Zero Deficiencies:
Closing the Gap

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INTRODUCTION

Broker-dealers face constant regulatory risks that continue to increase. These risks have short-term and long-term ramifications. In the short term, failure to follow a regulatory requirement may result in a fine, censure, or other disciplinary action by regulators such as the SEC, FINRA, the states, or the MSRB. Longer term, multiple regulatory violations can tarnish a broker-dealer’s reputation and, in many instances, result in increased regulatory scrutiny of the firm’s activities.  

Clearly, broker-dealers have a business incentive to reduce or even eliminate regulatory deficiencies. Given the budget-conscious environment and strict regulatory landscape, this may seem like a daunting goal. It is extremely difficult to be perfect, particularly in the face of resource constraints. In fact, most SEC and FINRA examinations yield multiple findings. As a result of these findings, the SEC or FINRA will issue a deficiency letter. In the case of more significant findings, FINRA may issue a letter of caution. In the worst cases, regulators may bring an enforcement action, with accompanying censures and/or fines. Statistics of recent SEC and FINRA enforcement actions indicate an increase in the number of cases initiated against broker-dealers in 2011. The SEC brought 112 enforcement actions against broker-dealers in the last year, which was an increase of 60 percent from the prior fiscal year. FINRA filed 1,488 actions in 2011, which was an increase of more than 13 percent from the 1,310 disciplinary actions brought in 2010.  

Still, some broker-dealers have in fact exited regulatory examinations with no findings and have received the coveted “no further action” letter. Such an accomplishment does not mean the firm is perfect and has no regulatory violations. It does, however, give some indication that a broker-dealer’s compliance and supervisory programs are working effectively.

This white paper will discuss why broker-dealers should consider setting zero deficiencies as the primary objective of their compliance and supervisory programs, and the practical tools that broker-dealers can use to achieve this goal.

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1 – The SEC has instituted a Risk Analysis and Surveillance Unit that ranks registered broker-dealers based on the occurrence of complaints, regulatory actions, and self-regulatory organization exam deficiencies. FINRA also is instituting a risk-assessment process. A broker-dealer with a poor regulatory risk ranking will be subject to more frequent and possibly more extensive SEC and FINRA exams.


3 – See Richard G. Ketchum, “Testimony before the Committee on Banking, Housing, and Urban Affairs, United States Senate,” April 24, 2012.

ESTABLISHING THE ZERO DEFICIENCY OBJECTIVE

As the SEC and FINRA have indicated in their publications and staff speeches, broker-dealers should adopt reasonably designed compliance and supervisory systems that are effective at preventing, detecting, and remediating deficiencies. Given that many examination deficiency letters identify seemingly immaterial technical gaps, it may seem that regulators expect broker-dealers to be perfect. That is not the case. As Sutherland Asbill & Brennan LLP partner John Walsh indicated in "Institution-Based Financial Regulation: A Third Paradigm" (authored when Walsh served as Chief Counsel of the SEC’s Office of Compliance Inspections and Examinations), regulators use examinations as a means to work “with firms in a nonpublic dialogue to comment on the adequacy and effectiveness of the firms’ compliance institutions.” In other words, examinations give regulators an opportunity to provide feedback to firms on the effectiveness of their compliance and supervisory programs.

Broker-dealers that aim to be deficiency-free in their regulatory examinations should first establish a zero-tolerance policy toward violations in their day-to-day activities. This policy should focus on minimizing the chance of any potential gaps in the firm’s compliance and supervisory programs. By setting this policy, the firm enhances its chances of achieving minimal or even zero regulatory examination findings.

After a zero-deficiency objective is established, the firm’s Chief Compliance Officer and designated principals need to build a strong compliance and supervisory framework. It is important that the broker-dealer nurture a strong compliance-oriented culture guided by the “tone at the top.” This can be accomplished by senior management strongly supporting the firm’s compliance function to influence behavior as needed within the organization. Success, however, ultimately depends on achieving “buy-in” to the zero-deficiency objective from all functional areas (e.g., Sales, Trading, Operations, and other business units).

Firms with a zero-deficiency objective should design their compliance and supervisory framework to suit their organization’s size and complexity and to address their specific business activities. Tailoring the supervisory system to the firm’s business activities is encouraged by regulators, as most clearly described in NASD Notice to Members 99-45.

Firms also should design the compliance and supervisory duties, which can be voluminous, to maximize results and minimize costs. Compliance costs have increased as the regulatory burden has increased. A 2011 survey by Thomson Reuters indicated that a majority of global compliance officers believed their compliance budgets would increase that year.

A number of broker-dealers have formally or informally implemented a zero-deficiency objective and achieved zero or minimal regulatory findings. To develop a successful compliance and supervisory

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5 – For example, FINRA indicated in Footnote 47 of Regulatory Notice 12-25 that the supervision rule requires that the supervisory system be “reasonably designed to achieve compliance with applicable laws and regulations.” In addition, see FINRA Regulatory Notice 12-25, “Additional Guidance on FINRA’s New Suitability Rule,” May 2012.

6 – See John H. Walsh, “Institution-Based Financial Regulation: A Third Paradigm,” Harvard International Law Journal 49, No. 2 (Summer 2008). Mr. Walsh served as Associate Director-Chief Counsel in the SEC’s Office of Compliance Inspections and Examinations.


framework, firms should adopt a regulatory compliance program that contains the following components:

• A comprehensive set of written procedures that are easily understood, current, and practical
• A compliance calendar that identifies and schedules compliance and supervisory tasks
• Comprehensive execution of the scheduled tasks on a consistent basis
• Institution of ongoing mechanisms that test the performance of those tasks and refine them as needed
• Establishment of an effective remediation process

The sections that follow provide more detail on some important issues regarding each of these components.

Written Supervisory Procedures

Comprehensive, well-tailored written supervisory procedures (“WSPs”) form the cornerstone of a broker-dealer’s approach to meeting regulatory requirements and overall expectations. The procedures, among other critical objectives, identify the controls designed by the broker-dealer to address the firm’s risk areas and regulatory exposure. One common weakness regarding this core component of a supervisory system is that broker-dealers often fail to devise and institute an effective procedure to develop the WSPs and then maintain their relevance and currency with regulatory developments. Added to this challenge is the need to communicate any updates throughout the organization in a clear and prompt manner.

The optimal method to prepare and maintain WSPs includes the following steps:

• Identifying and addressing all new relevant regulations, notices, and alerts
• Identifying and addressing all new relevant regulatory actions
• Identifying and addressing any changes in business practices
• Developing practical, not theoretical, methods to address regulatory exposure resulting from the elements described above
• Assessing the impact of implementing the WSPs on staffing, IT capabilities, and any relevant tools (exception reports or system alerts, for example)
• Designating qualified, appropriate principals to take responsibility and be accountable for executing the activities called for by the procedures
• Identifying the frequency of the supervision that must occur and maintaining evidence of the supervisory actions

When completed, a firm’s WSPs should clearly designate responsibilities for supervision and compliance. Designations should be detailed in a table so that it is clear what everyone’s responsibilities are. As a part of the designation process, the firm should define the difference between “supervision” and “compliance.” Generally, supervision involves directly ensuring that the broker-dealer’s activities comply with applicable regulatory requirements. The Compliance Department (“Compliance”) usually oversees the supervisory function. In other words, Compliance monitors the supervisory controls and those responsible for them to ensure their consistent and effective application. In 2005, the Securities Industry Association published a white paper on the role of compliance and provided the following description of the supervisory function:
The management function in a securities firm, not the Compliance Department function, has the responsibility to supervise business units and to direct firm and employee activities to achieve compliance with applicable laws. Supervisory systems function more efficiently when there are clear lines of authority and accountability to line management within a firm; the nature and limits of the Compliance Department’s responsibilities must be clearly communicated to supervisors and senior management. While the Compliance Department, a non-business line function, plays an important advisory and monitoring role within a firm’s overall compliance system, it does not have supervisory authority.9

If Compliance assumes the supervisory role, this oversight function can be marginalized. FINRA emphasized the importance of the delineation of roles between supervision and compliance in a 1998 decision.

We note that the supervisory structures of many firms do not give line supervisory authority to compliance officers. …because the Manual specifically stated that the compliance department was to supervise all sales, trading, and investment banking activities, Respondent 1, as the Director of Compliance, had this supervisory responsibility. By assigning Respondent 1 both supervisory and compliance responsibilities, [the firm] deprived itself of the benefit of two separate and independent reviews, one by a line supervisor whose function it would have been to carry out the supervisory functions designated in the Firm’s procedures manual, and the other by a compliance officer, whose function it would have been to review the Firm’s operations through normal surveillance activity.10

Many broker-dealers do not memorialize all supervisory procedures in one manual. In these instances, it is advisable to maintain a table of supervisory procedures. Firms could develop a central WSP manual, which may be supported by memos (e.g., specific markup policy) and periodic updates (e.g., compliance alerts). Not only will the table help the firm’s staff know where all the supervisory controls are documented, it will also help the regulators review the firm’s documentation of its overall supervisory framework.

**Compliance Calendar**

A broker-dealer’s WSPs should describe the myriad tasks and responsibilities necessary for it to remain compliant. Keeping up with required tasks is critical to remaining in compliance. Thus, a compliance calendar can be a critical means to success.

A compliance calendar should list all regulatory duties a designated principal must complete according to regulatory or business deadlines. These calendars can be maintained in Microsoft Outlook, in a spreadsheet, or in specifically designed software. Some firms supplement their calendars with checklists that guide the designated principal through his or her responsibilities.

A compliance calendar helps ensure that the duties are performed on time and that no task gets missed. To achieve the best results, the controls in the WSPs should be mapped to the compliance calendar to confirm that all required duties have been scheduled.

The biggest challenge broker-dealers have in implementing their WSPs is translating the responsibilities into a routine that designated principals can easily follow. If these tasks are not scheduled in a practical way, they may not be completed. Creating and following a comprehensive compliance

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calendar is one way to avoid this. Of course, other methods exist for scheduling and completing compliance and supervisory duties. The important lesson here, though, is that broker-dealers that do not adopt such tools often find that their personnel fail to fulfill important compliance responsibilities.

An illustration of the importance of this process can be seen in larger broker-dealers that have many departments, personnel, and offices. A great deal of effort is put into developing comprehensive WSPs. However, difficulty arises in ensuring that all supervisory controls are identified and responsibilities are confirmed. Generally, these broker-dealers engage in an exercise where Compliance maps each area of the WSPs to a specific supervisory control and to the responsible designated principal or group. What is generally missing in the process is a formal protocol (e.g., preparing a compliance calendar) for the persons responsible for the supervisory controls to schedule all their duties. This protocol would further ensure that there is a routine in place to ensure that all prescribed duties are executed on an ongoing basis. In the absence of such routines, principals may develop their own practices, which may fail to address the highest areas of risk.

**Execution**

Now that the duties have been identified in the WSPs and scheduled in the compliance calendar, the designated principals must execute them. Several factors can affect principals’ abilities to fulfill such duties. These include other responsibilities, the tools and resources provided, and the principals’ experience.

One way to help designated principals complete their tasks is training. This may involve short discussions describing responsibilities or more formal instruction. In addition, principals and compliance personnel can keep current by attending educational conferences and other forums and then returning to their firms to share the information. What many firms do not realize, and therefore do not practice, is that training should be ongoing. For their compliance efforts to be effective, broker-dealers should obtain and disseminate relevant information to the designated principals so they can succeed in their supervisory duties.

As previously mentioned, appropriate tools also are essential to help designated principals complete their supervisory duties properly. These can include exception reports or alerts generated internally from databases or provided by the clearing firm (if applicable). To make sure these reports and alerts are meaningful and useful, broker-dealers can consider taking these steps:

1. Establish baseline parameters.
2. Create a list of red flags or scenarios of possible negative events.
3. Identify how red flags should be addressed or how such negative events should be resolved, including what specific actions should be taken.
4. Catalog these red flags and scenarios and create new ones over time.
5. Review the alerts and exceptions and analyze the false positives – as they reoccur, they can be filtered out from ongoing reviews to leave more time for real issues.
6. Perform timely investigations of each issue and make sure the steps taken in analysis, escalation, conclusion, and resolution are documented.
7. Hold periodic meetings to discuss exception reports and alerts, note current issues, and use that knowledge to further enhance the process.
In Notice to Members 99-57, FINRA emphasized that “a key aspect of these supervisory procedures is exception and other compliance reports that a member creates to help meet these supervisory responsibilities.”\(^1\) In Notice to Members 99-45, FINRA provided further guidance on this topic: “For example, a supervisory system may include elements such as automated exception reports and surveillance programs that monitor for unusual trading activity in customer accounts.”\(^2\) In addition, the SEC has noted that

...exception reports include reports that identify exceptional numerical occurrences, such as frequent trading in customer accounts, unusually high commissions, or an unusually high number of trade corrections or cancelled transactions. These reports help supervisors, compliance officers, and securities regulators to discover sales practice problems such as excessive switching, unauthorized trading, and other indications of securities fraud.\(^3\)

The WSPs should instruct supervisors on which reports produced by the surveillance system they should review in performing their supervisory responsibilities. This would include a description of how often these reports should be reviewed, the steps to be taken if suspicious activity is discovered, and how to document the supervisor’s oversight activities.

**Testing**

For any compliance and supervisory framework to remain effective, there must be a feedback process. In other words, the framework needs to be monitored constantly and closely to make sure it is working as designed. Conducting testing to provide this feedback is one of Compliance’s primary oversight functions.

As part of its oversight, Compliance should review the evidence of completion of duties by the designated principals. This helps ensure that responsibilities have been completed fully and on time. How much Compliance should monitor or review depends on

- how new the task or corresponding regulation is;
- the designated principal’s past performance;
- the extent of past regulatory findings, especially in areas where the principal has responsibility;
- how much time and resources Compliance has available; and
- the potential risk created by a failure to complete the task.

Specific tests can include

- branch office inspections required by NASD Rule 3010;
- annual supervisory and control testing required by NASD Rule 3012;
- annual financial audits required by Rule 17a-5 under the Securities Exchange Act of 1934;
- IT testing, including disaster recovery and privacy; and
- ad hoc reviews and assessments.

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FINRA has pointed out that many broker-dealers continue to fail to test and verify, on an annual basis, the sufficiency of their supervisory procedures.\textsuperscript{14} FINRA has also noted that “testing and verifying a firm's supervisory procedures on an annual basis ensures that the firm's supervisory procedures are reviewed and amended on a regular basis in light of changing business and regulatory environments.”

To further help firms minimize regulatory gaps, there should be an ongoing “self-analysis” that is performed by the different functional areas within the broker-dealer. Instituting a risk management structure and process will provide an effective means for a firm to self-analyze how well its controls are mitigating risks. The risk management process should include the impact on compliance of new products or services and changes in operational procedures. As changes occur in products, services, and operations, a designated group or committee should discuss possible issues and develop protocols to reduce the exposure to risks.

Firms also should make sure that each functional area understands what is happening in other groups in the organization, especially with regard to how actions taken by one group affect the overall workflow. For example, if the account opening area in Operations must obtain new information before allowing an account to open, but there is a massive backlog of accounts with incomplete documentation, other areas will be affected. The Front Office must make sure it obtains all required account opening documentation in a timely manner, and is aware of what documentation is still outstanding. There may be technical problems that IT needs to be aware of in order to implement fixes. Compliance also would need to be aware of this situation because it will affect books and records requirements and because customers may complain of delays in opening accounts.

Notably, organizations will continue to find new investment opportunities (e.g., derivatives, crowd sourced investments, hedge funds) to offer customers. However, the Operations, Finance, and Compliance areas often need to catch up with the business units’ sales efforts to make sure there are processes to execute and oversee these new opportunities. In short, broker-dealers need to ensure that their infrastructures across the firm and within functions keep pace with their business growth and evolution.

Finally, a broker-dealer’s risk management process should identify and address risks other than regulatory ones. If left unattended, such risks—operational, financial, reputational, market, liquidity, and fraud, to name a few—can have significant negative consequences. This comprehensive risk management process should focus on how the risks within each functional area affect the overall organization. Failure to address risks in the organization can result in economic losses as well as regulatory violations.

To best seek to achieve zero deficiencies, Compliance needs to be part of the communication process when significant gaps are detected via testing. This will help ensure that the related risks are addressed as completely as possible.

**Remediation**

When gaps are identified, a formal process is needed to escalate any significant weaknesses to those in the organization who can correct them. Senior management also must be made aware of the potential risk these gaps present to the broker-dealer. If gaps are not remediated, then the compliance and supervisory systems may fail.

\textsuperscript{14} – See “Common Examination Findings: Supervisory Control Procedures” on the FINRA website.
One critical practice is to track action plans of remediation to ensure that necessary steps are taken by the appropriate persons in a timely fashion. Often the tracking role falls to Compliance. However, it is better practice for the relevant business area to be held responsible for the corrective action.

FINRA’s Regulatory Notice 08-70 highlights regulators’ expectations regarding remediation. The notice provides insights into how a firm can influence the outcome of FINRA’s investigations by cooperating and undertaking remedial actions. The following are categories of cooperation that FINRA noted:

- Self-reporting before regulators are aware of the issue
- Extraordinary steps to correct deficient procedures and systems
- Extraordinary remediation to customers
- Provision of substantial assistance to FINRA’s investigation\(^\text{15}\)

Note the second bullet, which indicates that if a firm is proactive in finding and correcting a problem, sanctions can be reduced. The key, though, is that the remediation action must be taken early on or at least before FINRA’s investigation ends. Similarly, in the third bullet, FINRA indicated that “extraordinary” restitution to customers also can help in reducing FINRA sanctions.

One notable example of reductions in FINRA sanctions is the credit given in a recent settlement regarding a failure to protect confidential customer information.\(^\text{16}\) Because the firm notified customers and offered them credit monitoring and restoration services for one year, FINRA took those actions into consideration in imposing its fine. Specific SEC actions from 2009 and 2010 also indicate that the Commission considered remedial steps taken by broker-dealers in its settlement with them, including the firms’ conduct of internal investigations and implementation of significant corrective actions.

**CONCLUSION**

Broker-dealers’ compliance and supervisory frameworks can be complex and challenging to maintain. The key to reaching or at least getting as close as possible to a zero-deficiency level lies in implementing and then diligently refining a comprehensive compliance and supervisory program. The critical elements of these programs are practical, up-to-date written supervisory procedures, an all-inclusive and strictly monitored compliance calendar, a regularly scheduled compliance and supervisory testing regimen, and a rigorous, promptly executed remediation process.

To put it simply, if a firm says what it is going to do and then does it, the chance of regulatory findings diminishes. Ultimately, broker-dealers that realize the greatest success will nurture a dynamic firm-wide process to implement, and then continuously enhance, their compliance and supervisory structures and procedures.

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\(^{15}\) These categories are nearly identical to those referenced in the SEC’s “Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions,” SEC Release No. 44968, October 23, 2001. This report, often referred to as the “Seaboard Report,” describes some of the criteria the SEC will consider in determining whether, and how much, to credit self-policing, self-reporting, remediation, and cooperation as part of resolving enforcement actions.

\(^{16}\) See “FINRA Imposes Fines Totaling $600,000 Against Lincoln Financial Securities and Lincoln Financial Advisors for Failure to Protect Confidential Customer Information,” FINRA news release, February 17, 2011.
DISCLOSURE

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