



HIRING PRACTICES: COMPLIANCE AND RISK MANAGEMENT

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Topics To Be Covered

Introduction

Forms U-4 and U-5

Background screening, pre-hire review and consulting previous employers

Evaluating disciplinary actions and customer complaints

Hiring brokers from competing firms

- Client ownership
- Soliciting clients

Consequences of compliance failure

- Disciplinary actions

Background Information

- Over the last decade, securities regulators have focused on the practices of broker-dealers in the hiring, retention, heightened supervision and termination of registered representatives. This increased scrutiny has included coordinated “sweeps,” SRO notices to members, a rule proposal, examinations probing firm hiring and supervisory procedures, and disciplinary actions.

Introduction (cont.)

The SEC's Large Firm Project Report

- SEC concerns relating to the hiring, retention and supervisory practices of large brokerage firms surfaced as a result of the Commission's examination findings developed during inspections in the early 1990s. As a result, the SEC staff, in conjunction with NYSE and NASD personnel, conducted a review of the hiring, retention and supervisory processes of the nine largest brokerage firms in 1993.

Introduction (cont.)

- In the SEC's May 1994 report "The Large Firm Project: A Review of Hiring, Retention and Supervisory Practices," the Commission suggested that broker-dealers improve their compliance systems for reviewing broker activities and enhance the role of legal and compliance professionals in broker hiring, retention and termination decisions.

Introduction (cont)

- At the time The Large Firm Project Report was issued, SEC Chairman Arthur Levitt stated that “firms need to take a harder look at a broker’s disciplinary record before hiring” and that the Commission was “putting firms on notice that if they do take the risk of hiring a broker with a bad record, they must be especially vigilant in their supervision.”

The Joint Regulatory Sales Practice Sweep

- Two years after the issuance of The Large Firm Project Report, the staffs of the SEC, NASD, NYSE and representatives of NASAA conducted a follow-up sweep of small and medium-sized brokerage firms. The sweep also included a review of the hiring, retention and supervisory procedures of those firms. The March 1996 “Joint Regulatory Sales Practice Sweep” report noted that “some firms are willing to employ registered representatives with a history of disciplinary actions or customer complaints” and that “many of the branches examined utilized only minimum hiring procedures.”

The Joint NASD & NYSE Memorandum

- In April 1997, the NASD and the NYSE issued a joint memorandum discussing the Sweep Report and providing guidance to member firms on the heightened supervisory recommendations of the Sweep Report. The Joint Memorandum (NASD NTM 97-19) reiterated the Sweep Report's recommendations concerning improved hiring procedures and heightened supervisory protocols. Significantly, the Joint Memorandum also provided guidance to firms that had hired brokers with prior disciplinary, customer complaint or arbitration histories.

Introduction (cont.)

NASD proposed rule on heightened supervision

- In September 2003, the NASD requested comment on a proposed new rule that would require firms to adopt and implement heightened supervision plans for those employees who met or exceeded certain numbers of (1) customer complaints and arbitrations, (2) regulatory actions or investigations or (3) terminations for cause or internal reviews.

SEC Staff Guidance Concerning the Supervision of Remote Offices

- In connection with providing guidance concerning the supervision of small, remote sales offices, the SEC's staff in the Division of Market Regulation cautioned firms to carefully review forms U-4 and U-5 when hiring brokers and to be "especially cautious about employing personnel with disciplinary histories." See SEC Staff Legal Bulletin No. 17: Remote Office Supervision (March 19, 2004).

SEC and SRO Rules re: Background Investigations

- SEC Rule 17a-3(12) requires firms to obtain a questionnaire or application for employment for each associated person. The questionnaire or application must be approved in writing by the firm and contain certain employment, regulatory and personal information. Form U-4 satisfies this requirement.
- SEC Rule 17f-2 requires firms to fingerprint certain employees and submit the fingerprints to the U.S. Department of Justice.

Forms U-4 and U-5 (cont.)



- NASD Rule 3010(e) mandates that firms have the “responsibility and duty to ascertain by investigation the good character, business repute, qualifications, and experience of any person prior to making such a certification in the application of such person for registration with this Association.” The rule also requires firms to obtain a copy of an applicant’s Form U-5 no later than 60 days after the filing of an application for registration.
- NYSE Rule 345.11 requires firms to “thoroughly investigate the previous record of persons whom they contemplate employing.” The NYSE rule also requires a firm to obtain a copy of the applicant’s Form U-5 within 60 days of the filing of an application for registration.

Steps to consider for background screening

- Obtain the signature of the applicant on Form U-4/Item 15A.
- Obtain a copy of the applicant's CRD record.
- Obtain a completed work history and regulatory questionnaire from the applicant.
- Conduct an appropriate background check.
- Contact prior employers.
- Interview the applicant.
- Complete the internal review process.

Background Screening, Pre-Hire Review and Consulting Previous Employers (cont.)



Obtain the signature of the applicant on Form U-4/Item 15A

- This permits the firm to access the applicant's CRD record.

Obtain a copy of the applicant's CRD record

- Distribute the CRD record to the appropriate individuals within the firm.
- Review the CRD record for affirmative answers (e.g., customer complaints, arbitrations, disciplinary actions, failure to satisfy CE requirements, resigned/fired/permitted to resign after certain allegations made, etc.) and non-voluntary terminations.
- Obtain additional information and/or documentation regarding affirmative answers and non-voluntary terminations.
- Refer questions or concerns to senior supervisory and/or legal/compliance personnel.

Obtain a completed work history and regulatory questionnaire from the applicant

- Consider gathering information concerning the applicant's production, business mix, outside business activities, educational background, work history, regulatory background, etc.
- Determine whether any disclosures by the applicant rise to the level of statutory disqualification.
- Follow FTC rules/guidance if the firm obtains and uses a consumer report as part of its background investigation.
- Consider including a certification such that the applicant acknowledges that the information being provided is true and correct and, if found to be otherwise, the applicant may be denied employment or terminated by the firm.

Conduct an appropriate background check

- Consider reviewing the background of an applicant through the use of outside vendors, where legally permissible.
- Care should be used in utilizing information from consumer reporting agencies (e.g., conforming to the rules/guidance concerning applicant notice and consent).

Contact prior employers

- Contact the previous employer to confirm dates of employment and, if possible, the circumstances of the applicant's termination. Consider attempting to obtain the following information:
 - What will be the reason for termination reported on the applicant's Form U-5?
 - Does or will the applicant have any affirmative answers reflected on the Form U-5?
 - Is the applicant the subject of an internal investigation?
 - Did the applicant leave after allegations of fraud, violations of rules or failure to supervise?
- In accordance with Form U-4/Item 15B, contact the applicant's previous employers for the past three years and document the names of the persons contacted and the date of the contact.

Interview the applicant

- In connection with interviews, consider the following:
 - The applicant's training, experience and qualifications
 - Any history or pattern of problematic conduct
 - Frequency of changes in employment
 - Regulatory history of prior firms
 - The applicant's history of financial responsibility (e.g., judgments and liens)
 - Outside business activities
 - The applicant's investment strategies, products and customers
 - The existence and nature of any pending or prior customer complaints, arbitrations, investigations, disciplinary proceedings, etc.

Complete the internal review process.

- The applicant's candidacy for employment should be reviewed by the firm's management and legal/compliance professionals. Traditionally, legal/compliance professionals have had a consultative, rather than approval, role in this process.
- Complete and document the hiring decision.

Discharges, terms for cause and permits to resign

- If an applicant was ever discharged, termed for cause or permitted to resign, consider obtaining additional information and documentation, including:
 - a detailed statement regarding the separation and any relevant documents
- Consider requiring additional levels of management review and approval prior to extending an offer of employment.

Evaluating Disciplinary Actions and Customer Complaints (cont.)



Customer complaints, arbitrations, disciplinary history or criminal actions

- If the applicant's CRD record, fingerprint review or regulatory questionnaire disclose customer complaints, arbitrations, disciplinary history or criminal actions, consider obtaining additional documentation and information, including:
 - a detailed statement concerning the matter
 - a copy of the customer complaint, arbitration, disciplinary history or criminal action and any responses to those actions
- Confirm that the applicant is not subject to an SRO or state-mandated heightened supervisory program or the subject of a statutory disqualification.
- Consider requiring additional levels of management review and approval prior to extending an offer of employment.

Financial disclosures

- If the applicant's CRD record or work history questionnaire discloses liens or bankruptcies, consider obtaining additional documentation and information, including:
 - a detailed statement of the circumstances of the lien or bankruptcy
 - a copy of the lien discharge or bankruptcy discharge documents
- Consider requiring additional levels of management review and approval prior to extending an offer of employment.

Work experience at firms with prior regulatory actions

- If the applicant's CRD record discloses that the individual was previously employed by a firm that has been disciplined by a securities regulator for significant or repeated sales practice problems or that engages in practices that are subject to heightened regulatory scrutiny (e.g., the sale of penny stocks), consider obtaining additional documentation and information, including:
 - a description of the training received at such firm
 - the business and product mix of the applicant at the firm
 - the length of service at the firm
- Consider requiring additional levels of management review and approval prior to extending an offer of employment.

Frequent changes of employment

- If the applicant's CRD record discloses that the individual had frequent changes of employment in the industry, consider obtaining additional documentation and information, including:
 - a detailed statement regarding the basis for such moves
- Consider requiring additional levels of management review and approval prior to extending an offer of employment.

Hiring Brokers from Competing Firms



Background Information

- Generally, securities firms require newly hired brokers to sign employment agreements.
- Typically, such agreements contain provisions stating that all records and the information reflected on such documents are confidential and the exclusive property of the broker-dealer.
- Employment agreements typically provide that a broker will not solicit business from the firm's clients for a certain period of time following the termination of the broker's employment.

Hiring Brokers from Competing Firms (cont.)

- Broker-dealer employment agreements ordinarily state that a breach of the agreement entitles the firm to injunctive relief.
- Employment agreements containing these kinds of restrictive covenants are enforceable if (1) enforcement is necessary and reasonable to protect the employer's legitimate business interests, (2) the restrictions do not impose an undue hardship on the employee, and (3) enforcement does not harm the general public.

Hiring Brokers from Competing Firms (cont.)

Client Ownership

- As noted, broker-dealers generally take the view that the firm, rather than an individual broker, own all records (e.g., new account documents, monthly statements, etc.) and the information contained on such materials. By extension, broker-dealers believe that they “own” the client relationship.

Hiring Brokers from Competing Firms (cont.)

Soliciting clients

- As noted, broker-dealers generally prohibit brokers from soliciting clients after termination. In this regard, brokers are typically not permitted to attempt to encourage clients to transfer their accounts to a broker's new firm or open new accounts at the new employer.

Disciplinary actions regarding hiring and heightened supervision

- Over the last several years, securities regulators have instituted several enforcement actions that allege certain failures by firms to establish and implement reasonable hiring and heightened supervisory procedures.
- These cases include the following matters:

Consequences of Compliance Failure (cont.)

In the Matter of Olde Discount Corp. et al. (Sept. 10, 1998)

- In the SEC's action against Olde Discount Corp. and three senior executives of the firm, the Commission alleged that “[a]s a consequence of the firm’s compensation, production, hiring and training practices, an environment was created at Olde in which a number of Olde registered representatives engaged” in various sales practice abuses.
- In the Olde case, the Commission was critical of the firm’s hiring process, which included providing prospective brokers with a research report and asking candidates to “pitch” the subject stock to an Olde manager with the goal of convincing the manager to want to purchase the security.

Consequences of Compliance Failure (cont.)

In the Matter of D.E. Frey and Company, Inc. (Sept. 26, 2000)

- The Commission alleged that D.E. Frey failed to supervise three registered representatives, each of whom had a disciplinary history or was the subject of various customer complaints and had engaged in certain sales practices abuses. In two instances, the firm was also alleged to have failed to develop and implement increased supervision over brokers who were the subject of special supervision provisions imposed by state regulators.

Consequences of Compliance Failure (cont.)

In the Matter of Prospera Financial Services, Inc. (Sept. 26, 2000)

- The SEC was critical of the firm for failing to place two registered representatives on heightened supervision despite the brokers' histories of customer complaints and regulatory sanctions. Both brokers came to the firm with prior customer complaints and while at Prospera were each the subject of separate investigations and regulatory sanctions. Despite these activities, the Commission alleged that the firm both lacked adequate heightened supervisory procedures and failed reasonably to implement procedures that the firm had established.

Consequences of Compliance Failure (cont.)

In the Matter of Gruntal & Co. L.L.C. (Nov. 7, 2001)

- The NYSE sanctioned the firm for allegedly failing to supervise a broker who was the subject of a prior NYSE investigation and sanction. The NYSE found that while at Gruntal a broker consented to a censure and a one year suspension from the securities industry for acts she had engaged in at a prior employer. Upon completion of her suspension, the broker returned to Gruntal but the NYSE alleged that for approximately three years thereafter, the firm failed to establish and implement written procedures directing the particularized supervision of the broker to address the findings in the prior disciplinary action.

Consequences of Compliance Failure (cont.)

In the Matter of Kirkpatrick, Pettis, Smith, Polian Inc., Peter Lahti and Gregory Adams (Nov. 5, 2003)

- The SEC alleged that as BOM of a retail office, Adams recommended the hiring of a broker due to the broker's experience. The firm conducted a background check and learned that the broker had been the subject of a prior disciplinary action concerning stock manipulation, had a history of financial insolvency and regularly took large positions in a small number of stocks for his customers. Despite receiving the background report and being asked to carefully monitor the broker's activity, Adams is alleged to have failed to increase his level of supervision over the broker who later allegedly engaged in a manipulative stock scheme.

Consequences of Compliance Failure (cont.)

Disciplinary actions relating to failure to conduct or evidence background checks on newly hired brokers.

- Securities regulators have periodically sanctioned firms for either failing to conduct or evidence the completion of background checks in compliance with NASD and NYSE rules.
- These cases include actions against Stockcross Financial Services, Inc. (NYSE March 2004) (alleging that the firm had no written procedures regarding the hiring of registered representatives), Tanager Capital Group LLC (NASD September 2003) (asserting that the firm failed to perform required background investigations on 17 new hires and did not obtain Form U-5s from prior employers in 5 instances), Seaboard Securities, Inc. (NASD June 2000) (alleging the firm failed to evidence background checks of newly hired brokers) and many NYSE actions, including Dean Witter Reynolds, Inc. (NYSE August 1994) (alleging that the firm had not conducted background checks for 30 employees).

Consequences of Compliance Failure (cont.)

- The NYSE has brought a few cases regarding the hiring or retention of statutorily disqualified individuals. These include: Edward D. Jones (NYSE March 2004) (alleging that the firm employed individuals who were subject to statutory disqualification despite these persons having disclosed the existence of criminal convictions at the time they were hired); and Charles Schwab (NYSE July 2000) (alleging that the Firm had persons associated with it who were statutorily disqualified without permission of the NYSE).

Consequences of Compliance Failure (cont.)

Culture of abusive sales practices

Litigation and arbitration

Loss of reputation