NATIONAL REGULATORY SERVICES
Branch Office Compliance Practice Conference
San Francisco, California

SUPERVISION OF BRANCH OFFICES, OSJ'S AND
OFFSITE BROKERS AND INDEPENDENT CONTRACTORS

May 24 and 25, 2001

by

Paul B. Uhlenhop, Esq.
John D. Ruark, Esq.
LAWRENCE, KAMIN, SAUNDERS & UHLENHOP, L.L.C.
Chicago, Illinois

NATIONAL REGULATORY SERVICES
Branch Office Compliance Practice Conference
San Francisco, California
May 24 and 25, 2001

INDEX

NATIONAL REGULATORY SERVICES
BRANCH OFFICE COMPLIANCE PRACTICE CONFERENCE

By: Paul B. Uhlenhop, Esq.*
John D. Ruark, Esq.
Lawrence, Kamin, Saunders & Uhlenhop, L.L.C.
Chicago, Illinois

SUPERVISION OF BRANCH OFFICES, OSJ'S AND OFFSITE BROKERS AND INDEPENDENT CONTRACTORS

I. INTRODUCTION

This outline focuses on supervisory responsibilities in connection with branch offices, offices of supervisory jurisdiction ("OSJs"), and offsite brokers, including independent contractors. All of these arrangements present particular and challenging supervisory responsibilities. It should be noted that branch offices, offsite registered representatives and independent contractors are not disfavored by the NASD. The NASD recognizes that many small communities are well served by remote offices, a branch, an independent contractor, an offsite registered representative or independent contractors working for insurance agents, banks or others. In many cases, a fully staffed branch office is impractical and not economical in relationship to the size of the community. In such instances, a one-man office or an insurance agency or bank with duly licensed securities personnel can provide a very real service. However, for the broker-dealer responsible for these remote offices or representatives, such offices present particular supervisory challenges in that sales practice problems may not be identified as quickly as they might be at a larger, more centralized firm. Without on-site supervisors and compliance personnel, there are more opportunities for supervisory failures and sales practice abuse. The most serious of these problems is selling away of securities products or Ponzi schemes, many of which have resulted in significant losses to firms. In addition to civil liability, there is the ever-present possibility of enforcement actions by the Securities and Exchange Commission ("SEC") and by self-regulatory organizations, all of whom have authority to sanction for failure to reasonably supervise associated persons. Regardless of the type of office, the supervisory responsibility remains the same. It is just more difficult to meet the obligations in the circumstances of a remote branch office, offsite registered representatives, independent contractors or securities representatives of insurance agents or banks.

II. SUPERVISORY RESPONSIBILITIES.

A. In General.

The supervisory responsibility of broker-dealers and persons who may be supervisors is spelled out in the Securities Exchange Act of 1934 ("'34 Act") in Sections 15(b)(4)(E) and 15(b)(6), New York Stock Exchange ("NYSE") Rule 342 and NASD Conduct Rule 3010.

The '34 Act indirectly mandates a supervisory requirement. Under the '34 Act, a broker-dealer and its supervisory personnel are at absolute liability for a violation by a subordinate that

* Mr. Uhlenhop is a member of the bars of the states of Illinois and of New York. Mr. Ruark is a member of the bar of the State of Illinois.

they supervise unless the broker-dealer has adequate written supervisory procedures that have been reasonably implemented. Section 15(b)(4)(E) of the '34 Act provides for liability of a broker-dealer or an associated person who has violated the securities or commodities laws or who "has failed reasonably to supervise, with a view to preventing violations of the provision of such statutes, rules and regulations, another person who commits such a violation if such person is subject to his supervision." Subsection (E) further provides that

> "no 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 person, and
>
> (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and systems without reasonable cause to believe that such procedures and systems were not being complied with." (emphasis added)

NASD Rule 3010 is similar to Section 15 of the '34 Act in structuring its requirements around the concept of reasonable supervision. Rule 3010 requires that

> "Each member shall establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of this Association. Final responsibility for proper supervision shall rest with the member."

In particular, each member firm shall establish, maintain and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of its registered representatives and associated persons in a manner reasonably designed to achieve compliance with the securities laws and regulations and with the applicable rules of the NASD. Rule 3010 establishes a number of requirements including, but not limited to, the following:

> (1) Written supervisory procedures.
>
> (2) Designation of registered principals with authority to carry out the supervisory responsibilities.
>
> (3) Designation of an OSJ for each location that meets the requirements. Each OSJ must supervise branches and other sites where business is conducted.
>
> (4) Designation of one or more registered principals at each OSJ, including the main office, and one or more registered representatives or principals at each non-OSJ branch office, with authority to carry out supervisory responsibilities assigned to that office.

(5) The assignment of each registered person to an appropriately registered representative or principal.

(6) Qualified supervisory personnel.

(7) Annual compliance review.

(8) Annual review of supervisory procedures.

Rule 3010(b) requires that the written supervisory procedures set forth the titles, registration status and location of the supervisory personnel and the specific responsibilities of each supervisory person. A member must maintain internal records regarding all such persons and the date when their responsibilities become effective. Last, but not least, each member must maintain written supervisory procedures at each OSJ and each location where supervisory activities are conducted. In addition to the annual review of supervisory procedures required by Rule 3010(a), Rule 3010(b) requires further that these procedures be changed any time there is a material change in the business of the member. This in essence means that a broker-dealer should review its procedures whenever it offers new products or acquires new offices. Since such changes in business are frequent, most broker-dealers should review procedures more frequently than annually. At many firms, review of procedures is conducted on a quarterly basis.

Rule 3010(c) requires that each member conduct an internal inspection of all of its operations on an annual basis. This includes all offices, including branch offices. Rule 3010(d) sets forth certain on-going requirements which may be paraphrased as follows:

(1) A registered principal must be responsible for the review and endorsement of all transactions and incoming and outgoing correspondence and electronic correspondence. Not all correspondence need be reviewed, but there must be a reasonable supervisory procedure.

(2) Each member must develop written procedures for the review of incoming and outgoing electronic correspondence with the public relating to its securities business.

(3) Each member must provide for the review and retention of correspondence.

See Section III.B.4. below for a further discussion.

Rule 3010(e) requires the investigation of the background business qualifications and experience of each registered person. The SEC Books and Records Rule 17a-3(a)(12) also requires a full history of each person who is employed by a firm or associated with handling funds, securities or soliciting customers. Rule 3010(f) also provides as follows:

> Any applicant for registration who receives a request for a copy of his or her Form U-5 from a member pursuant to this Rule shall provide such copy to the member within two (2) business days of the request if the Form U-5 has been provided to such person by his or her former employer. If a former employer has failed to provide the Form U-5 to the

> applicant for registration, such person shall promptly request the Form U-5, and shall provide it to the requesting member within two (2) business days of receipt thereof. The applicant shall promptly provide any subsequent amendments to a Form U-5 he or she receives to the requesting member.

Rule 3010(g) defines Office of Supervisory Jurisdiction and Branch Office, which is discussed further below in Section III.B.1.

Establishment of written supervisory procedures is a complex and continuing task. Appropriate procedures cannot be taken from a book or downloaded from the internet. Boilerplate alone is not adequate. While "canned" procedures may provide a useful starting point, supervisory procedures have to be tailored to each broker-dealer and its business. NASD Notice to Members ("NTM") 99-45 and NTM 98-96 provide an excellent statement of what the NASD expects in this regard. One needs to consider the customer base, product lines, and geographic locations of offices and personnel. Further, the broker-dealer's current systems, operating units and organizational structures need to be considered. Likewise, experience of personnel and their background is important in developing procedures. The applicable regulatory requirements are constantly changing and business is constantly changing, so it is a never-ending chase to keep written supervisory procedures current. Most important, supervisory procedures must be practical and tailored to the business. Supervisory procedures that are too complex are generally not followed. If they are not followed, there is almost automatic liability. Complex procedures that are not followed are, in many cases, worse than no procedures at all.

B. OSJs and Branch Offices.

1. NASD Rule 3010.

NASD Rule 3010(g)(1) defines an Office of Supervisory Jurisdiction as follows:

> "Office of Supervisory Jurisdiction" means any office of a member at which any one or more of the following functions take place:
>
> (A) order execution and/or market making;
>
> (B) structuring of public offerings or private placements;
>
> (C) maintaining custody of customers' funds and/or securities;
>
> (D) final acceptance (approval) of new accounts on behalf of the member;
>
> (E) review and endorsement of customer orders, pursuant to paragraph (d) above;
>
> (F) final approval of advertising or sales literature for use by persons associated with the member, pursuant to Rule 2210(b)(1); or
>
> (G) responsibility for supervising the activities of persons associated with the member at one or more other branch offices of the member.

The NASD is reviewing the definition of OSJ in light of the recent changes in the business, particularly with respect to trading firms. The NASD has granted limited relief in this area for offsite proprietary trading locations where the trading system has real time monitoring capability at

an office of an OSJ or the electronic trading system at the OSJ has approval control or limits on executions. This relief has been granted only in connection with proprietary trading transactions. The NASD has not permitted such relief in the case of any type of customer transactions where the office is held out to the public as an office of the firm.

Rule 3010(g)(2) defines the term Branch Office as "any location identified by any means to the public or customers at a location at which the member conducts an investment banking or securities business", excluding the following:

> (A) any location identified in a telephone director line listing or on a business card or letterhead, which listing, card, or letterhead also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch locations are directly supervised;
>
> (B) any location referred to in a member advertisement, as this term is defined in Rule 2210, by its local telephone number and/or local post office box provided that such reference may not contain the address of the non-branch location and, further, that such reference also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch location are directly supervised; or
>
> (C) any location identified by address in a member's sales literature, as this term is defined in Rule 2210, provided that the sales literature also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch locations are directly supervised.
>
> (D) any location where a person conducts business on behalf of the member occasionally and exclusively by appointment for the convenience of customers, so long as each customer is provided with the address and telephone number of the branch office or OSJ of the firm from which the person conducting business at the non-branch location is directly supervised.

It is important to remember that the terms "Branch Office" and "OSJ" are not synonymous. Because the differences in supervisory requirements between Branch Office and OSJ can be confusing, the terms need to be reviewed carefully when, for example, determining whether an office really is an OSJ or whether a Branch Office falls within the subparagraph (g)(2) definition. Further, one needs to consider the branch office exclusions of Rule 3010(g)(2). These exclusions offer a variety of helpful relief for remote offices and representatives. Further relief may be found in subsection (g)(3) of Rule 3010, which permits a member to substitute a central office address and telephone number for the supervisory branch office or OSJ under certain conditions, the most important of which is that a supervisory program exists to review complaints and to see that they are followed up with the local office.

C. New York Stock Exchange Rule 342.

NYSE Rule 342 is applicable to New York Stock Exchange member firms and is quite different than Rule 3010. Rule 342 of the New York Stock Exchange is not as far-reaching or as

particularized as Rule 3010. While Rule 342 does not define a branch office, it does require prior NYSE consent for each office "other than a main office." Thus, under the literal wording of the rule, when a registered representative operates from home or remote location, each such location is considered an office. However, the NYSE has supplemented Rule 342 so that the rule similar in concept, if not wording, to the NASD Rule. For that reason, NYSE Rule 342 is not discussed at length in this paper.

D. Compliance Officers.

Over the past 10 years, the SEC enforcement staff and various self-regulatory organizations have brought proceedings against compliance officers for failure to supervise. The SEC has clearly stated that legal and compliance personnel are not automatically supervisors for purposes of the '34 Act. The SEC and other regulators, when determining whether a compliance officer has supervisory responsibility, will focus on the degree of responsibility, ability, or authority to affect the conduct of the broker whose behavior is at issue. *See In re Gutfreund*, 52 S.E.C. 2849, 1992 SEC Lexis 293 (Dec. 3, 1992). A more basic test is whether the compliance officer has the ability to hire or fire an employee. *See In re Arthur James Huff*, 50 S.E.C. 524, 1991 WL 296561 (Mar. 28, 1991). However, since *Gutfreund*, this later test is not definitive. Under *Gutfreund*, a compliance officer will be deemed to be a supervisor if it is shown that he or she was in a unique position in relationship to the wrongful conduct such that he or she has the ability to stop it and that the employer has authorized the particular compliance personnel to go beyond his usual compliance and legal duties to supervise a particular employee or operation.

In the 21(a) Report accompanying the *Gutfreund* consent order, then-Commissioner Mary L. Schapiro (now President of the NASDR) stated as follows:

> There are three critical messages in this report concerning who may be deemed to be a 'supervisor.' First, employees who have legal or compliance responsibilities do not become 'supervisors' solely because of their positions. In other words, the Commission will analyze each case on the basis of its unique facts and circumstances, taking into account the managerial structure of the particular firm and the devolution of responsibility within the firm. Second, the determination of whether a particular person is a supervisor depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employees whose behavior is at issue. Again, the facts and circumstances are crucial, as is an analysis of responsibility and control, to making the determination. And third, it is possible, to <u>become</u> a supervisor under a particular set of facts and circumstances, even if formerly you did not have 'direct supervisory responsibility for <u>any</u> of the activities of the employee.'
>
> * * * * *
>
> In my view, the facts and circumstances which may make you 'become' a supervisor vis-à-vis a particular employee, when formerly you were not, are (1) your knowledge and awareness of allegedly improper conduct, and (2) being so situated within a firm that you have some ability to affect the conduct at issue.

Remarks of Commissioner Mary L. Schapiro, *Broker-Dealer Failure to Supervise: Determining Who is a "Supervisor,"* at 14-15, SIA Compliance and Legal Seminar (Mar. 24, 1993).

Most large wirehouses consider their compliance officers to be staff personnel, not line supervisors, and their procedures make it clear that the compliance officers do not supervise specific registered representatives or principals. Compliance staff provide compliance advice to line supervisors but the decision as to whether to hire, fire, discipline or carry out the advice remains with the line supervisors. However, if the written supervisory procedures, particularly the designations of supervisors, are not clear regarding who has responsibility for supervision of a particular person, the compliance officer may be charged as supervisors. The SEC and the self-regulatory organizations' basic principle seems to be that if the written supervisory procedures do not clearly delineate the line of supervision, all persons dealing with a violator will be charged for failure to supervise. It appears that the SEC is reaching in some cases beyond its past acknowledged standard to name compliance personnel if (1) they are very senior persons; (2) they can, by reason of their influence within the firm, cause a person to be terminated or stop the violative conduct. This could create troublesome precedent due to its fact-intensive nature and the difficulty of application. If continued, ultimately, the courts and the SEC are going to have a difficult time dealing with the potentially arbitrary nature of this standard.

It is critically important that compliance officers establish a supervisory chain of command which does not include compliance personnel. Furthermore, supervisory procedures should not specifically assign supervisory responsibilities to compliance professionals. If they do, then the compliance personnel may have supervisory responsibilities. Of course, the fact that compliance personnel review actions or activities of others will not necessarily amount to direct supervision.

III. KEY SUPERVISORY ISSUES FOR OFFSITE BROKERS, INDEPENDENT CONTRACTORS AND REMOTE BRANCHES.

A. Royal Alliance and Other Recent SEC and NASD Proceedings.

No discussion of this topic is complete without discussion of the SEC action *In re the Matter of Royal Alliance Associates, Inc.* ('34 Act Release No. 38,174 1997 SEC Lexis 113 (Jan. 15, 1997)). *Royal Alliance* presents a series of problems and is well worth study. Essentially, Royal Alliance was organized as an independent contractor firm. Royal Alliance was a broker-dealer with over 2,500 registered representatives and over 1,500 offices, many of which were small. There were approximately 350 OSJs, including more than 40 one-person offices. Two account executives in unrelated scams, one in Florida and one in North Carolina, obtained funds from customers and engaged in complex Ponzi scams, which included forging signatures on third party checks, forging letters of instructions, guaranteeing forged signatures, and a variety of other practices. One of the account executives had come to Royal Alliance with a history of several customer complaints. The SEC took Royal Alliance to task for its compliance system, which was based upon a foundation of annual on-site inspections. The SEC noted that, in particular, Royal Alliance had no structure to follow-up deficiencies noted in annual on-site inspections. Consequently, verification that deficiencies were corrected was often deferred until the next annual inspection. The SEC further expressed its doubt as to whether a single pre-announced annual inspection was adequate for Royal Alliance to satisfy its supervisory obligations. The SEC also cited the failure of the annual inspections to detect the violative conduct, even though a number of

red flags were raised by such conduct. The SEC also noted that Royal Alliance did not take into account the history of the account executive and implement appropriate measures of heightened supervision. In *Royal Alliance*, the SEC put the industry on notice that it would closely scrutinize the supervision of not only independent contractors, but of all remote office registered representatives.

In the Matter of Consolidated Investment Services, Inc. ('34 Act Release No. 36,687, 1996 SEC Lexis 83 (Jan. 5, 1996), the employees had agreed to comply with an agreement with CIS which prohibited expressly the violative conduct. Nevertheless, CIS was held responsible and, as part of its settlement, agreed that it would not employ registered representatives unless they were supervised on site by a registered principal and were subject to semi-annual surprise inspections. As noted below, most broker-dealers should consider at least semi-annual surprise inspections of remote offices for a variety of reasons.

Another case of note where the firm was found to have failed to supervise independent contractors was *In the Matter of New York Life Securities* ('34 Act Release No. 40,459, 98 SEC Lexis 2000 (Sept. 23, 1998)). In this case, the independent contractor registered representatives were insurance agents of New York Life who were supervised by a manager in each branch office. In another case involving independent contractor representatives, (*In the Matter of FSC Securities Corp.*, '34 Act Release No. 40,765 (Dec. 9, 1998)), the SEC found failure to supervise involving improper mutual fund switching and sales of unsuitable securities. The SEC, in particular, criticized three elements of FSC's supervisory system: (1) the lack of exception reports that could reliably detect mutual fund switching; (2) the fact that while OSJ principals were producers themselves such principals' own business was not supervised by designated individuals; and (3) the failure of compliance auditors to examine "a sufficient number of customer accounts during audits of OSJs."

There is at least one victory for compliance personnel recently in *In the Matter of Quest Capital Strategies, Inc.* (Admin.Proc. File No. 3-8966 (Initial Decision No. 141), 1999 SEC Lexis 727 (April 12, 1999)). In this case, the SEC found that Quest's compliance system was reasonably designed to prevent and detect the violations complained. Importantly, Quest conducted a detailed investigation of the background of all registered representatives. The broker-dealer required each registered representative to sign an agreement not to engage in a variety of prohibited activities. Quest distributed updated compliance procedures manuals to its registered representatives. Importantly, Quest used an annual compliance questionnaire which certified that the account executive had complied with each of the specific procedures. The questionnaire was very detailed and inquired about the other activities. See Section III.B.2.c. below for further discussion on practical procedures.

B. Areas of Supervision that are Critical and Where Weakness Can Result in Regulatory Action.

1. Hiring and Training – Investigation and Background.

a. General Records and Investigation. NASD Rule 3010(e) specifically requires an investigation into the background of any registered representative. A similar investigation of other employees or persons associated with broker-dealers is required indirectly by

SEC Rule 17a-3, which requires a written record of the background of registered personnel and all other employees with access to funds or securities.

b. Questionnaires. In addition, the registered representative should be required to complete a detailed questionnaire with his background, financial positions, investments and specific, detailed description of outside activities. There should be a background and credit check and some third party contacts regarding his outside business activities. The background check should be extensive for registered representatives in remote locations. Telephone calls should be made not only to the references and employers required to complete the U-4, but also to other prior employers and other persons in the community who may have knowledge of the individual and his actions. Records of these calls and information obtained should be maintained. It is also important to do a credit check on any registered representative to determine if he or she has financial difficulties. There is a high correlation between registered representatives with financial difficulties and those who engage in illegal sales activities, Ponzi schemes and the like.

As part of the hiring process, the account executive should be put through a training program as to what is involved in outside securities activities. Registered representatives often do not understand how many different business activities may be deemed to involve securities. For example, most do not understand that a promissory note alone may, under certain circumstances, be deemed to be a security. Likewise, an interest in an LLC or an interest in a common investment scheme, including a partnership or limited partnership, may be a security. Few training programs do a good job providing information in all the possible ways an account executive might be deemed to be selling away. There should be detailed education regarding this area because it is the single most vulnerable spot for remote representatives and branch offices. It is the area that has caused the most civil liability and enforcement penalties. Many registered representatives naively believe that they can assist a local contractor in selling notes or interests in the development of a shopping center or an apartment building or similar activities without knowing that they may involve securities.

In hiring a representative who has prior complaints, even those resolved favorably, the firm is in fact on notice in the eyes of the NASD and the SEC that there may be compliance problems. The account executive's background, and each prior complaint, should be thoroughly investigated as well as each complaint. It may be necessary and prudent to tailor specific supervisory procedures to monitor the account executive in such cases. New complaints of the same type as previous complaints are a red flag that must be carefully investigated.

c. Registered Representative Agreements. Most firms with remote offices and representatives have agreements with their registered representatives. The agreements should specifically delineate key areas of prohibited conduct, such as third party check endorsements, outside business activities and a variety of other conduct. The contract should specifically state that the employee has read and will abide by the compliance and operational manual. The contract should also specifically affirm that the information furnished to the firm in the representative's employment application is true and correct.

d. Compliance and Operations Manual. All firms should have a compliance manual and operations manual for the registered representatives. This should not be confused with a supervisory manual which is designed for supervisory personnel or supervisory procedures for supervisors. The compliance manual for registered representatives should be a list

of "dos and don'ts" and should be in plain English. Such a compliance manual is an important part of the supervisory system because providing a copy of the supervisory procedures alone does not necessarily provide the registered representative with details as to what he needs to know both from an operational and compliance standpoint.

e. Insurance Agency Representatives. If the registered representative has another business, such as selling insurance, and the other business is through a different company, compliance personnel should verify essential details with that company. If the registered representative has an established business, there should also be a visit to the business, including a physical inspection, and a review of its advertising and other activities.

f. Bank Networking Arrangements. The same procedures discussed above should be employed for bank employees who are registered representatives of a broker-dealer. Furthermore, there should be particular training with respect to NASD Rule 2350, "Broker-Dealer Conduct on Premises of Financial Institutions." Likewise, the rules of financial institutions regulators with respect to securities activities on financial institution premises should be carefully reviewed and incorporated into registered representative agreements. Investigation of bank employees and their backgrounds should include all of the above steps, but may not need to be as intensive because bank employees are generally closely supervised and examined by the bank regulators where the representative is a full-time bank employee. Because of the higher level of supervision which bank employees receive, as a general matter, bank networking relationships with a bank employee as a registered representative do not pose the same risk as do insurance agents who are registered representatives or other remote registered representatives.

2. On-Going Compliance.

a. In General. On-going compliance includes supervision of all areas of the activities and is beyond the scope of this outline. However, there are some key supervisory responsibilities that should be emphasized. In Section IV, specific marketing supervision is discussed.

b. Outside Activities. The registered representative's contract and the firm's supervisory procedures should provide that the registered representative can engage in any new business activities only with the written approval of the central office. Some firms do provide that branch managers or OSJ principals may approve outside activities, but this is not recommended because they may not understand the nature of the activities and possibility of selling away.

c. Assignment of Supervision. As discussed above in Section II.A., under NASD Rule 3010(b), it is critically important that all associated persons have a designated line supervisor. If there is dual supervision, each supervisor is potentially liable for supervision. Furthermore, principals also need to be supervised, particularly where they have their own sales activities, and in a large organization there will be supervisors of supervisors. Generally, the SEC and the NASD do not pursue sanctions all the way up the chain of supervision unless supervisors up the chain are directly involved in the violative activity or know of red flags indicating violations.

d. Inspections of Remote Sites. Rule 3010(c) requires an annual inspection of each office and each OSJ. This inspection mandate requires inspection of each branch office, OSJ or other location held out to the public as a place of business. Since the SEC stated in Royal Alliance that annual inspections may not be sufficient, some firms have moved to semiannual inspections. The SEC has also emphasized, as discussed above, that the inspections should be surprise inspections. Traditional methods such as annual questionnaires or annual telephone interviews alone will no longer be deemed sufficient. The surprise inspection is difficult, however, for firms with remote representatives because when the auditors arrive, the registered representative may be out of town or may have other things scheduled. However, the necessity of surprise is critical to the audit.

The inspector should use a checksheet covering all areas of activities and all products. It is not enough to examine a representative's securities business only if the person also has other business activities, such as insurance or real estate, that operate out of the same or other offices. Programs should be developed to determine whether there is selling away or other possible violative activities in the related business. In many cases, outside business activities, particularly if it involves real estate or other ventures in the community, may involve selling away. The broker-dealer should make inquiry and satisfy itself that these activities do not in fact involve securities activities. An annual questionnaire should include completion of personal financial statements by the representative. If the person has financial problems, additional procedures should be developed and the representative's activities carefully monitored. Some firms conduct an annual credit check to determine if the registered representative has financial problems. Bankruptcy, foreclosure and credit litigation are all red flags. An annual contact with a local business banker, particularly in small communities, regarding the activities and reputation of individual may yield important information. It is very difficult to detect selling away and the firm should go to considerable lengths to be able to show that it made adequate inquiry regarding other business activities of the employee.

The local inspection should test transactions and should review books and records. The test should involve different periods of time for at least two or three different time periods within the year. The tests should cross month's end in at least two or three instances. Customer positions should be verified with the account executive's holding pages. If not possible to verify all clients' positions because of the number of clients, a sampling should be undertaken. Likewise, all sales, advertising, business cards should be reviewed on a spot basis. Testing should be done for churning if there are equities, options or other types of activities. Mutual fund switches and variable annuities should be specifically scrutinized.

The annual questionnaire should be formatted in "check the box" style so that the representative must read each particular statement of specific compliance. There should be a general statement at the end that he or she has reviewed the compliance manual and all updates and complied with the same. All deficiencies should be noted in the inspection report and should be brought to the attention of the compliance director and the applicable line supervisor. When deficiencies are found, there should be specific resolution of what is going to be done to prevent them in the future. If the deficiencies noted in a prior examination appear again, disciplinary action should be taken or the employee terminated.

e. Selling Away.

1) Unregistered securities. "Selling away" is the sale of securities products outside the broker-dealer that are not authorized by the broker-dealer or conducted through its books. As discussed above, many supervisory actions have involved registered representatives who engaged in selling away. NASD Rule 3040 specifically prohibits selling away by registered representatives. Rule 3040 states as follows:

> (a) Applicability
> No person associated with a member shall participate in any manner in a private securities transaction except in accordance with the requirements of this Rule.
> (b) Written Notice
> Prior to participating in any private securities transaction, an associated person shall provide written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction; provided however that, in the case of a series of related transactions in which no selling compensation has been or will be received, an associated person may provide a single written notice.
> (c) Transactions for Compensation
> (1) In the case of a transaction in which an associated person has received or may receive selling compensation, a member which has received notice pursuant to paragraph (b) shall advise the associated person in writing stating whether the member:
> (A) approves the person's participation in the proposed transaction; or
> (B) disapproves the person's participation in the proposed transaction.
> (2) If the member approves a person's participation in a transaction pursuant to paragraph (c)(1), the transaction shall be recorded on the books and records of the member and the member shall supervise the person's participation in the transaction as if the transaction were executed on behalf of the member.
> (3) If the member disapproves a person's participation pursuant to paragraph (c)(1), the person shall not participate in the transaction in any manner, directly or indirectly.
> (d) Transactions Not for Compensation
> In the case of a transaction or a series of related transactions in which an associated person has not and will not receive any selling compensation, a member which has received notice pursuant to paragraph (b) shall provide the associated person prompt written acknowledgement of said notice and may, at its discretion, require the person to adhere to specified conditions in connection with his participation in the transaction.

(e) Definitions

For purposes of this Rule, the following terms shall have the stated meanings:

(1) "Private securities transaction" shall mean any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission, provided however that transactions subject to the notification requirements of Rule 3050, transactions among immediate family members (as defined in IM-2110-1, "Free-Riding and Withholding"), for which no associated person receives any selling compensation, and person transactions in investment company and variable annuity securities, shall be excluded.

(2) "Selling compensation" shall mean any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security, including, though not limited to, commissions; finder's fees; securities or rights to acquire securities; rights of participation in profits, tax benefits, or dissolution proceeds, as a general partner or otherwise; or expense reimbursements.

Any securities activities, including activities of a registered representative as a registered investment adviser are required to be run through a registered representative's broker-dealer. See Section III.B.2.(d)(1) below for a more detailed discussion. Generally, the sale of unregistered securities that are not run through the broker-dealer's books occur in two different formats. In the first case, the registered representative is naive and just does not understand that the investments, notes or other things that he is selling are securities. In the other case, the notes or interests that are being sold are part of a deliberate fraud or Ponzi scheme by the registered representative. If a registered representative is associated with another financial service firm, such as an insurance agency or bank, the broker-dealer must carefully scrutinize both the products offered through the broker-dealer, and also the other products offered by the representative to ensure that none are part of a Ponzi scheme. For example, one of the authors once encountered a situation where an insurance agent/registered representative was converting customer premiums for life insurance as well as variable annuity funds and mutual fund products. The registered representative manufactured phony insurance policies and variable life insurance policies which he prepared himself using desk-top publishing software. In several other cases, account statements, confirmations and other documentation normally received from the insurance company, bank or broker-dealer were cleverly duplicated using electronic graphic facilities. This type of activity is difficult to prevent. However, one way that it can be detected is by annually contacting a number of customers and confirming that their positions balance with the broker's records.

2) Investment Adviser Activities of Registered Representatives. NASD NTM 94-44 discusses the responsibilities of a broker-dealer if it has a registered representative who is dually registered as an investment adviser. In such cases, the activities of the registered representative involving securities must be accounted for and booked by the broker-dealer. More importantly, the broker-dealer has supervisory responsibilities for certain of the registered representative's investment advisory activities.

f. Conversion of Client Funds. Conversion of client funds is, other than Ponzi schemes, the single most difficult thing to detect. If there is any question concerning the possibility of conversion of funds, clients must be contacted directly by counsel or senior compliance personnel. The verification should be both orally and in writing. Details of the account should be sent to the customer and the balances and positions in the account confirmed in writing.

The authors have seen numerous cases where contact with the customer at an early stage would have quickly led to the discovery of conversion of funds. Diversion of customer checks to a fictitious account or entity are often part of a Ponzi scheme. Some times, the fictitious entity has the same name as the broker-dealer or a similar name as the broker-dealer. A good example is the Old Naples Securities case – a broker-dealer of that name owned an affiliate called Old Naples Financial. *See* In re Old Naples Securities, Inc., No. 99-2510, (11th Cir. Aug. 23, 2000). In that case, checks made payable to Old Naples Securities were diverted into the account of Old Naples Financial and converted by the president of Old Naples Securities.

Local depository accounts for a firm can also create complex issues when an account executive is permitted to deposit customer funds into an account for the broker-dealer or its clearing firm or if a local account executive has the ability to process withdrawals for customers. Withdrawals should be permitted only upon written request of the account holder and only when such requests are sent directly to the broker-dealer from the account holder. Each withdrawal check should be mailed or delivered directly to the customer's address and separately confirmed directly to the customer. Failure to confirm a withdrawal directly to the customer has been a cause of problems for broker-dealers in the past.

g. Complaints. The failure to follow-up on complaints is the single most frequently cited reason for disciplining a securities professional for failure to supervise. All complaints should be carefully investigated and such investigation should be carefully documented. All complaints received should be forwarded to a central office, with copies to the principal to be certain that they are carefully investigated. Complaints should be catalogued by representative and by office. If there are a number of complaints about a particular representative, particular office or particular product, this is a red flag that cannot be ignored. They must be thoroughly investigated by contacting and interviewing the employee and the customer. It is not enough to accept the account executive's story on its face. The cases involving supervision have time and time again sanctioned principals, who were made aware of complaints, but failed to follow up and contact the customers directly. Often the supervisory principal has a friendship with the account executive. This can make it difficult to carry out the requisite follow-ups. But it must be done. A principal must be totally objective, and more than one principal has been severely sanctioned for accepting an explanation at face value. Complaints should be carefully and objectively scrutinized. Failing to do so can cost a securities professional his ticket.

h. Review of Transactions. Daily or intra-day review of all securities transactions by remote representatives or other representatives under the direct supervision of a principal is the single most important surveillance practice that a principal may utilize and employ. Such surveillance is the first line of defense against a variety of marketing and sales practice violations. The review should look at transactions for suitability. If securities transactions are being effected for accounts that the principal does not recognize, this is an immediate red flag which would require the principal to determine the basis for the recommendation of the securities

and whether they are suitable for a particular customer. Many transactions or large-sized transactions in a single issue by an account executive or particular office is a red flag regarding suitability (and may even raise suspicions regarding possible manipulation). In particular, large option transactions or margin transactions in a security should be investigated as to whether they fit the pattern of the individual investor for suitability, but also as to whether possible insider trading or manipulation is behind the trades. Mutual funds and variable annuities should be reviewed for switching or breakpoint sales.

The front line supervisor is not expected to catch all violations. However, the review of transactions on a daily or intra-daily basis and the investigation of discrepancies as a matter of course is the firm's first line of defense. In connection with each daily review, a record of the review should be maintained by indicating on the blotter or other transactions sheets or on the computer that they have been reviewed, the time of review and any discrepancies noted. The investigation of any discrepancies and the resolution of the discrepancy should be in a memorandum which should be retained.

i. Violations, Restitution and Sanctions. If a firm discovers a violation or series of violations, the firm must make difficult decisions regarding making potential restitution to customers, revising supervisory procedures and compliance procedures, sanctioning the individuals involved and last, but not least, reporting the violations to the appropriate regulatory authorities. These decisions are difficult decisions which must weigh the threat of civil litigation and enforcement activity by the appropriate regulatory authorities. Such decisions should be made with the aid of counsel that has significant experience in dealing with the appropriate regulatory organizations and is well-versed in the risk involved. Whether to sanction an account executive or other employee and the level of sanction is often also a difficult issue. It is the authors' experience with both the SEC and the NASD that such steps will not necessarily preclude action against the firm or senior supervisors. However, in many cases, it will result in either a significantly reduced sanction or no sanction at all against the firm or senior supervisory personnel and in some cases, the registered representative.

IV. MARKETING

A. In General.

Since the primary purposes of most branches, offsite locations and registered representatives is to engage in selling activities and marketing, it is not surprising that other than selling away, sales practice marketing violations are the most frequently encountered types of violations with respect to remote branch offices, independent contractors, remote representatives, dual insurance and securities agents. For such reason, the key areas are suitability, advertising, sales promotion, correspondence and, recently, websites and e-mails. Telemarketing and unregistered persons also present challenges.

B. Suitability.

Suitability of transactions is a particularly important supervision responsibility. See NASD Rule IM-2310-1 and NYSE Rule 405. In some firms, this review is conducted by OSJ and branch offices and in other cases it is conducted by a central office responsible for reviewing the suitability of all transactions. In addition to the general suitability rules (NASD Rule 2310 and NYSE Rule

405), there are particular rules for options, mutual funds, collateralized mortgage obligations, variable contracts and other products. If the product line is relatively limited, central office review is often more efficient and more effective than review by a remote principal. Such approval also provides better control in that the necessary documentation, such as switch letters, non-solicitation letters and other necessary documentation, must be obtained before transactions may be effected. If the suitability review is done by a OSJ, the principal must be careful to maintain detailed records of the review. Often, this is difficult for the registered principal in an outlying office, particularly if he is engaged in his own sales activities. If there are options or similar transactions, they need to be reviewed by registered options principal and also by the Compliance Registered Options Principal, usually at a central office. See IV.C.I. below.

In general, a supervisory system with respect to suitability requires review by a principal of each transaction. Some firms attempt to do this from the OSJ in addition to the first line principal's review. Many firms also review each transaction in a general or centralized regional office. Some times such reviews are on a sampling basis. The NASD Rule 2310 requires that "in recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer on the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." With respect to specific products such as variable annuities, options, collateralized mortgage obligations and other complex requirements, the NASD has offered guidance to members by reason of notices to members discussed below. NYSE Rule 405 is equivalent in effect but is somewhat different conceptually. Known as the "know-your-customer" rule, it requires that a broker use due diligence to learn the essential facts relative to every customer, order, cash or margin account carried or accepted by the broker and every person holding a power of attorney over any account. Rule 405 applies even where a broker has made no recommendation. However, the concept behind the rule and its interpretation by the NYSE and courts impose similar obligations as NASD Rule 2310 and the specific suitability rules for complex products discussed below.

The most important red flags in connection with suitability are customer complaints. It is important that complaints be carefully investigated and be received without skepticism. In most cases, the customer should be contacted and interviewed and appropriate action taken. If there are a series of complaints concerning a particular account executive or office, in the authors' experience, it does generally indicate that something is amiss. In such event, careful investigation is doubly important. Where there are violations, the firm should consider appropriate restitution to customers and possibly sanctions or disciplinary action against the account executive.

C. Special Products.

1. Options.

NASD Rule 2860 provides a substantial, complex and detailed series of provisions for regulation of options. The key provisions in dealing with marketing at the branch level are contained in IM-2860-2 "Diligence in Opening Options Accounts".

The detailed suitability information specified in IM-2860-2 must be obtained from the client using the standard form. The information must initialed and verified by the customer. Rule 2860 in subsection (b)(17) requires maintaining detailed records with respect to any

complaint. The same Rule requires special approval and authorization of discretionary accounts. Discretion by the account executive for an options account must be approved in writing by a registered option principal. A senior registered options principal ("SROP") is required to review each discretionary account to be certain that there is a reasonable basis for believing the customer has the ability to understand and bear the risk of the strategies and transactions proposed. Each discretionary order by an associated person must be approved by the branch office manager or other registered options principal.

With respect to each branch office engaged in the options business, the principal supervisor must be qualified as a registered options principal or a limited principal general sales security supervisor unless there are less than three registered representatives, and their activities are supervised by a registered options principal or a limited principal general sales security supervisor elsewhere. Each broker-dealer must have a SROP to supervise the other registered options principals. Each SROP is responsible for implementing specific procedures. Each firm must have a compliance registered options principal ("CROP") (who may also be the SROP) who shall have no sales functions and be responsible to review and propose appropriate action with respect to compliance. Regular reports on the supervision must be filed with senior management or the senior compliance officer.

Rule 2860 provides further that the principal supervisory office having jurisdiction over any office serving customer options accounts, must maintain and have readily accessible various information with respect to options compliance and the accounts services by that office.

2. Variable Contracts.

NASD Rule 2820, regarding marketing variable contracts, includes detailed provisions regarding the distribution, sales charges, selling agreements and member compensation in connection with the redemption of products. The NASD has issued various guidance with respect to variable annuities, including NTMs 96-86 and 99-35. NTM 99-35, in particular, is instructive and quite specific. All points covered in NTM 99-35 should be dealt with in a suitability review before the product is actually sold. Furthermore, educational material for account executives should be conformed to 99-35. Finally, the best surveillance is to have a checklist for each customer transaction that is filled out by the account executive and signed by the customer with an addendum for the account executive to complete and verify to send along with the application for the particular product. Bonus annuities and replacements present particular problems. If replacements are being considered, additional forms should be prepared and the transactions should be reviewed just as in connection with a mutual fund switch.

3. Investment Company Products.

NASD Rule 2830 regulates the sale of investment company products. It includes a number of provisions with respect to distribution sales charges and discounts for dealers which are beyond the scope of this article. However, from a sales standpoint, there are specific prohibitions against selling dividends or withholding orders. Also, importantly, member compensation and non-cash compensation is regulated in detail by Rule 2830. However, these are not directly related to marketing by a remote branch office or representative. More important is IM-2830-1 dealing with breakpoint sales. Specifically, IM-2830-1 states:

> The sale of investment company shares in dollar amounts just below the point at which the sales charge is reduced on quantity transactions so as to share in the higher sales charge applicable on sales below the breakpoint is contrary to just and equitable principals of trade.
>
> Investment company underwriters and sponsors, as well as dealers, have a definite responsibility in such matters and failure to discourage and to discontinue such practices will not be countenanced.
>
> For purposes of determining whether a sale in dollar amounts just below a breakpoint was made in order to share in a higher sales charge, the Association will consider the facts and circumstances, including, for example, whether a member has retained records that demonstrate that the trade was executed in accordance with a bona fide asset allocation program that the member offers to its customers:
>
> - which is designed to meet their diversification needs and investment goals; and
> - under which the member discloses to its customers that they may not qualify for breakpoint reductions that are otherwise available.

In connection with any mutual fund switch, there should be a review by the principal responsible for the registered representative. In addition, a broker-dealer should have a system to identify any particular registered representative or office that is generating a significant number of switches and should review such switches, at least by sampling.

4. Direct Participation Programs.

NASD Rule 2810 details the regulation of members and their associated persons participating in the sale of direct participation programs. A good part of Rule 2810 deals with offering compensation, due diligence and other activities by the members, including participation in roll-ups. However, there are specific suitability standards for direct participation programs which should be carefully monitored. Supervisory procedures should be developed to insure that direct participation programs, since they are generally illiquid, are sold only to persons who can stand the risk (generally, very wealthy individuals). If they are sold through remote branches or registered representatives, careful supervision by the central office or regional office of the authorizations and review of suitability for these transactions should be part of the supervisory procedures. Many broker-dealers require approval in the home office by a senior compliance or line supervisor for any direct participation sale. In most cases the program itself requires pre-approval by the compliance department or senior official before a sale may be made by a remote representative. In such case, files should be maintained with respect to the due diligence. With respect to any sale of direct participation programs, there should, at a minimum, be a review by a principal and, in most cases, a review by a more senior official.

5. New Products.

New products always present supervisory problems, in part because many new products have features that may be difficult for a registered representative or supervisor to immediately comprehend. For example, Edward D. Jones & Co., L.P., was sanctioned last year for violation of New York Stock Exchange rules in connection with the sale of callable CDs. Edward D. Jones has 3000 account executives, most of them in one-man offices. Over the years, Edward D. Jones has had an exemplary record of supervision and compliance. (The father of one of the authors was a former partner of Edward D. Jones and instrumental in helping establish the concept of one-man offices throughout the United States.) The callable CDs being sold had a term of 10-15 years. Although callable at full price, these instruments had a fluctuating value due to the length of term. The New York Stock Exchange cited 87 of the firm's 3000 account executives for violation of suitability and failure to explain the nature of the product. Edward D. Jones itself received over 100 complaints from its customers. This case illustrates the type of problem that can occur when a new product is introduced and either the account executives simply do not understand the product or adequate supervisory reviews for suitability are not made. Edward D. Jones & Co., L.P., NYSE Hearing Panel Decision, 00-187, (October 31, 2000).

D. Websites, E-Mails, Advertising, Sales Promotion and Correspondence.

1. In General.

In addition to the anti-fraud rules and specific rules of the SEC with respect to advertisements, NASD Rule 2210, "Communications with the Public", is the principal rule that is applicable with respect to this subject matter. See also NYSE Rule 472. Rule 2210 very broadly defines "advertisement", "sales literature" and "correspondence." It is a complex rule with specific provisions for particular types of products. All advertising and sales literature must be pre-approved by the signature of a registered principal. The rule further requires a separate file of such advertisements and sales literature which includes names of the person(s) who prepared and/or approved the use of advertisements and sales literature. For new firms and certain products, such as mutual funds, variable contracts, unit investment trusts and collateralized mortgage obligations, pre-filing with NASDR is required. Rule 2210(c) provides exemptions for particular types of material prepared by third parties and administrative advertisements, such as change of offices, internal material, and material filed with the SEC. Rule 2210(d) sets forth general standards for advertising. There are specific standards with respect to use of the NASD's name and the name of the firm. In addition to Rule 2210, the NASD manual has interpretations with respect to specific products such as collateralized mortgage obligations, variable contracts, mutual fund rankings, bond fund volatility ratings and other products. In addition, NASD Rule 2220 deals specifically with communications about options with the public. NYSE Rule 440A is a similar rule regarding options with almost identical language. As discussed below in Section IV.E., the NASD Telemarketing Rule 2211 is also applicable.

Supervision of advertising, sales promotion and communication has become more difficult as a result of the electronic communication revolution. Remote account executives, particularly those who are independent contractors or associated with insurance general agents, may want to have their own websites and e-mail communication systems. This presents particular challenges. Most firms with a large network of remote offices or representatives require that all advertisements and sales literature be pre-approved at a central office or a regional office in

addition to prior approval by the OSJ or responsible registered principal. Some firms have compliance procedures that prohibit the use of advertisements or sales literature except in a format that has been pre-approved by the regional or central office. In all cases, because the communications rules are so complex, advertisements and sales literature should be reviewed and approved by someone with considerable experience. Based on experience, the authors do not believe that all registered principals necessarily have the background to carefully scrutinize and knowledgeably approve advertisements and sales material because the complexity of the rules and interpretations in this area. Consequently, it is recommended that firms use either pre-approved material or they have knowledgeable review with a compliance person or in a central office. This is particularly true with respect to specialized products.

2. Specialized Products Rules and Advisories.

   a. CMOs, see IM-2210-1 and NTM 98-53.

   b. Variable Annuities, see IM-2210-2.

   c. Investment company advertisements and sales material, see specific provisions in Rule 2210, IM-2210-3 and NTM 95-74 and 95-80.

   d. Bond Fund Volatility Rankings, see IM-2210-5 and NTM 00-23.

   e. Options Communications, see IM-2210 and NTMs 91-62, 92-56.

3. Websites and E-Mail.

Websites and e-mail present a particularly difficult problem for firms with remote offices and branches. E-mail is considered a form of correspondence which, until recently, required pre-approval by a registered principal before correspondence could be sent to a customer. Websites are advertising. The rules regarding correspondence to customers have been eased somewhat because of the electronic communication revolution. The NASD has issued a number of NTMs, advisories and interpretations. Particularly important is NTM 98-3 and NASD staff interpretation letter to the Investment Company Institute (Nov. 11, 1997).

However, the broker-dealer continues to be responsible for reviewing all communications with customers, whether by written correspondence or by e-mail. This requires a system of supervision of all correspondence and e-mails to customers. Necessarily, this means that e-mail outside the broker-dealer's own system should be prohibited because any e-mail through the private computer of a registered representative cannot be readily reviewed or retrieved by the firm. Any e-mail system used by a remote representative, particularly if it is not part of the firm's own system, must have the capability to retain messages without erasure so that it can be reviewed. Furthermore, since review should be on an on-going basis, the firm's system should be designed so that a registered principal or a compliance officer receives copies of all e-mails electronically so they may be retained as part of the broker-dealer's records. However, in most cases this is not practiced. As a result, many firms still prohibit any communication with customers by e-mail except through the company's electronic communication system.

Similar problems arise with personal websites. Some firms permit remote representatives or general agents with representatives to have their own websites. However, this presents a considerable danger because the broker-dealer will be responsible for any such website. Because any material appearing on a website is deemed to be advertising, it must comply with all of the communication rules which, as explained above, are quite complex. At a minimum, most firms require pre-approval of the website and any changes thereto. Furthermore, since copies of all advertising and sales literature must be maintained, all changes on the website must be retained and available for inspection by the self-regulatory organizations. Because of these problems, many firms prohibit representatives from marketing through any website other than the firm's website. Some large organizations with remote representatives have developed methodologies for their individual remote representatives to use part of the firm's website for their own operations or office.

Here, too, again, the red flags and warnings come mainly from customer complaints or letters. If, in connection with an annual inspection or otherwise, the firm learns that a remote executive is either not submitting material for pre-approval or engaging in activities outside of the permitted activities as indicated above, this must be carefully investigated and appropriate action taken.

E. Telemarketing.

NASD Rule 2211 and NYSE Rule 440A specifically regulate telemarketing. The NASD Rule 2211 provides that outbound telephone calls to the residence of any person without the consent of the person is prohibited except between 8:00 a.m. and 9:00 p.m. Further, any solicitation call must identify the caller, the member firm, the telephone number and address where the caller may be contacted and must state that the purpose of the call is solicitation. There is an exception for calls to customers who are already existing customers within the preceding 12 months. Firms should maintain a list of persons called who have stated that they do not want to received further telephone solicitations. Many firms surveil telephone calls by taping all or some calls of representatives. In most cases, telemarketing calls by remote representatives are not taped due to cost. Furthermore, such taping is generally considered intrusive. However, some firms have begun to use systems to tape solicitation calls or else have prohibited such cases completely.

F. Unregistered Personnel.

1. In General.

Where a broker-dealer has remote branches and remote registered representatives, there exists the possibility of unregistered personnel. Unregistered personnel present a particular problem because the blue sky laws of many states allow rescission of any transaction by an unregistered person regardless of whether the client has been damaged. Of course, rescission is sought only where a customer loses money on a transaction. Thus, use of unregistered persons is really writing puts for free to the customer by the firm and by the unregistered person.

There are two situations that present danger. The first occurs during a representative's training period or when he is waiting for registration to become effective in a specific state. The second occurs where a registered representative uses an assistant or secretary who is not properly registered to engage in activities such as soliciting clients or accepting orders from clients or otherwise going beyond permitted activity. In either case, the broker-dealer is, in

effect, giving the customer puts on the transaction. As a result of the Gramm-Leach-Bliley Act, in network arrangements, non-registered bank employees may engage in administrative activities only and may not accept orders from customers. They may only refer a customer to an appropriately registered representative.

Remote representatives who have a significant amount of business almost necessarily need assistance. When an account executive has a large book of business, annual audits should include appropriate investigation into the assistance he has managing his business. This is especially true in instances where the account executive is not available on a regular basis at his primary office, particularly if he is the sole registered representative at his office.

E:\PBU\WINWORD\PBU\NRS\Articles-Outlines\Supervision-Branch Offices OSJ Offsite Brokers.doc