

FINRA Reviews & Responses: SDDCO's Update on Small Firm Exams

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SDDCO Regulatory Services LLC shares their report on FINRA exams of small broker-dealers. The study includes an accounting of 2012 FINRA exceptions and citations, an overview of the response process, and unexpected challenges for small brokerage firms.

SDDCO Regulatory Services LLC (SDDCO-RS) ("SDDCO-RS") provides outsourced regulatory compliance services to broker-dealers. Their study of 2012 regulatory reviews concerns a subset of broker-dealers: 20 firms with fewer than 20 representatives that do not handle customer funds or securities ("Small Firms").

Exams in the Update -

The Financial Industry Regulatory Authority ("FINRA") conducts cycle exam of member broker-dealers to check for compliance with federal securities laws, rules and regulations. Of the 20 Small Firm exams reviewed, 16 were routine cycle exams, occurring every three to four years, and 4 were six-month exams for new FINRA members.

Final Disposition Letter -

SDDCO-RS assessed the Final Disposition Letter issued by FINRA at the completion of each Small Firm exam, which can state one of four outcomes:

- 1) No Further Action: 45 percent of Small Firms received no deficiencies;
- 2) Cautionary Action: 55 percent received a letter per deficiencies with a deadline for a reply;
- 3) Compliance Conference: no Small Firms receive this formal meeting notice. In three years of studying results, SDDCO-RS has not seen this outcome;
- 4) Enforcement Referral: no Small Firms received a referral to FINRA Enforcement, which can result in a punitive sanction or fine.

Exceptions and Citations -

The Final Disposition Letter with its examination report ("Report") can identify exceptions and citations found during the review. An exception refers to a rule or law with which FINRA believes the firm did not comply. For each exception, FINRA lists citation(s) detailing a related non-compliant activity. In 2012, examiners listed 52 exceptions across 55 percent of the Small Firm Reports. Within these exceptions, they cited 80 activities; the Reports with exceptions averaged 7 citations each.

Citation Topics -

Within 2012 Small Firm Reports containing exceptions, topics most cited were: Written Supervisory Procedures (40%); Outside Business Activity (25%); Anti-Money Laundering; (25%); Financial Reporting (15%); FINRA Registration (15%); Customer Identification Program (10%); E-communication Review/Retention (10%); Supervision (10%); Fidelity Bond (10%); Annual Compliance Meeting (10%); and Branch Office Reviews (10%).

Responding to FINRA -

SDDCO-RS explains that FINRA often points out compliance issues during the on-site examination, enabling a firm to respond to or rectify issues immediately. Correcting an issue early could prevent its appearance in the FINRA Report.

Exceptions that do land in the formal Report generally require a written response. Most small firms leverage existing resources to evaluate the merits and status of exceptions and citations. The CEO/CCO meets with key personnel—perhaps, in-house counsel or a retained compliance consultant—to review applicable documents, manuals and business practices. Firms with retained consultants typically utilize this expertise in drafting the reply.

SDDCO-RS recommends that broker-dealers respond to FINRA by outlining a Corrective Action Plan detailing their completed, in progress or planned action steps. A firm may dispute exceptions, though SDDCO-RS stresses to be certain of the position and respond with documentation to evidence compliance.

Small Firm Challenges -

SDDCO-RS finds FINRA rules and exam to be more oriented towards conventional broker-dealers—firms handling customer accounts and dealing in traditional products such as stocks and bonds. “FINRA examiners are using a playbook designed for traditional firms,” said Evan Ignall, Partner. “Often the examiners themselves find it challenging to apply FINRA rules to firms with limited business models. Some don’t acknowledge the disconnect. But others do and work with such firms and their consultants to discern which rules apply and how.”

A disconnect between the review process and non-conventional broker-dealers could be evidenced by a surprising finding. An in-house review of exam outcomes across 2012, 2011 and 2010 revealed that brokerage firms with limited business models (no customer accounts) received a similar or greater number of exceptions than brokerage firms with customer accounts.

Post-Exam Trend -

SDDCO-RS recounts that FINRA closed several 2012 cycle exams and then followed up months later with routine information requests as though the exam were still in process. SDDCO-RS observes that while this is consistent with FINRA's goal of moving toward real-time oversight, clients were confused but typically cooperated.

Enforcement Actions -

"Small Firm examinations can be painful," said Ignall, "but, if managed properly, should not result in a sanction or fine. The exceptions FINRA finds in these firms are typically procedural and don't present investor protection concerns. We make sure our clients pay attention and correct deficiencies on time and then communicate these corrections to FINRA."

About SDDCO Regulatory Services LLC -

The SDDCO Regulatory Services LLC provides full-service compliance consulting to FINRA member broker-dealers, onsite and off, on a project or retainer basis. Seasoned professionals facilitate FINRA membership and support ongoing compliance with the rules and regulations of the industry. Service inquiries can be sent via <http://sddco.com/contact/ask-us/>

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