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July 2009

## Branch Office Document Scanning and Electronic Records Management

By Pam Metrione and Tom Bartlett, LIMRA Consultants

### *A Double-Edged Sword*


It has become common practice for some registered representatives (RRs) working in broker-dealer (BD) branch offices to scan paper documents onto their office computers or network drives. Branch office employees voluntarily scan office and client documents and destroy the originals in an effort to save storage space and to improve the accessibility of these records. Scanning documents is not inherently a problem; however, what happens after the electronic record is created is critical.

BDs need to ensure that their RRs understand and adhere to the firm's requirements related to the security and retention of scanned documents. In general, RRs are not aware of the potential risks and liabilities that arise from electronic storage of BD records. Some RRs may also be under the impression that their BD wants them to scan and then dispose of all their original paper documents. The BD may not even be aware that the RRs are scanning paper documents.

BDs should inform their RRs of the following potential risks associated with scanning and electronic records management at branch offices, and develop applicable policies and procedures to deal with the following eight situations:

1. **No back-up of scanned documents:** Scanned documents cannot exist solely on a representative's computer. Fire, flood, theft, or a computer crash could destroy the electronic records. Offices need to establish and adhere to an appropriate backup schedule and process. Firms must be aware of requirements to have third party vendors in custody of firm books and records file the required notice under paragraph (f)(3)(vii) of Rule 17a-4. This rule ensures independent availability of, and access to, the firm's electronic records by FINRA. The firm must file its intent to store books and records electronically with its local District Office 90 days in advance of permitting such record storage, in accordance with SEC Rule 17a-4(f)(2)(i).
2. **Privacy breach issues:** The electronic storage of firm records containing clients' personal information is now a heavily regulated area not only under Regulation SP, but also under an increasing array of state requirements. Such records may need to be encrypted, periodically inventoried, and audited for secure access. When these records are lost, stolen, accessed by unauthorized persons, or misplaced, those events may need to be reported to the regulators and all impacted clients.

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### COMING SOON

- LIMRA's Compliance & Market Conduct Study Group  
July 21, 2009, Weston, MA (8 am to 3 pm)

### SERVICES AND PRODUCTS

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- WSP and compliance manuals

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3. **Inadequate backup of scanned documents:** Backups must be done regularly and properly secured. Backups may not be left at the branch office where they could be destroyed in a fire or flood right along with the computer. Copies of the backup need to be retained in a safe location separate from the primary location. Backups should be stored in a fireproof container at a minimum, or may be stored with a vendor specializing in 17a-4 compliant data backup and recovery. The backup needs to be on a suitable write once read-many (WORM) storage medium (e.g., secure online services, optical platters, CD-R, DVD-R, or BD-R). BDs are required to verify that scanned documents and electronic records management at a branch office comply with SEC Rule 17a-4.
4. **Inadequate indexing:** Scanned documents may not be organized well, making it difficult to search for information in response to a regulatory inquiry or internal investigation. Before undertaking a scanning project, firms need to decide which documents will be scanned, how those documents will be used, and how they should be filed. For example, if incoming correspondence is scanned, the firm needs to decide where those documents should be filed. It may be prudent to file the correspondence in the client's file and also in the branch office's incoming correspondence file.
5. **Poor image quality:** Regulations permit the use of scanned documents if they are as legible as the original documents. A scanned document's image quality must be verified immediately after it is scanned — before the destruction of the original paper document — to ensure readability.
6. **Destruction of original paper documents:** RRs sometimes destroy the paper documents after scanning, and they need to be aware of their BD's requirements on how to destroy certain original paper documents. This should only be done with appropriate guidance from the BD as to what papers should be destroyed, how they should be destroyed, and the required documentation for such destruction. Certain types of paper documents should be shredded due to data privacy and confidentiality issues (e.g., any document containing non-public information such as a person's social security number).
7. **Destruction of scanned documents:** Documents may reach the end of their retention period, or a legal requirement may require the destruction of a scanned document. BDs should inform their RRs if scanned and paper documents need to be destroyed. The method used for scanning should facilitate the destruction of the paper documents.
8. **Scanning software and electronic storage medium:** Firms may need to periodically update the software used for scanning, and the storage medium. Hardware and software changes may require a change in the storage medium or a change in the scanning software in order to access the stored information.

## Automated Compliance Tools — Friend or Foe?

By Dan Young, LIMRA Consultant

We live in the digital age. Everyone is bombarded with emails, texts, and information at a lightning pace. We are expected to know, read, digest, and respond to information quicker than ever. Couple this with strained budgets and shrinking margins and you can see where the desire to automate certain compliance functions emanates.

I have used both manual and automated solutions for many diverse broker-dealer functions. I believe the wave of the future is to automate more compliance functions because automation provides transparency, universality, and ease of regulatory oversight. In addition, automation can help a firm more fairly distribute personal liability, rather than singling out compliance staff.

### Transparency

An automated system clarifies parameters. A user can determine what the system checked and the decision reached. Therefore, a compliance officer can point to the virtual paper trail to prove that supervision was carried out. This can be a double-edged sword because deficient supervision may also be revealed. However, assuming a reasonable supervisory construct, principals can easily demonstrate compliance with their rules. This protects the company from litigation and enforcement action. It also allows the compliance staff to act with confidence, as it greatly reduces the degree of personal responsibility associated with the position.

### Universality

When automation occurs, compliance becomes fairer. The discretion is limited, which, by definition, levels the playing field. Large producers are not treated differently, and exceptions must be documented. This takes the pressure off of the compliance staff to make exceptions. It also allows changes to be quickly disseminated. For example, if regulatory guidance changes certain parameters or rules, those can be programmed in and applied quickly if automation exists. If not, then the company must undertake training and education, which is slower, more costly, and less likely to be followed universally.

Automation is especially powerful for parent companies that own multiple broker-dealers and/or registered investment advisers. Often the General Counsel or Chief Compliance Officer at the parent company will have ultimate responsibility for the supervision of all of the subsidiaries. Automation allows the parent company's officers to look at statistics and trends. When one subsidiary is audited and receives regulatory guidance then the parent organization can ensure that the other subsidiaries immediately and holistically institute changes, thereby gaining the benefit of that guidance.

## Ease of Regulatory Oversight

FINRA and the SEC have already begun to find ways to conduct audits with automation. As automation becomes the norm, regulators can supervise with automated solutions, obviating the need for large document productions and costly on-site exams. The less time the regulators spend at broker-dealers, the easier their job becomes.

This also means less disruption of business. If regulators are on-site, management must leave their day-to-day tasks to interact with those individuals. Management must also produce documents and information. By remotely downloading information that is easily searched and filtered, management can minimize the time spent away from daily business.

## Personal Liability

Regulators demand accountability and require certifications by CEOs. This can put the compliance staff in a no-win situation when they are pressured to make exceptions or to take subjective factors into account. If they do so, and

regulators take issue with those decisions then the compliance staff can be held personally responsible. An objective rules engine minimizes the subjectivity and number of personal exceptions. Moreover, if enforcement action becomes warranted then it is the entire firm's policies and procedures, applied universally, that are to blame and the compliance staff would not be singled out for personal liability.

## Conclusion

Regardless of a firm's unique business model and practices, compliance will continue to become more automated, as have most other aspects of the financial services industry. This will eventually allow for transparent, universal rules to be easily audited by regulators. Automation lends itself to discovering trends and internal monitoring, especially for companies that own several subsidiaries. This can prevent inadvertent problems for parent company officers. If automation is properly implemented it will save money, helps clients, and more fairly distribute blame.

## What I've Learned as an Arbitrator

By Catherine Ladnier, LIMRA Consultant

In 1990, I became an industry arbitrator and was appointed to the Board of Arbitrators of the NASD and the Panel of Arbitrators of the New York Stock Exchange. As an industry arbitrator for 19 years, I've participated in many cases and rendered decisions that have had a profound effect on the parties.

Arbitrators take their responsibilities very seriously. Our decisions are final and cannot be appealed, except in extreme cases. My arbitration experience has taught me many lessons which have helped me as compliance professional, including:

1. The broker-dealer's Compliance Manual is submitted as a primary exhibit for claimants. Therefore, it should be the bible for registered representatives. Arbitrators, especially neutral industry arbitrators, expect broker-dealers and their affiliated persons to adhere to the rules. Industry arbitrators are expected to bring knowledge of those rules to the process — not to represent the industry. As an industry arbitrator, I've recommended to my fellow public arbitrators a greater award to the claimant even though the claimant contributed to his losses. This was based on the fact that a rule or regulation had not been honored. Arbitrators can also initiate a disciplinary referral to FINRA for a perceived violation of the rules and such referrals go to the top of FINRA's stack. I've served on only one case in which the violations were so offensive as to warrant such drastic action.
2. Claimants' exhibit number one is always the client's New Account Form and this document can save or sink the broker-dealer and its representative. Few documents submitted in evidence tell the arbitration panel as much about the claimant and the client's investments as account

documentation. Complete client information is critical, especially if it relates to the client's occupation, financial profile, risk tolerance, time horizon, and prior investment experience. "NA" is literally not applicable in terms of properly completing account documentation.

3. 'Know Your Customer' really means know your customer in arbitration. Details about the client should be documented. A representative's notes to the files, along with other items, can be submitted in arbitration. Though arbitrators generally follow the rules of evidence, arbitration panels have much more leeway than courts in admitting evidence. The unsophisticated investor who relied solely on the representative is a very common profile among claimants, although many times the description is false.
4. Representatives should not help a client load the gun if the client wants to commit investment suicide. I've had a few cases in which the representative enabled the client to make poor investment decisions that lost the client a lot of money. Once in arbitration, that representative is no longer the enabler but the perpetrator with an inevitable "yes" answer on the representative's U4. Representatives with such clients should go directly to their supervisors for guidance.

Adherence to the policies outlined in the broker-dealer's Compliance Manual in conjunction with sound business practices and a good dose of common sense provide the representative and affiliated broker-dealer with some armor in arbitration proceedings. This armor certainly isn't bullet-proof, but it does provide a better defense than entering the hearing room unshielded.

# Preparing for the New Risk-Focused State Insurance Department Examination

By Jim Yoakum, LIMRA Consultant

A new “risk-focused” approach will be utilized for all state insurance department examinations beginning on or after January 1, 2010. This sweeping change from the prior specific risk analysis approach resulted with the NAIC’s adoption of the new Annual Financial Reporting Model Regulation (AFRMR). The revised Examiner’s Handbook provides direction on the new approach, and the NAIC Implementation Guide contains guidance as well. It is important to understand the risk-focused approach and begin preparing now for your company’s 2010 examination.

## Objectives of the Risk-Focused Approach

The revised approach is intended to broaden and enhance the identification of risk inherent in an insurer’s operations and utilize that evaluation in the formulation of on-going surveillance of an insurance company. The risk-focused approach focuses more on a company’s risk management culture, corporate governance structure, risk assessment processes, and control environment. It is expected that with a prospective risk assessment solvency issues will be better identified. This will result in enhanced focus on the broader issue of management’s ability to identify, assess, and manage the business risks of the insurer. Consequently, regulators will likely acquire a more complete and dynamic understanding of the insurer’s capability to manage the risks it assumes.

## The New Risk-Focused Examination Process

The Examiner’s Handbook outlines a seven-phase examination process:

1. Utilize a top-down approach, understand the company, and identify key functional activities to be reviewed.
2. Identify and assess inherent risk in activities. Risks that will be examined include credit, market, pricing and underwriting, reserving, liquidity, operational, legal, strategic, and reputational.
3. Identify and evaluate risk mitigation strategies/controls and determine how well they mitigate inherent risks.
4. Determine residual risk by ascertaining how well the controls reduce the level of inherent risk.
5. Utilize the risk assessment, establish procedures, and conduct the examination.
6. Update the assessed prioritization of the insurer and establish a risk surveillance supervisory plan.
7. Issue a public examination report and, if needed, a management letter with results and observations not contained in the public report.

## Differences from the Prior Specific Risk Analysis Process

The risk-focused approach differs from the specific risk analysis process in that risk is assessed throughout the organization on a prospective basis. The changes include: (1) every account will not be tested; the focus will be on areas of greatest risk and to limit testing of areas with less risk. There will be a greater reliance and increased importance on the insurer’s prior internal and external audit reports; and (2) information on an insurer’s internal controls and risk management will be requested to a greater extent than in the past. However, an insurer will not be expected to create internal control and risk management documentation for the examination. Instead existing documentation will be required, including SOX compliance documentation. Requests for interviews with senior management members and potentially the Board of Directors will also be part of the internal control mitigation and sufficiency evaluation.

## Getting Prepared

The following actions will assist in preparation for your 2010 risk-focused examination:

1. Review internal processes that are used to manage state insurance department examinations and align them with the new approach to ensure an effective and efficient examination.
2. Educate senior management and the Board of Directors on the risk-focused approach and inform them of the expanded role they may play.
3. Review all internal control and risk management documentation (policies, procedures, etc.) to determine adequacy and sufficiency and make improvements.
4. Ensure adequacy of internal processes to comply with all applicable laws and regulations.

## Other Required Changes

In addition to the formulation of the new risk-focused examination, the AFRMR also includes these changes: (1) reduces the number of consecutive years from seven to five that an audit partner may participate on the external audit of an insurer; (2) requires insurance companies to have an audit committee that is solely responsible for appointment, compensation, and oversight of the company’s auditor; and (3) requires companies with \$500 million or more in direct premiums to file a report with its domiciliary state insurance department regarding an assessment of its internal controls over financial reporting. This is to be filed concurrently with the company’s annual audited financial report.

*More detailed information to assist with implementation of the risk-focused approach can be found in the AFRMR, the Examiner’s Handbook, and the Implementation Guide.*