

Between Exams

*Preparing for a FINRA Exam When You Don't
Think You Need To*

Introduction

How should a broker-dealer prepare for a FINRA exam when it's a long way off? To use an academic analogy, what efforts can broker-dealers make at midterm to improve their performance on the final exam?

We posed that question to five compliance consultants with extensive experience in the securities industry. While they emphasized different activities and strategies, their ideas coalesced around four themes: take advantage of FINRA resources, invest in software, test often, and promote a compliance-friendly culture.

Take Advantage of FINRA Resources

According to Ginny Voos, Senior Compliance Consultant at BD Compliance Associates in Atlanta, FINRA doesn't want a bad exam any more than a broker-dealer does. That's why "they offer extensive help to broker-dealers," she says, "but broker-dealers often don't know about the kinds of help available or are afraid to ask for it." Voos and others emphasize the usefulness of FINRA's website, district offices, and district committees:

- **FINRA's Website:** FINRA has, indeed, made the leap into the digital age, says Carrie Wisniewski, Voos' colleague and President at BD Compliance Associates. All of FINRA's regulations, guidelines, suggestions, conferences, templates, and other communications are online for members. According to Wisniewski and the other consultants, the two most important documents are 1) The annual Regulatory and Examinations Priorities Letter, which highlights FINRA's areas of emphasis for the calendar year and 2) The "Weekly Update," which features the latest Regulatory Notices, news about compliance education events, and other compliance information (and is available electronically by subscription). Other helpful resources are the Written Supervisory Procedures Review Checklist and several on-demand webinars of FINRA-sponsored panel discussions and other topics. Wisniewski says that, despite improvement, "a lot of material can still be hard to find" on FINRA's website. Her solution: use Google. "The result is usually the FINRA page I'm looking for."
- **FINRA District Offices.** According to Steve Thornton, founder and President of Thornton & Associates in Tarzana, California, broker-dealers underutilize compliance seminars sponsored by FINRA District Offices. These seminars, he says, "are generally led by supervisors of field examiners, and the agenda is set around regulatory issues that have occurred in recent examinations in those Districts. So you'll get good insight into FINRA's current approach to exams." Thornton also thinks that broker-dealers should call FINRA District offices with questions. "A lot of broker-dealers fear that FINRA will perform an audit based on the call, but that almost never happens," he says. Instead, FINRA will usually articulate general compliance guidelines and "point the broker-dealer in the right direction."

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- **FINRA District Committees.** Thornton also thinks that broker-dealers should be willing to run for and serve on FINRA District Committees, which are local groups of industry professionals who alert FINRA to industry trends and consult with FINRA on proposed policies and rule changes, among other tasks. "When you serve on a District Committee, you meet with FINRA examiners and other compliance professionals, which is a great way to keep up with changes in the industry and to help shape FINRA's regulatory agenda."

Invest in Software

Good email archiving software is "simply a must" according to Marc Horin, President of National Compliance Consultants in Chicago. "It's something FINRA has really emphasized in the past few years." Steve Thornton recommends investing in a program that tracks all forms of electronic communication, including tweets, texts, and social media postings. "Regulators haven't updated their communications rules to reflect modern reality," he says, "but they will soon". Carolyn May, an independent compliance consultant in Little Rock, Arkansas, agrees: "As the workforce gets younger, electronic communication is going to grow," so broker-dealers should begin storing and tracking it as soon as possible.

According to May and others, creating a compliance calendar is also a must, and it's usually an easy and inexpensive way to leverage existing software. If a broker-dealer has enterprise software that contains a common calendar, it only needs to add compliance events to it – as in "begin preparing for the Rule 3012 filing" and "review exception reports from the previous month." Enterprise-type calendars are also available for free from Google, Yahoo, and other sources. "With these, a broker-dealer only needs to invest a little time to get a huge benefit," says May. "First, everyone will be reminded of what they need to do at the appropriate time. Second, reminders will be on the general calendar, which means that tasks won't get lost if someone leaves the firm. And completed checklists can be submitted to FINRA as evidence of following supervisory procedures."

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Marc Horin is skeptical about investing in other compliance software for broker-dealers. "Compliance is not complicated, and it's not a high-tech business," he says. "The biggest question is not 'Do you have the right software?' but 'Are you going to do your compliance work?'" Before buying compliance software, broker-dealers need to make sure that it actually offers a valuable service– something more, in other words, than managing a compliance calendar.

Horin also notes that "clearing firms are offering more compliance-friendly reports," although he warns that broker-dealers need to thoroughly understand the limits of those reports. "A clearing firm may define 'excess commission' differently than the broker-dealer would, for example. An inappropriate baseline will likely make any exception report or similar compliance tool functionally useless."

The other compliance consultants we talked to are more positive about using software, but still advise caution. Ginny Voos advises against adding one more piece of software to an un-integrated set of office management programs. "Broker-dealers should solicit feedback from other users to ensure that the software is meaningful, reliable, and will easily integrate into the firm's current data processing."

Steve Thornton and Carolyn May emphasize the importance of finding software that fits a broker-dealer's particular operations. "Increased regulation has driven more and more broker-dealers into specialization, making them more 'boutiquey' than before," says Thornton. Firms should hold out for software that produces reports customized for their particular operations, says May. She also warns against jumping on the "latest" program. "You don't want to be the guinea pig. A lot of vendors come and go in this industry, so I recommend working with an established company."

Test Often

"Exam time is too late to start testing," says Ginny Voos. "If you wait until then, you probably won't have a good exam."

At first, "test more often" sounds like adding a lot of extra work for the entire broker-dealership. But it needn't be, says Carolyn May. In particular, the Rule 3012 filing "is an excellent opportunity to test. You ask the same questions an examiner would and see if you can produce the answers easily."

Other testing doesn't need to be extensive. "Broker-dealers can test for different products every quarter," says Carrie Wisniewski. "They just need to make sure that their tests flow out of their Written Supervisory Procedures because that's what FINRA always starts with." They can also routinely grab 100 random mutual fund or annuity transactions, for example, and see if they're reported correctly. Such testing, adds Ginny Voos, is a quick way to determine if it's easy to find records. If it's not, the broker-dealer can change procedures or look into a software solution. "Taking too long to gather information can be a red flag to a regulator and can prolong the exam process," she says.

These compliance consultants also recommend using outside professionals to perform internal tests. "It's a fresh set of eyes," says Marc Horin. "They'll notice habitual procedures that aren't quite right or which the firm is not performing fully."

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Promote a Compliance-Friendly Culture

"Compliance is never the popular department," admits Carolyn May. According to Steve Thornton, the reason is simple: "Historically, broker-dealers are run by entrepreneurs who want to put resources into sales. Compliance is a cost of doing business, so it is perceived as eating into revenue."

But "it only takes one big fine" for a broker-dealer to realize that it needs a more compliance-friendly culture – if, that is, the fine doesn't destroy the dealership, says May. And it seems clear that FINRA is less hesitant than ever to impose fines over \$100,000. In 2012, it levied 79 such fines (13 of which were over \$1.5 million), the most since it was founded in 2007. All in all, FINRA administered over 1500 disciplinary actions in 2012, resulting in fines of \$68 million and restitution to harmed investors amounting to \$34 million – again, all record numbers since FINRA's founding.

How does a broker-dealer improve its compliance culture and avoid such fines? Through its executive leadership and among its compliance staff.

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- **A broker-dealer's executive leadership** needs to consist of people who understand that compliance promotes good business practices that prevent fines, avoid litigation, and generate profits. "They need to be committed to the idea that compliance is a tool to make agents and customers better. It fosters revenues because it promotes the long-term good of the firm and its customers," says Marc Horin. A good broker-dealer President or CEO realizes "that every client is a potential lawsuit, every communication with that client is the source of a potential lawsuit, and every sales rep that doesn't comply is a threat to the firm – and they will hire accordingly," says Steve Thornton. Horin adds that such executives will also train accordingly. "They will concentrate on training supervisors on the demands of the Written Supervisory Procedures and then let them train the rest of the staff on actual activities that promote compliance." Advisors and other personnel don't need to know the ins and outs of the Written Supervisory Procedures, he says, so carefully designating compliance roles will save employees a lot of time and frustration.
- **Compliance staff** need to embrace a revenue-promoting understanding of compliance, according to Carolyn May. "They can't just be people who say 'no.' They need to ask, 'how can we help you follow the rules?' When advisors know that you're trying to help them, they'll do their job well and build a better compliance culture." Broker-dealer leadership needs to hire compliance professionals who promote the profitability of the firm with their actions and who understand that they need to work with the staff, not against it.

Calculating the Cost

"We'd like to do more compliance work in between FINRA exams, but we just can't afford it." It's a familiar lament but not a good excuse, say the consultants we interviewed.

For one, the cost of not doing well on a FINRA exam can be huge. Firms that are minimalist in terms of compliance "tend to blow up in a blaze of regulatory glory," says Carrie Wisniewski – or, at least, get fined heavily (as FINRA's regular notices make clear). In the end, noted Marc Horin, "FINRA treats small firms the same way they treat Merrill Lynch. It doesn't matter that they don't have the proportionate number of compliance staff," says Marc Horin. "Unless they want to be like the broker-dealers that have closed, merged, or become investment advisory firms because of regulatory pressures, they have to do good compliance work even when an exam is a long way off."

It's also the case that using software or devoting more time to testing "can reduce the number of employee hours – and thus the cost – associated with compliance tasks," says Ginny Voos. Carolyn May adds that the alternative to regular testing "is to work nights and weekends

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right before and during exams," and Steve Thornton likes to remind broker-dealers that FINRA examiners can stay in-house as long as they want. "If it takes a long time to produce the information they ask for, they can keep adding requests until they're satisfied. The SEC can also come in if the FINRA exam doesn't go well. It all adds up to a huge extra workload for everyone at the broker-dealer, which can eat up hundreds, if not thousands, of non-revenue producing hours."

Carrie Wisniewski adds that good compliance software is not as cost-prohibitive as many broker-dealers think. "It used to cost \$50,000 to \$100,000, but more competition and the cloud have really brought the price down so that small firms can afford it," she says. "If the program is customizable

to a broker-dealer's operations and if you don't need to be a technical genius to use it, it's definitely worth a look."

Conclusion

Finally, the consultants we interviewed agreed that the time between FINRA exams is an ideal window for improving compliance efforts. Without regulators looking over their shoulders, broker-dealers can first determine their actual costs of compliance – in terms of dollars and employee hours – and then determine what investments should be made in software, training, consultants, and extra testing.

When they make such investments, says Marc Horin, the next FINRA exam will be what it should be: a positive learning experience that points the firm in the direction of better compliance, better long-term customer relationships, and larger long-term profits.

Our Compliance Consultants

Marc Horin is President of National Compliance Consultants, Inc., which he founded in 1987 and which has offices in Chicago and Seattle. He has worked in the securities industry since 1974 as a Floor Governor and Floor Trading Committee member for three exchanges, a NASD examiner, and a Compliance and Operations Liaison for OTC and Block Trading. In addition to his work at National Compliance Consultant, he is an Arbitrator with AAA, NASD and NYSE. He can be contacted at marc@bd-ria-consulting.com.

Carolyn May is an independent compliance consultant based out of Little Rock, Arkansas. During her 25 years in the securities industry, she has been a CCO and CFO for numerous small broker-dealers, served on FINRA's District 5 Committee, served on FINRA's Small Firm Advisory Board, and taught at numerous NASD/FINRA seminars. She can be contacted at CarolynM12@aol.com.

Steve Thornton is President of Thornton & Associates, LLC, a compliance consulting firm he founded in 2006 in Tarzana, California. In his 20 years in the securities industry, he has been an NASD examiner, a Financial and Operations Principal and a General Securities Principal for over 50 broker-dealers, an independent compliance consultant, and a member of FINRA's District 2 Committee.

Ginny Voos is Senior Compliance Consultant at BD Compliance in Atlanta, Georgia, where she functions as CCO and FINOP for several small firms. She has worked in the securities industry since 2001 and currently serves on FINRA's District 7 Committee. She can be contacted at ginny@bd-compliance.com.

Carrie Wisniewski founded BD Compliance in Atlanta, Georgia in 1994 and Bridge Capital Associates, a FINRA firm, in 2007. Bridge Capital specializes in investment banking, corporate finance, and mergers and acquisitions on an independent contractor model. Her 28 years in the securities industry includes four years as an NASD examiner, recent service on FINRA's District 7 Committee, and current service as a FINRA Arbitrator and FINRA Hearing Panelist. She can be reached at carrie@bd-compliance.com.

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Terrapin Technologies, Inc.
615 First Ave NE, Suite 200
Minneapolis, MN 55413

P: 612-244-2330
F: 612-244-2303

