BATES RESEARCH

Broker-Dealer Branch Office Compliance

Supervision, Inspections and Operational Considerations

Bates Research

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Introduction

Over the past two years, regulators have undertaken several initiatives[1] to better understand a fast-changing financial marketplace, to improve agency efficiency, and to promote dialogue with those they regulate. Such proactive outreach is necessary not only due to the substantial uncertainty caused by, for example, new financial technologies (FinTech), but also in order to receive valuable feedback on the impact of the new obligations being brought to bear on market participants. Those impacts are felt acutely by registered broker-dealers at the furthest reaches of the regulatory chain, notably, those operating out of branch offices. Based on recent agency communications, regulators are starting to pay more attention to branch office supervision and compliance.

This paper discusses the responsibilities placed on the supervisors of broker-dealer branches in light of the Financial Industry Regulatory Authority's ("FINRA") announced examination priorities[2] and recently updated guidance on strengthening cybersecurity controls.[3]

FINRA Branch Supervision

Broker-dealers are required to register their branch offices with FINRA and other regulatory and/or state authorities.[4] When registering, firms must indicate whether or not the branch will be registered as an Office of Supervisory Jurisdiction ("OSJ") for the firm. OSJ branches require at least one qualified and registered principal of the firm be onsite to supervise and assume responsibility for the branch's securities-related business activities.[5] The scope of the business conducted at a branch and the number of branches a firm operates both affect the proper registration filings.

The General Framework

Three broad FINRA rules address the supervisory obligations required by registered broker-dealer firms.[6] FINRA Rule 3110 (Supervision) requires a firm to establish and maintain a system to supervise the activities of its associated persons in order to ensure compliance with securities laws and regulations. FINRA Rule 3120 (Supervisory Control System) requires a firm to test and verify the firm's supervisory procedures. FINRA Rule 3130 (Annual Certification of Compliance and Supervisory Processes) requires a firm to designate and identify one or more principals to serve as a chief compliance officer, and requires the firm's chief executive officer to certify annually that the firm has processes in place to establish, maintain, review, test and modify policies and procedures reasonably designed to achieve compliance with applicable laws and regulations including FINRA rules.

Under this framework, branch office supervision is where the rubber meets the road. Branch supervisors are responsible for ensuring that the procedures that are in place to ensure compliance with written supervisory procedures are being adhered to, documented and reported. These processes are in need of constant attention as regulators and enforcement agencies examine everything from controls over bad actors to suitability of investment recommendations. Compliance under FINRA's three-rule framework extends to each associated person at the branch office.[7]

Going from the general rules to specific branch compliance requirements presents unique challenges, due in no small part to branches having many

Three broad FINRA rules address the supervisory obligations required by registered broker-dealer firms:

- FINRA Rule 3110 (Supervision)
- FINRA Rule 3120 (Supervisory Control System)
- FINRA Rule 3130 (Annual Certification of Compliance and Supervisory Processes)

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different characteristics and special circumstances. The general framework, however, remains the same: a system of supervisory control policies and procedures ("SCPs"), written supervisory procedures ("WSPs")—which sometimes incorporate the SCPs as one document—and the oversight and means necessary to permit certification, under FINRA Rule 3130, that the firm's compliance program is reasonably designed to prevent and detect violations of securities laws. Branch compliance is, therefore, all about extending these three basic rules to cover all firm representative activity in all circumstances and to hold supervisors accountable.

Application of Framework to Branch Supervisors

Under Rule 3110, every firm must have WSPs that cover the activities of associated persons and all the types of businesses engaged in by a branch office. So, for example, the WSPs must provide for the review of a firm's securities business, correspondence and internal communications, and customer complaints. Moreover, the written procedures need to specify the individual(s) responsible for each review, the supervisory activities each person will perform, the frequency of review, and the manner in which it is documented.

The firm's supervisory control system under Rule 3120—the focus of much recent attention—must be tested to verify that the WSPs are reasonably designed to achieve firm compliance with all other FINRA rules. As a result, Rule 3110(a)(3) requires the firm to designate a registered principal to be responsible for establishing, maintaining and enforcing a firm's WSPs at the branch level. That branch office supervisor is charged with reviewing reports, often established by the home office, and responding to red flags identified during the report review. The branch office supervisor is also responsible for raising issues to senior management and to also follow any changes that have been implemented by the home office.

The emphasis on incorporating risk-based methodologies into testing helps to identify where modified or new WSPs may be necessary in light of shifting business and regulatory environments. FINRA's general approach to accountability, Rule 3130, requires the CEO to submit a report stating that he/she met with the designated CCO, and to certify to the firm's board of directors and audit committee (or equivalent bodies), if the size of the firm requires, that the firm has in place processes to establish, maintain, review, test, and modify policies and procedures reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules.

From a branch perspective, the result of the three-rule regulatory approach is increasingly clear: more and more detailed requirements flowing downhill that place greater expectations and compliance burdens on branch supervisors. One need only consider the unconsolidated, non-all inclusive, seventy-four page WSP checklist provided by FINRA[8] to get a general sense of the compliance burdens on supervisors. Supervisors face significant challenges in not only the evolving substantive areas of regulatory concern, but also in tailoring their supervision to reasonably address the unique risks within their branches.

Exam Priorities

From a regulator perspective, the shifting market conditions requires a framework broad enough to address continuing and evolving threats, flexible enough to enable broker-dealers to adapt their procedures to the unique attributes of

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their firm, and specific enough to hold leadership and registered representatives accountable. FINRA's latest examination priorities offer a glimpse at the many areas that need to be covered under an effective regulatory regime. (See Bates Group's Comparison Chart[9] for a broad indication of FINRA's exam priorities over the past few years.) As the priorities letter makes clear, these concerns are cumulative. They incorporate "topics that have been mainstays of FINRA's attention over the years." For that reason, and based on the sheer number of substantive issues that the self-regulating organization wants firms to address, FINRA bundled this year's continuing priorities into general risk categories.

FINRA communicated that an effective compliance program must cover Sales Practice Risk concerns. These include effective supervision over the suitability of recommendations of products such as mutual funds, variable annuities, share classes, trading in margin accounts and private securities transactions. It also includes special additional obligations concerning the protection of senior investors to prevent fraud, sales practice abuses and financial exploitation of this particularly vulnerable group. At the branch level, this also means that supervisors closely monitor accounts "where registered representatives serve in a fiduciary capacity, including holding a power of attorney, acting as a trustee or co-trustee, or having some type of beneficiary relationship with a non-familial customer account."

The FINRA 2019 examination priorities letter leaves no doubt that supervisors are on the hook for carrying out the supervisory tasks that they are assigned.

Remote Branch Office Inspections

One issue that highlights the supervisory challenges inherent in effective supervision of broker-dealer branches was described in a Progress Report on FINRA360, issued in April 2018.[10] FINRA360, launched in March 2017, was an initiative designed to foster dialogue and collaboration with market participants in order to improve the self-regulatory organization's efficiency.

In the Report, FINRA recounts that firms questioned the manner in which internal inspections for branch offices should be carried out, "particularly for those offices or locations with a limited number of associated persons or where only operational or limited supervisory functions take place." The seemingly simple matter of registered representatives working from personal residences—or anywhere outside of the office—actually presents complex issues associated with FINRA's general risk categories.

As a result of the member firms' inquiries, FINRA proposed an amendment to Rule 3110[11] that would give firms the option to conduct a remote inspection of a "qualifying office" to fulfill compliance obligations under Rule 3110. For branch supervisors, the new rules would require firms that conduct such remote inspections to have policies and procedures reasonably designed to determine whether a location is eligible for remote inspection as a "qualifying office" and to assess whether a remote inspection of any such office is reasonable.

From a regulator's perspective, the proposal to create qualifying offices was rationally related to fixing a problem that surfaced through good dialogue between the SRO and market participants. The costs and labor associated with the proposed fix, however, effectively stymied the proposal. It is possible that new technologies will provide a simpler solution to overcome some of these challenges.

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Cybersecurity and Branch Controls

In a recently-issued Report on Selected Cybersecurity Practices,[12] FINRA provided additional guidance for firms to improve their cybersecurity programs. The new guidance is in addition to protocols contained in a 2015 FINRA Report on Cybersecurity Practices[13] and based on the SRO's Risk Control Assessment Survey of high-level, mid-level and low-level revenue firms.

In the Report, FINRA sought to provide best-practices advice based on an assessment of the "evolving cybersecurity threat landscape, firms' primary challenges and the most frequent cybersecurity findings from our firm examination program." First among the topics was the adverse effect of branch autonomy on the implementation of consistent firm-wide cybersecurity controls.

In its review of branch controls, FINRA identified the vulnerabilities of customer information from branches that (i) purchase their own technology assets, (ii) use non-approved vendors, (iii) fail to follow firm software patching and upgrade protocols, and (iv) employ representatives who work from home.

Noting that "branch offices may have less developed cybersecurity controls in comparison to the home office," FINRA recommended—consistent with the three-rule framework—the "establishment of WSPs to define minimum cybersecurity controls and to formalize oversight of the branch offices."

FINRA also suggested many additional measures that branches should develop, including creating an "inventory of branch-level data[14] and software and hardware assets, maintaining branch technical controls and implementing a robust branch cybersecurity examination program."

Among other proposals, FINRA recommendations include: better training, better dissemination of cybersecurity guidance, improving lines of authority and responsibilities, more effective responses to violations of policy, and better technical controls regarding storage of sensitive customer or firm data.

Beyond tightening branch office controls, the FINRA Report goes on to identify numerous practices reflecting a range of additional protocols for firms that would ensure more stringent oversight, technical control and accountability. Specifically, the SRO offers recommendations on phishing attacks, insider threats, penetration testing and the use of mobile devices, all of which present unique challenges to branch office supervision.

FINRA's recommendations set expectations for compliance that firms can choose to ignore at their own peril. To hone in on that point, the Report makes clear that to satisfy minimum standards and obligations, a firm's branch review must "evaluate branches' cybersecurity vulnerabilities and ensure that branches are consistently applying cybersecurity controls across a firm's branch network." Branch reviews, the SRO reminds firms "may include on-site branch inspections, remote surveillance, inspections, reports and questionnaires to evaluate and record each branch's and registered representative's compliance with the firm's cybersecurity standards."

What's A Branch Supervisor To Do?

The financial services marketplace keeps growing more complex and risky. Regulators are working diligently to protect investors from both existing and emerging threats, ensure fair competition and encourage innovation. FINRA's three-rule framework stretches to accommodate multiple regulators' mandates,

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numerous risks (so numerous that they are now bucketed in categories) and a variety of business models. The framework covers the vast panoply of professional standards and topical requirements, and gives rise to extensive guidance and other less-overt forms of secondary obligation.

Firms, on the other hand, remain challenged by growing regulatory mandates and increased compliance costs within the context of sophisticated examination scrutiny and aggressive enforcement.

At the branch level, supervision over firm personnel continues to take the form of long checklists of tasks intended to ensure the survival of a regulatory examination at best, and an enforcement action at worst. Bob Lavigne, Managing Director of Bates Group's Compliance Solutions practice, says that "check-the-box compliance at the branch can actually increase risks for the firm—a result that will be a red flag for regulators during examinations." Branch supervisors must be attuned to the business practices of the representatives in their offices, outside of the day-to-day checklists of tasks to be performed. WSPs, SCPs, testing programs and the like must be tailored to the characteristics of the branch in such a way as to demonstrate to regulators that they can effectively address both specific and broader risk. That is a challenge.

About Bates Group's Compliance Solutions

The Bates Compliance Solutions (BCS) team of compliance professionals and consultants provides a comprehensive set of services tailored to the needs and requirements of broker-dealers. BCS provides ongoing updates to a firm's Written Supervisory Procedures in response to changes to: securities laws and FINRA Rules, internal processes, policies and business model and supervisory systems. Our team also provides services related to compliance and Supervisory Testing, CEO certifications and CEO reports, anti-money laundering testing and training, communications and advertising and a variety of compliance training. In addition, we provide FINRA examination Support, firm and branch office inspections and other ongoing compliance support related to, e.g. CRD filings with state and federal regulators and quarterly customer complaint and disclosure filing.

For more information about Bates Group's compliance services, please contact Rory O'Connor, Director, at roconnor@batesgroup.com or call (860) 671-7270.

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Endnotes

1 FINRA360, See, e.g. https://www.finra.org/sites/default/files/FINRA360ProgressReport_April2018.pdf

2 http://www.finra.org/sites/default/files/2019_Risk_Monitoring_and_Examination_Priorities_Letter.pdf

3 https://www.finra.org/sites/default/files/Cybersecurity_Report_2018.pdf

4 This includes the NYSE and relevant state authorities. See, http://www.finra.org/industry/manage-branch-office-registration

5 http://www.finra.org/industry/manage-branch-office-registration

6 http://www.finra.org/industry/supervision

7 Note this SEC Division of Market Regulation Staff Bulletin from 2004 reminding broker-dealers that small, remote offices require vigilant supervision.

8 http://www.finra.org/sites/default/files/WSP-Checklist.xlsx

9 https://www.batesgroup.com/news/finra-highlights-online-platforms-mark-up-disclosure-and-compliance-regtech

10 https://www.finra.org/sites/default/files/FINRA360ProgressReport_April2018.pdf

11 https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-38.pdf

12 http://www.finra.org/sites/default/files/Cybersecurity_Report_2018.pdf

13 https://www.finra.org/sites/default/files/p602363%20Report%20on%20Cybersecurity%20Practices_0.pdf

14 FINRA provides more information on asset inventories under its *Small Firm Cybersecurity Checklist* and in its *Report on Cybersecurity Practices*.

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