

Heightened Supervision

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I. INTRODUCTION

Over the last several years, 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," self-regulatory organization ("SRO") notices to members, examinations probing firm hiring and supervisory procedures, and disciplinary actions. In light of these initiatives it is important for firms to establish and implement reasonable heightened supervisory procedures. This outline focuses on that issue and provides guidance to firms considering the development or enhancement of policies and procedures for the heightened supervision of registered representatives.*

A. The Securities and Exchange Commission's Large Firm Project Report

Securities and Exchange Commission ("SEC" or "Commission") concerns relating to the hiring, retention and supervisory practices of large brokerage firms surfaced as a result of the SEC's examination findings developed during inspections in the early 1990s. As a result, the SEC staff, in conjunction with New York Stock Exchange ("NYSE") and National Association of Securities Dealers ("NASD") personnel, conducted a review of the hiring, retention and supervisory processes of the nine largest brokerage firms in 1993. The sweep culminated in the May 1994 issuance of the Commission's Divisions of Market Regulation and Enforcement report, "The Large Firm Project: A Review of Hiring, Retention and Supervisory Practices." (The report is available on the web at <http://www.sec.gov/news/studies/roque.txt>.)

In the Large Firm Project Report, the regulators found that the industry, the SEC, and the SROs needed to devote additional resources to the detection and prosecution of brokers with a history of sales practice abuses or those registered representatives who commit sales practice violations. Among other recommendations, the SEC staff 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. 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." (Remarks to the NASD by Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, available on the web at <http://www.sec.gov/news/speeches/spch005.txt>.)

* This outline was drafted by Ben Indek of Morgan, Lewis & Bockius LLP. It draws extensively on a prior outline created by Mr. Indek and John Bluhner that was developed in connection with a prior seminar, as well as outlines previously used at NASDR's Spring Securities Conference. The views expressed in the outline are those of the author and do not necessarily reflect those of the panelists or their organizations, companies, clients or colleagues. This outline is current as of March 7, 2002.

B. SEC, NASD, NYSE and NASAA Joint Regulatory Sales Practice Sweep

Two years after the issuance of The Large Firm Project Report, the staffs of the SEC, NASD and NYSE, along with representatives from the North American Securities Administrators Association, conducted a follow-up sweep to evaluate the sales practices of selected brokers associated with 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" ("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 utilize only minimum hiring procedures." (The report is available on the web at <http://www.sec.gov/news/studies/sweeptoc.htm>.) The staffs suggested that, among other initiatives, firms develop more stringent broker hiring protocols and increase special supervision of registered persons with disciplinary histories or customer complaints. Commission Chairman Levitt remarked that as a result of the Sweep Report, the SEC was asking firms to make several changes in their protocols and that "[h]iring practices was at the top of the list." (Remarks to the SIA Legal and Compliance Division by Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, March 18, 1996; available on the web at <http://www.sec.gov/news/speeches/spch089.txt>.)

C. NASDR and NYSE Joint Memorandum

In April 1997, NASD Regulation and the NYSE issued a joint memorandum ("Joint Memorandum") discussing the Sweep Report and providing guidance to member firms on the heightened supervision recommendations of the Sweep Report. (The Joint Memorandum is available on the web at <http://www.nasdr.com/pdf-text/9719ntm.pdf>.) The Joint Memorandum 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. The Joint Memorandum discussed the profile of brokers that should be considered by firms for heightened supervision and suggested types of procedures that broker-dealers should contemplate to supervise such employees. Finally, the Joint Memorandum informed firms that NASD Regulation and the NYSE examinations would include a review of the hiring and special supervision procedures established by member organizations.¹

D. Recent Enforcement Actions

In addition to noted regulatory activities, securities regulators have instituted enforcement actions that allege certain failures by firms to establish and implement reasonable hiring and heightened supervisory procedures. In September 2000, the SEC instituted several administrative proceedings concerning alleged deficient supervision at geographically dispersed broker dealers. Two of these actions specifically related to alleged inadequate heightened supervision.

¹/ Additional NASD guidance on supervisory issues can be found in NASD Notice to Members 98-38 (available on the web at <http://www.nasdr.com/pdf-text/9838ntm.txt>) and NASD Notice to Members 99-45 (available on the web at <http://www.nasdr.com/pdf-text/9945ntm.txt>)

In In the Matter of D.E. Frey and Company, Inc. (Rel. No. 34-43354) (Sept. 26, 2000) (available on the web at <http://www.sec.gov/litigation/admin/34-43354.html>), 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 practice 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. In sum, the SEC faulted D.E. Frey for allegedly failing to develop procedures for imposing heightened supervision on these brokers.

In In the Matter of Prospera Financial Services, Inc. (Rel. No. 34-43352) (Sept. 26, 2000) (available on the web at <http://www.sec.gov/litigation/admin/34-43352.html>), 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.

The NYSE recently sanctioned a member organization for allegedly failing to supervise a broker who was the subject of a prior NYSE investigation and sanction. In In the Matter of Gruntal & Co L.L.C. (Hearing Panel Decision 01-200) (Nov. 7, 2001) (available on the web at <http://www.nyse.com>), 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 the 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. In addition, when Gruntal did develop written heightened supervisory procedures it allegedly inaccurately portrayed the broker's prior sales practice history.

Two older cases are also of some interest. 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 Matter of Olde Discount Corp. et al. (Rel. No. 34-40423) (Sept. 10, 1998) (available on the web at <http://www.sec.gov/enforce/adminact/337577.htm>.) 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. See also In the Matter of GKN Securities Corp. and Robert H. Gladstone, (Rel. No. 34-40423) (Jan. 15, 1997) (available on the web at <http://www.sec.gov/enforce/adminact/3438173.txt>) (alleging that the firm and a supervisor failed to institute reasonable procedures to supervise new, inexperienced brokers recruited to the firm and to implement adequate special procedures to monitor those brokers who later became subject to multiple customer complaints).

Finally, regulators have sanctioned individuals for allegedly failing to provide for heightened supervision. In In the Matter of Martin Marvin Berk (NASD Case #C10000089)

(Aug. 2000) (available on the web at <http://www.nasdr.com>), a registered principal was sanctioned for, among other things, failing to establish heightened supervision of a broker as required by an agreement with the New York Attorney General's Office and the firm's compliance procedures.

II. SRO RULES AND SIA BEST PRACTICES

- A. The SRO rules noted below describe the requirements of firms to reasonably supervise their brokers; they do not impose affirmative obligations to develop heightened supervisory protocols. As discussed above, however, the Large Firm Project Report, the Sweep Report and the Joint Memorandum may be read to suggest that ordinary procedures may not be adequate in certain situations.
1. NASD Conduct Rule 3010 (obligates broker-dealers to establish and maintain a system of supervision of brokers that is reasonably designed to achieve compliance with applicable securities laws and rules).
 2. NYSE Rule 342 (requires firms to supervise and control each office and delegate to qualified principals the duty to supervise the persons in such offices).
 3. The SIA's "Best Compliance Practices" suggest that firms identify brokers who are subject to heightened supervision and document such procedures.

III. WRITTEN POLICIES AND PROCEDURES

Firms should consider developing a written policy statement identifying potential candidates for special supervision and describing the circumstances under which such individuals will be subject to heightened supervision. Firms should also consider implementing procedures to enforce their heightened supervisory policies. A sample heightened supervision procedure is attached at Exhibit 1.^{2/}

IV. IDENTIFICATION OF CANDIDATES FOR HEIGHTENED SUPERVISION

- A. Firms should identify registered representatives requiring special supervision. The following factors could be considered in this process:
1. Brokers with a regulatory history (including client complaints, disciplinary actions or arbitrations);
 2. Persons hired in a non-registered capacity who were previously employed as registered representatives and have such a history;
 3. Registered representatives who develop such a history while at the firm (including persons who have three complaints filed against them within a one year period);

^{2/} The protocols in the attached procedure are provided for informational purposes only and must be tailored to any firm that wishes to design such a program.

4. Registered representatives terminated by a prior firm for what appears to be a significant regulatory reason, *e.g.*, sales practice abuses;
 5. Registered representatives with frequent changes of employment;
 6. Brokers that meet certain sales practice related criteria. For example, the number of extensions, trade corrections or liquidations could be used as measures to determine if brokers should be placed on special supervision;
 7. Brokers that have problematic complaint patterns;
 8. Brokers that states require to be subject to an enhanced program of supervision; and
 9. Brokers who are the subject of statutory disqualifications.
- B. As noted in the Joint Memorandum, firms should "examine the circumstances of each [broker's conduct] and make a reasonable determination whether its standard supervisory and educational programs are adequate to address the issues raised by the record of any such registered representative." Where firms determine that heightened supervision is appropriate, they must develop and implement such protocols.

V. ESTABLISHING A HEIGHTENED SUPERVISORY PROGRAM

- A. Where firms have identified an individual requiring heightened supervision, they should consider the following issues in establishing a heightened supervisory program.
1. The program should be tailored to cover the area of concern, *e.g.* specific products, general sales practices, or nature of registered representative's business. The procedures should recognize the nature of the firm's business and the size and structure of the organization.
 2. The plan for monitoring the registered representative's activities should be documented, in writing. Supervision that may be considered in developing an individualized supervision program includes: (i) using standard supervisory procedures, but implementing heightened procedures or sanctions if there is any sign of a problem; (ii) restricting a registered representative's activities in the area(s) that were the subject of prior problems; (iii) assigning a mentor to work with the registered representative; (iv) providing specialized training to the registered representative; (v) implementing closer than normal control over area(s) that were the subject of prior problems, such as more heightened evaluation prior to the approval for account openings or particular types of transactions; (vi) prohibiting the registered representative from handling certain types of accounts, such as discretionary accounts, options accounts or accounts that contain low-priced speculative securities; (vii) developing specialized reviews of a registered representative's activities, such as identifying transactions that are uncharacteristic in size or volume, unusual increases or decreases in commissions, transactions between accounts or excessive corrections; and

(viii) requiring more frequent branch manager contact with the registered representative's clients. The specific elements of any heightened supervisory program should be reviewed by the appropriate senior management (including business units, legal, compliance, audit) prior to being finalized.

3. The appropriate supervisor to monitor the special supervisory arrangement should be documented, in writing. The supervisor must be qualified to perform the required reviews and fully understand the broker's conduct and activities that led to the establishment of a heightened supervisory program. When supervisors change positions, the new principal responsible for overseeing the heightened supervision should be informed of the program's requirements and the broker's background.
4. The broker and the supervisor should sign a memorandum acknowledging all of the aspects of the heightened supervisory program and agreeing to carry out its terms. The memorandum should include the duration of the special supervision.

VI. IMPLEMENTATION OF A HEIGHTENED SUPERVISORY PROGRAM

- A. Once a heightened supervisory program has been established, firms should consider the implementation of such protocols. Issues to be considered include the following:
 1. Circulation of the memorandum outlining the heightened supervisory program to affected areas, including the appropriate business unit, compliance, legal, internal audit.
 2. Follow-up reviews to monitor for adherence to the program. This can be accomplished through the annual examination program, periodic spot checks or other methods.
 3. Documentation of the carrying out of the heightened supervisory program, including evidence retained in client files, separate supervisory files or other materials.
 4. An annual review of the memorandum signed by the broker and the supervisor.

VII. COMPLETION OF A HEIGHTENED SUPERVISORY PROGRAM

- A. Where appropriate, firms may wish to end a heightened supervisory program. Consideration should be given to the following issues when doing so.
 1. The termination of a heightened supervisory program should be in writing. The document should explain the reasons for the termination of the program.
 2. The termination of a heightened supervisory program should be approved by the appropriate senior management personnel in the firm.

Exhibit 1

SAMPLE HEIGHTENED SUPERVISORY PROCEDURES

I. HEIGHTENED SUPERVISION OF REGISTERED REPRESENTATIVES

A. Activities That May Subject Registered Representatives to Heightened Supervision

Newly hired registered representatives with a history of repeated client complaints, disciplinary actions or arbitrations with adverse rulings, *or* registered representatives who develop such a history while associated with the Firm will be reviewed to determine whether existing supervisory procedures are adequate or whether such persons should be subject to a heightened level of supervision. The following registered representatives are subject to possible heightened supervision:

- registered representatives with a regulatory history (including client complaints, disciplinary actions or arbitrations);
- persons hired in a non-registered capacity who were previously employed as registered representatives and have such a history;
- registered representatives who develop such a history while at the Firm (including persons who have three complaints filed against them within a one year period);
- registered representatives terminated by a prior firm for what appears to be a significant regulatory reason, *e.g.*, sales practice abuses; or
- registered representatives with frequent changes of employment.

Notwithstanding the foregoing, if senior management determines that a new hire has a significant disciplinary history or previously was employed by a firm with a history of regulatory problems, such registered representative may be subject to certain heightened supervision for at least the first year of his employment with the Firm

Finally, the Firm is obligated to adhere to any special supervision of an registered representative imposed as a result of an SRO or state disciplinary action or as a condition of registration.

B. Plans of Heightened Supervision

In connection with the review described in Section X of this Manual, the BOM and the DOC should review a registered representative's CRD record. Where it is determined that heightened supervision is appropriate, the BOM, in consultation with the DOC, will develop individualized supervisory procedures taking into account the registered representative's CRD record and the areas that were the subject of the registered representative's previous complaints, disciplinary actions or arbitrations. Supervision that may be considered in developing an individualized supervision program includes:

- using standard supervisory procedures, but implementing heightened procedures or sanctions if there is any sign of a problem;
- restricting a registered representatives' activities in the area(s) that were the subject of prior problems;
- assigning a mentor to work with the registered representative;
- providing specialized training to the registered representative;
- implementing closer than normal control over area(s) that were the subject of prior problems, such as more heightened evaluation prior to the approval for account openings or particular types of transactions;
- prohibiting the registered representative from handling certain types of accounts, such as discretionary accounts, options accounts or accounts that contain low-priced speculative securities;
- developing specialized reviews of a registered representative's activities, such as identifying transactions that are uncharacteristic in size or volume, unusual increases or decreases in commissions, transactions between accounts or excessive corrections; and
- requiring more frequent BOM contact with the registered representative's clients.

C. Documentation and Approval

The BOM must document, in writing, and forward to the Compliance Department for review, each special supervisory arrangement established, including assessment of the type of supervision needed, identification of the person responsible for providing the supervision, and specification of the frequency and scope of the review. Final approval of the program rests with X. The DOC should confer with the BOM to ensure that he fully understands the registered representative's prior conduct and is willing to accept responsibility for the heightened supervision. The registered representative will be alerted to the terms of the special supervision, including its duration. In addition, both the registered representative and the BOM will be required to sign an acknowledgment, indicating their understanding and their agreement to abide by the terms of the special supervision.

The BOM shall acknowledge in writing that he has carried out the heightened supervision and, at completion, provide a written assessment of the supervision and the individual's conduct, including whether the objectives were met.