

[I(a)] BD SUPERVISORY RESPONSIBILITIES¹

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I. INTRODUCTION

This outline covers the following topics to be discussed during the BD Supervisory Responsibilities panel at the NSCP East Coast Regional Meeting: (i) delegation of supervisory duties; (ii) red flag reviews; (iii) supervision of branch offices and producing managers; and (iv) supervisory controls and certification. To provide background on these subjects, the first section describes the SEC and SRO supervisory laws and rules.

II. BACKGROUND - SEC AND SRO SUPERVISORY RULES

The standard applicable under the securities laws regarding supervision is reasonableness. The relevant SEC and SRO rules related to supervision are set forth below.

A. Securities and Exchange Act of 1934

Section 15(b)(4)(E) of the 1934 Act authorizes the SEC to impose sanctions on a broker-dealer or any of its associated persons if the Commission finds that such entity or person has “failed reasonably to supervise, with a view to preventing violations of [certain provisions of the federal securities laws], another person who commits such a violation, if such other person is subject to [their] supervision.”

Section 15(b)(4)(E) also provides that no firm or person shall be “deemed to have failed reasonably to supervise any other person, if (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and (ii) [the firm or the supervisor] has reasonably discharged the duties and obligations incumbent upon [them] by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.”

B. New York Stock Exchange Rule 342

Rule 342(a) states that “each office, department or business activity of a member or member organization (including foreign incorporated branch offices) shall be under the supervision and control of the member or member organization establishing it and of the personnel delegated such authority and responsibility. The person in charge of a group of employees shall reasonably discharge his duties and obligations in connection

¹ This outline was drafted by Ben A. Indek and Michele A. Coffey of Morgan, Lewis & Bockius LLP (“Morgan Lewis”), with substantial assistance from associate Kerry J. Land, of Morgan Lewis. This outline is current as of March 10, 2009. The views expressed in the outline are those of the authors and do not necessarily reflect those of their firm, colleagues, clients or the other panelists.

with supervision and control of the activities of those employees related to the business of their employer and compliance with securities laws and regulations.”

Rule 342(b) provides that the “general partners or directors of each member organization shall provide for appropriate supervisory control and shall designate a general partner or principal executive to assume overall authority and responsibility for internal supervision and control of the organization and compliance with securities’ laws and regulations.”

The rule further requires that “this person shall: (1) delegate to qualified principals or employees responsibility and authority for supervision and control of each office, department or business activity, and provide for appropriate procedures of supervision and control; and (2) establish a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised.”

C. NASD Rule 3010

NASD Rule 3010(a) requires that each member organization “establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with and with applicable NASD Rules.”

Under Rule 3010(b)(1), members must “establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives, registered principals, and other associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of NASD.”

Furthermore, Rule 3010(c) requires each member to conduct an annual review of its businesses. The review must be “reasonably designed to assist in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and with applicable NASD rules. Each member shall review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses.”

III. DELEGATION OF SUPERVISORY DUTIES

In general, a line manager has supervisory responsibilities for those employees under him or her unless and until he or she reasonably delegates the duties to another.² Accordingly, supervisors may delegate certain tasks to registered and non-registered persons. Nevertheless, while a supervisor may delegate his or her duties, that person remains ultimately responsible for the performance of all necessary supervisory reviews.

1. Duties may only reasonably be delegated to a person qualified to complete the particular duty. For example, duties required to be

² For a recent discussion on the delegation of supervisory duties, see FINRA Regulatory Notice 07-59 concerning the supervision of electronic communications.

completed by a registered person may not be delegated to a non-registered person.

2. A supervisor must take reasonable steps to confirm that any delegated functions are properly executed and should evidence performance of his or her procedures to demonstrate overall supervisory control.
3. Where functions are delegated, protocols for the escalation of regulatory issues must be in place.
4. Supervisors and their delegates should document any delegation of duties.
5. In certain cases, the SEC has alleged that the delegation of duties to another became unreasonable due to the failures of the delegate. While a number of years old, the case discussed below is an example of such an action.

A. In the Matter of Janney Montgomery Scott LLC (“Janney”) and Norman T. Wilde, Jr. (“Wilde”), SEC Administrative Proceeding File No. 3-10255 (July 18, 2000)³

1. Wilde, the President and Chief Executive Officer of Janney, delegated certain responsibilities to Janney’s Compliance Director, including the responsibility to establish written supervisory procedures reasonably designed to prevent and/or detect violations of the federal securities laws.
2. From 1992 through 1996, Wilde became aware of certain deficiencies in Janney’s procedures on more than one occasion. In 1992, Wilde received deficiency letters and met with regulators regarding supervisory failures in the areas of disbursements and transfers of funds, review of outgoing correspondence and processing of customer complaints. In 1993, two employees were terminated for misappropriating customer funds through use of these same systems.
3. In 1996, it was discovered that, from 1988 to 1996, another Janney employee, Mark Graves, had misappropriated over \$1.8 million from approximately 25 customers. To accomplish his scheme, Graves exploited deficiencies in Janney’s internal operational systems, some of which were the same systems in which deficiencies had been called to Wilde’s attention as early as 1992.
4. In light of the previous failures, the SEC concluded that Wilde’s delegation of responsibility to establish procedures became

³ Morgan Lewis and Mr. Indek represented Mr. Wilde in this settlement.

unreasonable and violated Section 15(b)(4)(E) of the Exchange Act.

5. The SEC ordered Janney to pay a \$100,000 penalty and retain an independent consultant to review and recommend policies, procedures and practices to prevent and detect further improper conduct such as Graves’.
6. Wilde was ordered to pay a \$25,000 penalty.

IV. SUPERVISORY RED FLAG REVIEW: FOLLOW-UP AND DOCUMENTATION

In the securities industry, “red flags” are often referred to as warning signs that could alert a supervisor to the possibility of a violation of firm policies, securities laws or rules. In the context of retail branch offices, regulators have identified the following as potential red flags for managers overseeing brokers: customer complaints, excessive trade corrections, excessive commissions, improper written or faxed correspondence or electronic communications, churning, unsuitable trades, and unapproved outside business activities. In the capital markets trading arena, for desk managers tasked with oversight of traders and/or sales people, regulators have identified the following as potential red flags: excessive mark-ups or mark-downs, trades outside the market, unexplained profits and/or losses, pre-arranged trades, mismarked positions and front running.

As demonstrated below, regulators have criticized firms and individual supervisors for failing to notice red flags or failing to adequately respond to such indications of potential wrongdoing.

A. SWS Financial Services (July 17, 2008)⁴

1. FINRA settled a matter with SWS Financial Services (“SWS”) in which it alleged that the firm failed adequately to supervise its registered representatives.
2. Among other violations, FINRA alleged that, between December 1998 and February 2003, SWS failed to follow its schedule for inspecting unregistered branch offices. One unregistered branch office that was not inspected pursuant to the inspection schedule was located in the home of an independent contractor registered representative who fraudulently misused over \$700,000 of investors’ funds.
3. FINRA also found that SWS failed to supervise another registered representative and could not identify the representative’s assigned supervisor or evidence supervisory review of a client’s account that had losses of over \$54,000. FINRA alleged that SWS also failed to investigate and follow up on “red flags” that should have alerted it to

⁴ Some of the case summaries appearing in this outline were originally prepared by partners and associates at Morgan, Lewis & Bockius LLP for inclusion in the 2007 and 2008 publications titled “Year in Review: SEC and SRO Selected Enforcement Cases and Developments Regarding Broker-Dealers.”

possible improper activity by the representative. Specifically, a client's account appeared on exception reports at least 14 times, yet the firm failed to investigate and never contacted the investor.

4. In addition, FINRA alleged that SWS failed adequately to supervise discretionary trading accounts, direct mutual fund trading, and registration of its principals, and failed to retain required documents.
5. The firm consented to a censure and fine of \$150,000.

B. In the Matter of Ferris, Baker Watts, Inc. ("Ferris"), SEC Admin. Proc. File No. 3-13364 (February 10, 2009)

1. From about August 2002 through November 2005, Stephen Glantz, a registered representative employed by Ferris, participated in a scheme to manipulate the market for the stock of Innotrac Corp. ("Innotrac"), a NASDAQ security in which Ferris made a market.
2. With respect to Innotrac, Glantz and others engaged in a variety of devices (e.g., marking the closing price of the stock, engaging in matched and wash trades, and attempting to artificially create down bids to suppress short selling of Innotrac) designed to manipulate the price of the stock. Glantz also made unauthorized and unsuitable trades in Innotrac and certain other securities.
3. Ferris senior executives permitted Glantz to work under a special arrangement, allowing him greater freedom and less supervision than other registered representatives at Ferris. For example, Glantz was assigned to Ferris' Beachwood, Ohio branch office, but was permitted to work at Ferris' Institutional Trading Desk in Baltimore several days a week. Through this special arrangement, Glantz was able to evade Ferris' supervisory procedures.
4. Red flags regarding Glantz's conduct had been raised by the Compliance Department in writing on at least two separate occasions during the relevant time period. In one memo, the Compliance Department recommended that Glantz's employment be terminated.
5. The Commission found that Ferris failed to design reasonable systems to implement its written supervisory policies and procedures with respect to Glantz's special work arrangement and, therefore, Ferris failed to reasonably to supervise Glantz to prevent and detect violations of the securities laws.
6. The Commission also found that Ferris failed to report Glantz's activity to the government in a Suspicious Activity Report.

7. Without admitting or denying the Commission's findings, Ferris consented to the findings and agreed to pay a civil penalty of \$500,000 and disgorgement and interest in the amount of \$300,656.

C. In the Matter of Patrick J. Vaughn, SEC Admin. Proc. File No. 3-13367 (February 10, 2009)

1. In a companion case to Ferris, mentioned above, the SEC settled an action against Vaughn, who served as the Director of Retail Sales at Ferris from 2003 to 2005. In his role, Vaughn was one of the highest level supervisors at Ferris and had authority over Glantz.
2. The SEC found that Vaughn failed to reasonably respond to red flags regarding Glantz's misconduct and special working arrangement.
3. Vaughn was aware that, when Glantz was hired, he had ten customer complaints on his Form U-4. Vaughn had also been informed that Glantz had a questionable reputation in the industry. Despite this knowledge, Vaughn permitted Glantz to work under a special arrangement whereby he split his time between the Beachwood, Ohio branch office and the Institutional Trading Desk in Baltimore. Under this arrangement, Glantz was subject to less supervision than other registered representatives at Ferris.
4. Between 2003 and 2005, Vaughn was notified several times that Glantz was not properly supervised.
 - a. For example, shortly after Glantz began work at Ferris, Vaughn received a memo from the Compliance Department warning of possible manipulative and unsuitable trading in Innotrac stock and of improper supervision of Glantz.
 - b. A few months later Vaughn and other senior executives discussed the significant and unusual accumulation of Innotrac shares in the accounts of Glantz's customers. That same day, a senior executive emailed Vaughn and indicated to him that it was unclear who had daily supervisory responsibility over Glantz's activities. While Vaughn and the other senior executives restricted the use of margin for future purchases of Innotrac, they did not take action with respect to the supervision of Glantz.
5. Later, Vaughn and other senior executives transferred Glantz to the Baltimore branch office without informing the Baltimore branch manager about the issues regarding supervision of Glantz or his handling of customer accounts.

6. After an audit of the Baltimore branch office, the Compliance Department wrote a memo recommending that Glantz's employment be terminated for unauthorized and unsuitable trading. In the memo, the Compliance Department also stated that Glantz had been "essentially unsupervised." Rather than terminate Glantz's employment, Vaughn and other executives determined to place Glantz under special supervision. Not until investors filed a lawsuit naming Ferris as a defendant was Glantz's employment terminated.
7. The SEC found that Vaughn failed to reasonably supervise Glantz to detect and prevent violations of the securities laws.
8. Vaughn was suspended from any supervisory or investment advisory capacity for a period of six months. Vaughn was also ordered to pay a civil penalty of \$50,000 and disgorgement and interest totaling \$16,627.

V. SUPERVISION OF BRANCH OFFICES AND PRODUCING MANAGERS

A. Supervision of Branch Offices

NASD Rule 3010 contains certain provisions relating to the oversight of branch offices. Several of these provisions are described below.⁵

1. Internal Inspections. Rule 3010(c)(1)(A) requires that supervisory offices be inspected every year. Under Rule 3010(c)(1)(B), the NASD requires inspections at least every 3 years of every branch office that does not supervise one or more non-branch locations. The cycle may be more frequent, and in such cases, an explanation of the criteria used to determine the frequency of the examinations must be included in a firm's written supervisory procedures.

Rule 3010(c)(2) requires that branch office inspections and reviews be reflected in a written report, which must be kept on file for three years. The report must include documentation of the testing and verification of the member's policies and procedures in the following areas: safeguarding of funds and securities, maintenance of books and records, supervision of accounts of producing managers, transmittal of funds between customers and brokers and between customers and third parties, validation of customer address changes, and validation of customer account information.

2. Review of Transactions and Correspondence. Rule 3010(d)(1) requires that members establish procedures for review by a registered principal of all transactions, and that such reviews be documented in writing. Written and electronic correspondence

⁵ Significant proposals to change Rule 3010 were made in May 2008 and are described in Regulatory Notice 08-24.

between registered representatives and the public also must be reviewed by a principal. A member's procedures for such reviews must be in writing and evidence that the reviews were completed must be maintained by the firm. Rule 3010(d)(2) requires that firms establish WSPs for the review of written and electronic correspondence between registered representatives and the public regarding investment banking or securities business.⁶ If the procedures do not require review of all correspondence prior to its use, then firms must provide training to employees regarding the firm's procedures governing correspondence, document such training and follow-up so that procedures are adhered to. Rule 3010(d)(3) requires retention of correspondence of registered representatives relating to investment banking or securities business.

3. Because of the perceived challenges in supervising small, remote offices, in 2004 the Staff of the SEC provided guidance to industry in this area.⁷ The Staff urged firms to review policies and procedures so that they are reasonably designed to prevent and detect wrongdoing in such offices. Some supervisory practices suggested by the staff include: implement onsite and offsite inspections of routine business and of particular events; conduct unannounced onsite inspections; monitor from offsite trading, handling of funds and use of personal computers; designate supervisory responsibility, noting a direct supervisor for each representative and assigning specific responsibilities to the supervisor; review Forms U-4 and U-5 during the hiring process; monitor outside business activities; implement procedures to detect financial misconduct; train representatives regarding securities laws and rules; monitor and verify customer address changes; monitor use of the signature guarantee stamp; and maintain and review incoming and outgoing correspondence.

The Staff also encouraged supervisors to develop efforts to increase customer awareness of firm procedures. The Staff suggested that supervisors confirm new account information with customers, direct customer correspondence to a central location, notify customers of firm policies prohibiting representatives from accepting cash or checks payable to the representative or borrowing money from customers, establish procedures for direct communication from the firm to customers and inform customers of regulatory information that is publicly available.

⁶ Further guidance concerning the supervision of electronic communications can be found in FINRA's Regulatory Notice 07-59.

⁷ SEC Division of Market Regulation, Staff Legal Bulletin No. 17: Remote Office Supervision, March 19, 2004.

B. Supervision of Producing Managers

NASD Rule 3012 contains certain provisions relating to the oversight of producing managers. Several of these provisions are described below.

1. In 2004, the SEC approved rule proposals by NYSE and NASD to require broker-dealers to strengthen controls over their supervisory systems and producing sales managers. Among other things, member firms' supervisory control policies and procedures must include procedures to review and supervise on a day-to-day basis the customer account activity conducted by the member's branch office managers, sales managers, regional or district sales managers, or any person performing a similar supervisory function. NASD Rule 3012(a)(2)(A).
2. Specifically, broker-dealers must have procedures that are reasonably designed to provide heightened supervision over the activities of "producing managers" who are responsible for generating a threshold percentage of the revenue of the business units supervised by the producing manager's supervisor over the course of a rolling, 12 month period. NASD Rule 3012(a)(2)(C). A person who is senior to or "otherwise independent" of the producing manager must perform these day-to-day supervisory reviews. NASD Rule 3012(a)(2)(A)(i).
 - a. A "producing manager" is a branch office manager, a sales manager, a regional or district sales manager or any person who performs a similar supervisory function and who services customer accounts in a capacity requiring registration.⁸
 - b. A person is senior to a producing manager if: (i) the person does not report to the producing manager; (ii) the person's compensation is not determined in whole or part by the producing manager; (iii) the person is not in the same chain of authority; and (iv) the person has the authority to oversee, direct, and correct the activities of the producing manager and take all necessary remedial actions, including termination, if and when necessary.⁹
 - c. A person is "otherwise independent" of a producing manager if: (i) the person does not report either directly or indirectly to the producing manager; (ii) the person is situated in a different office than that of the producing manager; (iii) the person must not otherwise have supervisory responsibility over the activity being reviewed (including not being directly compensated based in whole or in part on the revenues

⁸ See NASD Notice to Members 04-71.

⁹ *Id.*

accruing from those activities); and (iv) the person alternates such review responsibility with another qualified person every two years or less. NASD Rule 3012(a)(2)(A)(i).

3. The following is an example of an enforcement action concerning the supervision of producing managers.
4. **Raymond James Financial Services, Inc. (“RJFS”) (Feb. 21, 2007)**
 - a. In February 2007, the NASD settled an action against RJFS for an alleged failure to maintain an adequate supervisory system and to maintain adequate books and records.
 - b. Between 2000 and 2004, RJFS allegedly permitted approximately 1,100 branch managers to serve as the primary supervisors of their own business activities. Among other steps, the branch managers approved their own transactions, opened and accepted new accounts, and reviewed their own correspondence.
 - c. As a result, the firm did not detect one branch manager’s recommendation of unsuitable mutual fund and variable annuity purchases to, and misleading correspondence with, at least five elderly customers. The firm did not detect that more than ninety percent of her accounts listed the same primary investment objective (“growth”) and the same risk tolerance (“medium”).
 - d. The NASD also found failures with the firm’s supervisory system and written procedures with respect to variable annuities, with the firm’s branch audit program, and with the firm’s retention of books and records.
 - e. RJFS consented to a \$2.75 million fine. The NASD permanently barred the branch manager whose conduct was at issue.

VI. SUPERVISORY CONTROLS AND CERTIFICATION

Supervision is a prime component of all FINRA examinations.¹⁰ Firms are required to have adequate supervisory systems, policies and procedures in place to address supervision of all the areas of business.

A. Written Supervisory Procedures (“WSPs”)

1. NASD Rule 3010 requires WSPs to be clear and include a description of how supervision of an activity will be handled and

¹⁰ FINRA publication: Improving Examination Results (May 2008) available at www.finra.org.

who will be the responsible supervisor. WSPs should address the Who, What, When and How.¹¹

- a. WHO – WSPs should clearly identify the supervisor who will be responsible for a certain task. The regulators have cautioned that a department name or group is not sufficiently specific. The identification of a specific supervisor for each supervisory role is important, not only so that the individual is aware of his or her responsibility, but also so that other firm personnel and regulators can easily recognize the supervisor.
 - b. WHAT – WSPs should describe the particular supervisory reviews and the associated actions for which the supervisor will be responsible. The WSPs should delineate the actual systems used by the firm to detect misconduct.
 - c. WHEN – WSPs should specify the number and frequency of reviews.
 - d. HOW – WSPs should instruct the supervisor as to what actions must be taken to complete the review, including steps for reporting results, maintaining documentation of the review and addressing problems detected during the review.
2. WSPs should be reviewed regularly and updated as needed. Compliance professionals should engage business employees and management in discussions regarding compliance procedures, business priorities, industry events, and new regulations. Open discussions between compliance and the business help lead to WSPs that are accurate, complete and are reasonably designed to prevent and detect misconduct.

B. Supervisory Control Systems

1. NASD Rule 3012(a)(1) requires that a principal be designated to establish, maintain and enforce the firm's supervisory control system so that supervisory procedures are reasonably designed to achieve compliance with securities laws and rules. The principal is required to submit a report annually to senior management detailing the supervisory controls, summarizing testing results, identifying significant exceptions and noting any changes in supervisory procedures as a result of the testing.
2. Under NASD Rule 3012(a)(2)(B), firms are required to test and verify annually that supervisory control procedures are reasonably

¹¹ For guidance concerning the development of WSPs, see NASD Notice to Members 98-96 and NASD Notice to Members 99-45.

designed to achieve compliance, specifically in the following three areas:

- a. Transmittal of customer funds or securities,
- b. Changes to customer addresses, and
- c. Changes to customer investment objectives.

C. CEO Certification

1. In December 2008, FINRA Rule 3130 became effective after approval by the SEC as part of consolidation of the NASD and NYSE rulebooks into the new consolidated FINRA Rulebook. FINRA Rule 3130 replaced NASD Rule 3013, which was first approved by the SEC in September 2004.
 - a. FINRA Rule 3130(b) requires members' Chief Executive Officers ("CEOs") to certify annually that "the member has in place processes to (1) establish, maintain and review policies and procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules and federal securities laws and regulations; (2) modify such policies and procedures as business, regulatory and legislative changes and events dictate; and (3) test the effectiveness of such policies and procedures on a periodic basis, the timing and extent of which is reasonably designed to ensure continuing compliance with FINRA rules, MSRB rules and federal securities laws and regulations."
 - b. CEOs are required to conduct one or more meeting with the Chief Compliance Officer ("CCO") in the preceding 12 months. Rule 3130(c)(2).
 - c. Rule 3130(c)(3) requires that the member's processes be evidenced in a written report which is reviewed by the CEO and the CCO and submitted to the member's board of directors and the audit committee.