important for the auditor to know about, and pay extra attention to, any rep(s) in a branch that have been placed (recently or currently) on heightened supervision (HS). Hence, a best practice is to integrate branch audit with any system used to track reps' HS. It is also prudent to perform more unscheduled audits in braches wherein reps are on HS.

> Reps are placed on Heightened Supervision (HS) for repeated violations of firm policies or when patterns of risk associated with their business can be identified. FINRA's probable implementation CARDS[4] will increase the importance of heightened supervision tracking and reporting.

12. Maintain Audit Work-papers:

Whether the firm's process is automated (web-forms and e-files) or manual, it is a requirement that each audit be preserved[9] (i.e. tracked and stored) and any associated records are readily accessible for secondary review. More advanced systems enable auditors to upload/store a variety of document formats (e.g. Word, PDF, Excel, jpeg, png, etc.) directly into a particular branch-inspection record. Some 'found' violations do not have an associated document, yet an onsite auditor may be able to 'scan' or snap a photo and 'upload.' For example, if non-authorized ads or signage are on display, the auditor can upload a jpeg (photo) directly to the associated audit file.

13. Generate a Branch Audit Report:

The Audit Group must generate and maintain a final branch audit report. FINRA has given wide latitude to firms around the scope of their audit processes. There are, however, specific areas that must be reviewed during an inspection, and included in a final report (kept on file for a minimum of 3 years)[3]:

- Safeguarding of customer funds and securities; maintaining books and records;
- Supervision of supervisory personnel;
- Transmittals of funds or securities from customers to third party accounts;

from customer accounts to outside entities; from customer accounts to locations other than a customer's primary residence; and between customers and registered representatives, including the hand-delivery of checks; and
- Changes of customer account information, including address and investment objectives changes, and validation of such changes.

14. System View Permissions:

Virtually every report and e-form in a branch audit system will contain sensitive data. As a best practice, your system should be able to enforce 'view permission' limits such that users (Auditors, Branch Managers, QA, Compliance Principals, et. al.) can only see and interact with their own audits, reports, or other direct line of supervision duties.

15. 17a-4 Compliance:

The SEC requires firms to 'make and preserve' books & records per Rules 17a-3 and 17a-4. While many firms focus on e-mail systems and trading platforms, branch inspection systems are an integral part of firm supervision. Consequently, firms must ensure their systems, and any third-party vendor technology employed, are in compliance with the SEC's records retention regulations.[9]

Keep your program moving forward!

With apology to any marine biologists now reading, an aquatic metaphor… A branch inspection program *"is like a shark, it has to constantly move forward or it dies!"*[10] Keep your program moving forward and always consider ways and means to update. Firms that act to improve systems and processes, will be in a better position to identify and remediate small problems before they become big, expensive and public…when 'professional sharks' circle.

Footnotes:

1 The phrase *"What we've got here is failure to communicate"* is a quotation from the 1967 film Cool Hand Luke, spoken first by Strother Martin (prison warden) and later by Paul Newman.

2 Regulatory Notice 11-54 – FINRA and the SEC Issue Joint Guidance on Effective Policies and Procedures for Broker-Dealer Branch Inspections http://www.finra.org/industry/regulation/notices/2011/p125205

3 Effective Dec 1, 2014, new 'consolidated' supervision rules 3110 and 3120 have replaced Rules 3012 and 3013. New covering regs notwithstanding, branch office inspection protocols remain largely 'as is' with several clarifications regarding independence (from the branch) of those performing inspections – See 3110(c)(3) and the inspection cycles for non-supervising branches and 'locations of convenience', which generally must be reviewed at least every three (3) years – See 3110(c)(1). http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p486189.pdf

4 FINRA's new Comprehensive Automated Risk Data System (CARDS) continues to move closer to adoption. See http://www.finra.org/Industry/Regulation/Notices/2014/P600952 NOTE: Dec 1, 2014 was the final date for industry comment on CARDS.

5 Source: CBC – Branch Office Examinations and Audits: Broker-Dealer Inspections http://www.finra.org/web/groups/industry/@ip/@edu/documents/education/p126271.pdf

6 Source: Quotation *"Inspect what you expect"* is from many sources including the book How Leaders Manage.

7 A firm's Compliance or Audit Group is commonly responsible for overseeing branch-office inspections. A number of firms also require any non-remediated audit exceptions be reported to the firm's Board of Directors. Once notified, the Board can coordinate response actions with Compliance/Audit. This adds a layer of oversight and is in line with Sarbanes Oxley guidelines.

8 Source: Quotation from the film classic Lawrence of Arabia and also referenced in the modern sci-fi film Prometheus.

9 SEC Rule 17a-4 http://www.finra.org/web/groups/industry/@ip/@reg/@rules/documents/interpretationsfor/p037775.pdf

10 Source: Quotation from Annie Hall movie and via Discovery http://www.discovery.com/tv-shows/shark-week/about-this-show/can-sharks-drown/

SmartPros Ltd.
12 Skyline Drive
Hawthorne, NY 10532
(914) 345-2620
(Nasdaq:SPRO)
www.smartpros.com

SmartPros® KEEPSMART®