

NASD's great divide: exam priorities vs. exam findings

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The desire to minimize chances of a failed regulatory examination surely ranks high on the list of reasons as to why a broker-dealer would strive to be compliant with rules and regulations. This interest provides an opportunity to use facts and information at the industry's fingertips to improve the likelihood of a passable regulatory inspection.

In fact, since 2002, NASD has distributed a publication called [Improving Exam Results](#) annually on its web site. This publication is composed of two sections. The first section discusses NASD examination priorities ("hot topics" that regulatory inspectors will focus in the upcoming year's examinations). The second section is a summary of the most common findings of the previous year's regulatory examinations. One might expect the types of violations posted in the exam priorities section to be compatible with the common-findings section, since NASD concentrates most of its efforts on addressing these "hot topic" violations; however, this is not the case.

Over the years, the exam priorities of NASD regulators have become increasingly specific and trendy. Most of these exam priorities parallel the rule filings made by NASD. For instance, in 2002, in accordance with the [USA PATRIOT Act of 2001](#), NASD required broker-dealers to establish and enforce an anti-money laundering compliance program, a regulation specified as rule [3011](#). On the heels of the rule's implementation was the addition of anti-money laundering to NASD's examination priorities for the following year. Similarly in 2002, shortly after the research analyst rules were [amended](#) to address analyst conflict of interest, the NASD added analyst conflict of interest as a top exam priority for the upcoming year of 2003.

In 2004, NASD filed changes to rule [2210](#) and [2211](#) that mandated companies to disclose mutual funds fees, expenses and standardized performance of different mutual fund share classes to customers. Like AML and analyst conflict of interest, disclosing the fees and expenses of certain mutual fund share classes to customers would soon become an exam priority of NASD, showing up as could be expected in the 2004 publication as a priority for 2005.

While the message this sends to the broker-dealer community is not particularly surprising, it is notable. By calling out the high-priority examination topics for its member firms, the NASD does afford broker-dealers an opportunity to prepare in advance of an examination. Especially where the topic is relevant to the firm's operations, special care can be taken to review the spirit of NASD's initiative (found in summary format in the "Improving Exam Results" publication) and to ensure that manuals have been updated and policies and procedures implemented accordingly.

As an example, a read of the examination priorities of 2003 firms would readily signal that the upcoming regulatory examinations would emphasize filing suspicious activity reports and other preventative measures required by the USA PATRIOT Act and by rule 3011. Knowing this, firms would prepare accordingly to ensure AML compliance programs were adequate and to avoid the AML pitfall during a regulatory inspector's examination.

Equally notable in review of the "Improving Examination Results" publications is that while examination priorities are typically reflective of then-current rulemaking and tend to be trendier, the common findings reported in this publication as well are not. Common findings, the publications reveal, are in fact truly common: Year after year, the common findings are far more traditional in their nature.

Although the NASD examiners may be looking for AML rule violations, conflict of interest in mutual fund share-class sales practices, branch supervision, business continuity, variable annuity sales practices, market timing and the like, the broker-dealer community regularly fails examinations in "Compliance 101" areas, such as books and records, registration requirements and supervision. Just one example: In 2003, the exam priorities included AML, analyst conflict of interest, internal controls, branch-office supervision and variable annuities. The common findings for that year included books-and-records compliance with Securities and Exchange Commission rules [17\(a\)-3](#), [17\(a\)-5](#), [17\(a\)-4](#), continuing education requirements and failure to supervise the reporting of customer complaints. The wide discrepancies between the two also occurred in 2004 and once again in 2005, which the tables below illustrate.

The fact that the two sections of the "Improving Exam Results" guide are largely unrelated to one another raises questions about the examination program in general. Why, for instance, is there no apparent correlation between the examination priorities (what the NASD claims to be examining) and the common findings (what areas firms are actually failing in during exams)? There are several possible answers. One is that although the NASD on a national scale seeks to mitigate or evaluate risk in certain priority areas, regulatory inspectors have insufficient qualifications to be able to adapt and spot these new highly specific violations, and thus findings related to

these priority topics are much fewer in number. Another possible explanation is that many firms among the broker-dealer community have still not mastered compliance with the longstanding and more fundamental rules such as SEC rules 17(a)-3 and 17(a)-4 and NASD rules [3010](#) (generally, supervision) and [1120](#) (firm and regulatory element continuing education).

Whatever the explanation, the opportunity for the broker-dealer community to use "Improving Examination Results" as a resource in preparing for and surviving the regulatory examination with a favorable result is clear.

Exam priorities 2002-2005					
Topic	Description of examination priority	2002	2003	2004	2005
AML	Anti-money laundering (AML compliance officer)	YES			
AML	Anti-money laundering (General)		YES		
AML	Anti-money laundering (Customer-identification programs)			YES	
AML	Anti-money laundering (Customer-identification programs)				YES
Analyst conflict	Analysts' conflicts of interest	YES			
Analyst conflict	Analysts' conflicts of interest		YES		
Branch supervision	Branch-office supervision	YES			
Business continuity	Business continuity plans — Development of the plan		YES		
Business continuity	Business continuity planning — merits of the plan				YES
Controls	Internal controls	YES			
Controls	Supervisory controls		YES		
Controls	Heightened supervision and supervisory controls			YES	
Controls	Heightened supervision and supervisory controls				YES
Gifts	Gifts and gratuities				YES
Communications	Internal communications				YES
Mortgage proceeds	Mortgage proceeds used to finance investments			YES	
Mortgage proceeds	Mortgage Proceeds used to finance investments				YES
Mutual funds	Mutual fund breakpoints		YES		
Mutual funds	Mutual fund share classes			YES	
Mutual funds	Late trading and market timing of investment company products			YES	
Mutual funds	Mutual fund breakpoints			YES	
Mutual funds	Mutual fund share sales practices				YES
Net capital	Net capital and customer protection rules		YES		
Net capital	Net capital and customer protection rules			YES	
Non-conventionals	New products and non-conventional instruments				YES
Reg SHO	Regulation SHO-short sales				YES
Special products	Fee-based accounts			YES	
Special products	Hedge funds		YES		
Special products	Soft dollars			YES	
Special products	529 plans			YES	

Variable annuities	Variable annuities	YES			
Variable annuities	Variable annuities		YES		
Variable annuities	Variable insurance products			YES	
Variable annuities	Variable insurance products				YES

Common exam findings 2002–2005

Type	Description of common finding	2002	2003	2004	2005
AML	Anti-money laundering (NASD rule 3011) (testing)				YES
Books and records	Books and records (SEC rules 17a-3 and 17a-4) (Accrual-based accounting)	YES			
Books and records	Municipal securities trade reporting (MSRB rule G-14)	YES			
Books and records	Books and records requirements (SEC rules 17a-3 and 17a-4) (Check logs, disbursements)		YES		
Books and records	The use of electronic storage media (SEC rule 17a-4(f))		YES		
Books and records	Financial reporting (SEC rule 17a-5) (Submitting audit report to DEA)			YES	
Books and records	Books and records requirements (SEC rules 17a-3 and 17a-4) (Accurate liability reporting)			YES	
Books and records	Books and records requirements (SEC rules 17a-3 and 17a-4) (Accurate liability reporting)				YES
Reg and firm element	Regulatory element of continuing education (NASD membership and registration rule 1120(a))	YES			
Reg and firm element	Continuing-education requirements (NASD rule 1120)			YES	
Reg and firm element	Continuing-education requirements (NASD rule 1120)				YES
CRD and reg systems	Form U-4 reporting (Article IV, section 1(c) of the NASD by-laws and IM-1000-1) (Timeliness)	YES			
CRD and reg systems	Form U-5 reporting (Article V, section 3 of the NASD by-laws) (Timeliness)		YES		
CRD and reg systems	The reporting of customer complaints (NASD conduct rule 3070(a)(2)) (Timeliness)			YES	
CRD and reg systems	Registration requirements (Article IV, section 1, article V, section 2, 3) (Forms U-4; U-5 timeliness)				YES
WSP and supervision	Written supervisory procedures (NASD conduct rule 3010(b))	YES			
WSP and supervision	Supervisory obligations (NASD conduct rule 3010(a)(7)) (ACM)		YES		
WSP and supervision	Internal inspections (NASD conduct rule 3010(c))		YES		
WSP and supervision	Written supervisory procedures (NASD conduct rule 3010)				YES

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