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Broker-Dealer Supervision of Branch and Remote Offices

by:

Paul B. Uhlenhop
LAWRENCE, KAMIN, SAUNDERS & UHLENHOP, L.L.C.
Chicago, Illinois

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By: Paul B. Uhlenhop, Esq.[1]
Lawrence, Kamin, Saunders & Uhlenhop, L.L.C.
Chicago, Illinois

BROKER-DEALER SUPERVISION OF BRANCH AND REMOTE OFFICES

I. Introduction

The purpose of this panel and the accompanying outline is to focus on various areas of advanced broker-dealer compliance, including the following:

(1) supervisory responsibilities;

(2) key supervisory issues for remote office branches;

(3) marketing issues.

II. Supervisory Responsibilities

A. In General

1. Current Rules

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 National Association of Securities Dealers Regulation, Inc. ("NASD") Conduct Rule 3010 and 3012.

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 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 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

[1] Mr. Uhlenhop is a member of the bars of the states of Illinois and of New York and is a Senior Member of Lawrence, Kamin, Saunders & Uhlenhop, L.L.C., Chicago, Illinois.

(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(a) 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 applicable NASD Rules. Final responsibility for proper supervision shall rest with the member."

In particular, each member firm shall establish and maintain a system of supervision and enforce it 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 for the type of business that the member is authorized to conduct.

(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.

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(b) requires that tape recording of conversations and other special procedures with respect to certain registered persons at a discipline firm as defined in the Rule. Discipline firm is determined based upon the definition contained in Rule 3010(b) based on the disciplinary history of registered representatives and the size of the firm.

2. Rule 3012 – Supervisory Control System

When the NASD adopted Rule 3010, it also adopted Rule 3012 effective December 17, 2004. Rule 3012 is designed to designate a principal who shall be responsible for monitoring the supervisory control policies and procedures, including testing them to verify that (i) they are reasonably designed to achieve compliance and (ii) to create and amend the supervisory procedures where needed. The designed principal must submit to senior management no less than annually a report detailing the system, the summary of the tests, significant deficiencies and procedures to remedy the deficiencies. Procedures are designated to review and supervise customer activity by person's performing supervisory functions. The supervisory control system rule states in part as follows:

> (1) Each member shall designate and specifically identify to NASD one or more principals who shall establish, maintain, and enforce a system of supervisory control policies and procedures that (A) test and verify that the member's supervisory procedures are reasonably designed with respect to the activities of the member and its registered representatives and associated persons, to achieve compliance with applicable securities laws and regulations, and with applicable NASD rules and (B) create additional or amend supervisory procedures where the need is identified by such testing and verification. The designated principal or principals must submit to the member's senior management no less than annually, a report detailing each member's system of supervisory controls, the summary of the test results and significant identified exceptions, and any additional or amended supervisory procedures created in response to the test results.
>
> (2) The establishment, maintenance, and enforcement of written supervisory control policies and procedures pursuant to paragraph (a) shall include:
>
> (A) Procedures that are reasonably designed to review and supervise the customer account activity conducted by the member's branch office managers, sales managers, regional or district sales managers, or any person performing a similar supervisory function. A

> person who is senior to the producing manager must perform such supervisory reviews...(emphasis added).

Rule 3012 in subsection (2)(A) provides a limited exemption from the senior requirement quoted above if:

1. a member does not conduct a public business;
2. has capital requirements of $5,000 or less; or
3. employs 10 or fewer representatives.

In addition, to qualify for the exemption under subsection (2)(A), a member business must be conducted in manner necessitated by a limitation of resources that includes fewer than two layers of supervisory personnel. In each case, a person in another office of the member who is the same or similar position to the producing manager may conduct supervisory reviews. However, the person in the same or similar position: (i) may not have supervisory responsibility over the activity being reviewed; (ii) must report to his supervisor his supervision and review of the producing manager; and (iii) has not performed a review of the producing manager in the last two years. There is a further exemption if the member is so limited in size and resources that it cannot avail itself of the above exception; for example, a member with only one office or a member with two offices and insufficient number of qualified personnel who can conduct reviews on a two year rotation. In all cases, a member must use a principal who is sufficiently knowledgeable about the member's supervisory control procedures to conduct the reviews.

In any of the above cases, the member must document in its supervisory control procedures the factors it has relied upon to obtain an exemption by reason of its size and resources and why it has no other alternative than to comply with respect to one of the above exemptions. See the following section for a discussion of the procedures that are required by Rule 3012.

3. Required Inspections

In addition to the review and testing required by Rule 3012, Rule 3010(c) was recently amended, effective December 17, 2004 to require member inspection of its operations to evaluate its system of supervision. The inspection team must be "independent" as explained below. Rule 3010(c), in part, provides as follows:

> (1) Each member shall conduct a review, at least annually, of the businesses in which it engages, which review shall be reasonably designed to assist in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and with applicable NASD rules. Each member shall review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses.
>
> (A) Each member shall inspect at least annually every office of supervisory jurisdiction and any branch office that supervises one or more non-branch locations.

(B) Each member shall inspect at least every three years every branch office that does not supervise one or more non-branch locations. In establishing how often to inspect each non-supervisory branch office, the firm shall consider whether the nature and complexity of the securities activities for which the location is responsible, the volume of business done, and the number of associated persons assigned to the location require the non-supervisory branch office to be inspected more frequently than every three years. If a member establishes a more frequent inspection cycle, the member must ensure that at least every three years, the inspection requirements enumerated in paragraph (c)(2) have been met. The non-supervisory branch office examination cycle, an explanation of the factors the member used in determining the frequency of the examinations in the cycle, and the manner in which a member will comply with paragraph (c)(2) if using more frequent inspections than every three years shall be set forth in the member's written supervisory and inspection procedures.

(C) Each member shall inspect on a regular periodic schedule every non-branch location. In establishing such schedule, the firm shall consider the nature and complexity of the securities activities for which the location is responsible and the nature and extent of contact with customers. The schedule and an explanation regarding how the member determined the frequency of the examination schedule shall be set forth in the member's written supervisory and inspection procedures.

Each member shall retain a written record of the dates upon which each review and inspection is conducted. (Emphasis added.)

Rule 3010(c)(2) requires that a member must make a written report and keep on file for a minimum of three years each office inspection and review subject to an inspection for certain inspections conducted pursuant to paragraph (c)(1)(C) which is quoted above if the regular periodic schedule is longer than the three year cycle. In such case, the report must be maintained until completion of the next inspection report.

Each report is required to include testing and verification of the firm's policies and procedures, including supervisory policies and procedures in the following areas:

(A) Safeguarding of customer funds and securities;
(B) Maintaining books and records;
(C) Supervision of customer accounts serviced by branch office managers;
(D) Transmittal of funds between customers and registered representatives and between customers and third parties;
(E) Validation of customer address changes; and
(F) Validation of changes in customer account information.

If a member does not engage in all of the activities set forth above, the report must note that the firm does not engage in those activities and that before engaging in them a supervisory policy and procedure needs to be in place.

In addition, Rule 3010(c)(3) requires independence in connection with any inspection. Specifically, the rule requires the following:

> (3) An office inspection by a member pursuant to paragraph (c)(1) may not be conducted by the branch office manager or any person within that office who has supervisory responsibilities or by any individual who is supervised by such person(s). However, if a member is so limited in size and resources that it cannot comply with this limitation (e.g., a member with only one office or a member with a business model where small or single-person offices report directly to an office of supervisory jurisdiction manager who is also considered the offices' branch office manager), the member may have a principal who has the requisite knowledge to conduct an office inspection perform the inspections. The member, however, must document in the office inspection reports the factors it has relied upon in determining that it is so limited in size and resources that it has no other alternative than to comply in this manner.
>
> A member must have in place procedures that are reasonably designed to provide heightened office inspections if the person conducting the inspection reports to the branch office manager's supervisor or works in an office supervised by the branch manager's supervisor and the branch office manager generates 20% or more of the revenue of the business units supervised by the branch office manager's supervisor. For the purposes of this subsection only, the term "heightened inspection" shall mean those inspection procedures that are designed to avoid conflicts of interest that serve to undermine complete and effective inspection because of the economic, commercial, or financial interests that the branch manager's supervisor holds in the associated persons and businesses being inspected. In addition, for the purpose of this section only, when calculating the 20% threshold, all of the revenue generated by or credited to the branch office or branch office manager shall be attributed as revenue generated by the business units supervised by the branch office manager's supervisor irrespective of a member's internal allocation of such revenue. A member must calculate the 20% threshold on a rolling, twelve-month basis. (Emphasis added.)

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

4. Employee Investigation

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. *See* Section V for further discussion. 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.

5. Proposed Rule Change – Heightened Procedures for Problem Employees

In September 2003, the NASD published Notice to Members ("NTM") 03-49 proposing amendments requiring heightened supervision procedures for associated persons with a specified threshold of industry or regulatory related events. Although this rule is not effective, we understand the NASD is examining firms to determine if they have heightened supervision plans in as part of their written supervisory procedures even though the rule is not in place. The NASD staff believes that even though the rule is not in place, written supervisory procedures require heightened supervision of certain employees who have a history of customer complaints, arbitrations, litigations or regulatory actions. Under the proposed rule, special supervisory procedures would have to be adopted over the activities of the associated persons who have:

(1) Three or more customer complaints or arbitrations in the previous five years;

(2) Subject to three or more pending, adjudicated or settled regulatory actions or investigations;

(3) Subject to two or more terminations for cause or internal reviews for alleged investment-related misconduct in the previous five years.

The supervisory procedures currently are required for most persons who have been permitted to return to the business after they have been subject to a disqualification. Under the proposed rule, the firm must have written supervisory procedures for heightened supervision with registered persons falling within its definition. However, the firm may decide for reasons set forth not to impose the heightened supervisory restrictions. For example, if there have been three or more customer complaints and arbitrations and the associated person has won the arbitrations and the complaints are baseless, the firm has the option not to impose heightened supervisory procedures but must document the reasons for any person who is excepted from the procedures. It is expected that this proposed rule will be in effect shortly.

6. Proposed Rule 3013 – CEO Certification

The NASD has proposed and filed with the SEC proposed Rule 3013. Rule 3013 requires every member to designate a Chief Compliance Officer ("CCO"). In addition, the rule

requires that there be an annual certification from the Chief Executive Officer ("CEO") that the member has in place:

> processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable NASD rules, MSRB rules and federal securities laws and regulations, and that the chief executive officer has conducted one or more meetings with the chief compliance officer in the preceding 12 months to discuss such processes."

The accompanying interpretation IM-3013 would require the CEO to certify the following:

> 1. The Member has in place processes to:
>
> (a) Establish, maintain and review policies and procedures reasonably designed to achieve compliance with applicable NASD rules, MSRB rules and federal securities laws and regulations;
>
> (b) Modify such policies and procedures as business, regulatory and legislative changes and events dictate; and
>
> (c) Test the effectiveness of such policies and procedures on a periodic basis, the timing and extent of which is reasonably designed to ensure continuing compliance with NASD rules, MSRB rules and federal securities laws and regulations.
>
> 2. The undersigned chief executive officer (or equivalent officer) has conducted one or more meetings with the chief compliance officer in the preceding 12 months, the subject to which satisfy the obligations set forth in IM-3013.
>
> 3. The Member's processes, with respect to paragraph 1 above, <u>are evidenced in a report</u> reviewed <u>by the chief executive officer</u> (or equivalent officer), chief compliance officer, and such other officers as the Member may deem necessary to make this certification, and submitted to the Member's board of directors and audit committee.
>
> 4. The undersigned chief executive officer (or equivalent officer) has consulted with the chief compliance officer and other officers as applicable (referenced in paragraph 3 above) and such other employees, outside consultants, lawyers and accountants, to the extent deemed appropriate, in order to attest to the statements made in this certification. (emphasis added.)

The explanatory material in IM-3013 states that if the member does not have a Board of Directors or Audit Committee or equivalent, there need not be a report submitted to them.

The Interpretation specifically states that if a CEO has concluded that there is inadequate basis for making the certification, it would constitute conduct "inconsistent with the observance of high standards of commercial honor and just and equitable principals of trade in violation of NASD Rule 2110."

The interpretive material recognizes that supervisors with business line responsibility are accountable for discharge of a member's compliance policies and supervisory policies. IM-3013 also states that the NASD recognizes that the required consultation between the CEO and the CCO without more would not establish business line responsibility by the CCO for supervision.

As noted above, paragraph 3 requires an annual report must be prepared. The prior versions of the certification requirement filed by the NASD with the SEC received almost unanimous opposition from the industry. As a result, the NASD has proposed the new scheme and rule. The author expects that the SEC will receive significant comment about Rule 3013 because some of its provisions are on its face unworkable. How does a firm with only one principal comply with the report requirement? The testing requirement is also unspecified and vague. The NASD needs to articulate how the testing function may be preformed. This testing and the report requirements obviously will be very expensive for small broker-dealers and in most cases small broker-dealers will be unable to comply with the provisions as they are currently written.

7. Written Procedures Practice

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 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.

The supervisory control system under Rule 3012 provides that the procedures must be designed to review and monitor the following activities:

> (i) All transmittals of funds (e.g., wires or checks, etc.) or securities from customers and third party accounts (i.e., a transmittal that would result in a change of beneficial ownership); from customer accounts to outside entities (e.g., banks, investment companies, etc.); from customer

accounts to locations other than a customer's primary residence (e.g., post office, "in care of" accounts, alternate address, etc.); and between customers and registered representatives, including the hand-delivery of checks;

(ii) Customer changes of address and the validation of such changes of address; and

(iii) Customer changes of investment objectives and the validation of such changes of investment objectives.

The policies and procedures established pursuant to paragraph (a)(2)(B) must include a means or method of customer confirmation, notification, or follow-up that can be documented. If a member does not engage in all of the activities enumerated above, the member must identify those activities in which it does not engage in its written supervisory control policies and procedures and document in those policies and procedures that additional supervisory policies and procedures for such activities must be in place before the member can engage in them; and…

As described in Section II.A.2 above, Rule 3012(a)(2)(C) requires procedures reasonably designed to provide heightened supervision over the activities of each producing manager who is responsible for generating 20% or more of the revenue of the business units supervised by the producing manager's supervisor. For more specifics, see Section III.A.1 regarding Staff Legal Bulletin No. 17.

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)(A) defines the term Branch Office as "any location identified by any means to the public or customers as a location at which the member conducts an investment banking or securities business." However, the following are excluded from the definition of branch office:

> (i) 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;
>
> (ii) 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
>
> (iii) 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.
>
> (iv) 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.
>
> (B) Notwithstanding the exclusions provided in paragraph (2)(A), <u>any location that is responsible for supervising the activities of persons associated with the member at one or more non-branch locations of the member is considered to be a branch office</u>.

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.

The NASD has proposed revision of the definition of "Branch Office" in NASD Rule 3010(g)(2) designed to allow registration of branch offices through the CRD system. The proposed definition has gone through several amendments as a result of comments from the public and National Association of Securities Administrators ("NASA"). The current definition of a branch office as set forth above applies to any location identified to the public as a location in which the member conducts an investment banking or securities business. A branch office as defined in the proposal is any location other than the main office where one or more associated persons or members regularly conduct the business of effecting any transactions in or inducing or attempting to induce the purchase or sale of any security or that is held out as such excluding:

(A) a customer service or back office type function where there are no sales activities;

(B) certain associated persons' primary residence subject to certain limitations and restrictions;

(C) temporary locations used for securities business less than 30 days a year (i.e., secondary residence or summer home);

(D) an office of convenience to meet with customers where they are located which is not held out to the public as a branch office;

(E) any location that is primarily engaged in non-securities activities and from which there are less than 25 securities transactions effected in any one year provided there is information concerning the address, telephone number, location from which the associated person regularly conducts business;

(F) activities on the floor of a registered national exchange; and

(G) a temporary location in connection with a business continuity plan.

Unfortunately, the change in the rule will sweep in a number of locations that were previously not branch offices, primarily for trading offices where firms conduct proprietary trading on electronic markets. Electronic markets were not excluded from the national securities exchange definition. Thus, a broker-dealer that trades on eSpeed or similar upstairs electronic securities markets and does not hold the office out to the public and does not deal with any customers but conducts only proprietary trading will fall within the new definition. This definition has been pending for some period of time and there is still controversy. It is unclear whether the new definition will be adopted.

C. New York Stock Exchange Rule 342

The SEC recently approved the amendment to NYSE Rule 342 and certain other rules of the NYSE so that such rules are similar to the amended NASD Rules 3010 and 3012. The effective

date of Rule 342 and other recent NYSE rules adopted at the same time is December 17, the same effective date as the new NASD rules. The NYSE amended Rule 401 with respect to transmitting funds from customer accounts, customer changes of address and customer changes of investment objectives requiring procedures with respect to all of those areas. Also, Rule 408 was amended to be parallel to the NASD rule change. NYSE Rule 410 was changed with respect to maintenance of orders received from customers and changes in account name or designation. 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. *See* Section B above for a discussion regarding a uniform branch office definition proposal that would apply to New York Stock Exchange member branches.

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 NASD) 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 Remote Office Branches

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

1. Staff Legal Bulletin No. 17

The SEC Division of Market Regulation recently published Staff Legal Bulletin No. 17 entitled "Remote Office Supervision," March 19, 2004, www.sec.gov/interps/legal/mrs1b17.htm. Every compliance officer should have available and carefully read the Division's publication. It's an outstanding summary of supervisory policies and procedures for branches and remote offices. The policies and procedures cover the following area:

(1) Inspections:

(a) Routine or for-cause inspections;
(b) Unannounced inspections; and

(c) Off-site monitoring of trading, handling of funds and use of personal computers.

(2) Designated supervisory responsibilities;

(3) Background investigation, including Forms U-4 and U-5;

(4) Monitoring outside business activities and selling away;

(5) Procedures to detect financial misconduct;

(6) Education for representatives;

(7) Monitoring and verifying customer address changes;

(8) Signature guarantees, stamp controls; and

(9) Maintaining copies of and reviewing incoming and outgoing correspondence

In the area of customer awareness, the interpretation covers the following:

(1) Confirmation of new account information with customers;

(2) Directing all correspondence to a central firm location;

(3) Notifying customer of procedures and how to file complaints; and

(4) Informing customers about information available from regulators, including their websites;

A copy of Bulletin No. 17 is attached hereto and the details are discussed throughout the rest of this outline.

2. 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(12), 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 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 prior employers listed on Form U-4, but also to other persons

in the community who may have knowledge of the individual and his actions. Form U-5 should also be carefully reviewed. 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.

In hiring a representative who has prior complaints, regulatory investigations, arbitrations or disciplinary actions, even those resolved favorably, the firm is in fact on notice in the eyes of the NASD and the SEC that there may be possible compliance problems. The account executive's background, and each prior incident, 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. *See* discussion above regarding heightened supervisory procedures which are now expected to be in place with respect to any associated person having compliance issues, including complaints, arbitrations, litigation, regulatory investigations or sanctions.

c. Education. In addition to passing the regulatory exams, as part of the hiring process an account executive should have been through an extensive training program regarding compliance and the products that are offered by a broker-dealer. Another important area that is often overlooked is training registered representatives regarding what activities may involve securities. 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 offices and branches. 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.

d. Registered Representative Agreements. Most firms 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, private e-mail with clients 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. Likewise, the agreement should provide that other information furnished to the firm, including annual update questions, will be true and complete.

e. Compliance and Operations Manual. All firms must 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.

f. 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.

g. 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.

3. 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 may not engage in any new business activities without the prior 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. However, it should be understood that the supervisor must be in fact a supervisor at a higher level and not someone at the same level or someone reporting to the supervisor.

d. Continuing Education and Registration. In addition to the required continuing education and registration compliance, the broker-dealer should on an annual basis

review the activities of each account executive to be certain that the account executive has met his continuing education and registration requirements. It is particularly important in developing educational programs for branches and remote representatives that the programs cover problem areas and bring associated persons up to date with regulatory rule changes.

e. Inspections of Branches and OSJs. Rule 3010(c) requires an annual inspection of each OSJ and any branch office that supervises one or more non-branch location. Each other branch office must be inspected at least every three years. This inspection mandate requires inspection of each branch office, OSJ or other location held out to the public as a place of business. Although the rule only requires annual inspection for certain OSJs and certain branches and an examination every third year for certain other locations, the SEC and NASD staff realistically expect more frequent inspections. For their own protection, some firms have moved to semiannual inspections, particularly of remote offices. 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 examination.

The firm's procedures should have a methodology for "for cause" inspections of an office. These inspections may be limited to a particular account executive or the activity may cover the whole branch. These inspections should in all cases be a surprise examination. The detail of such examination should be considerably greater than those of a routine annual examination.

In annual inspections, the examiner should use a checksheet covering all areas of activities and all products. If the associated persons also have 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.

Rule 3012 provides a checklist of areas that should be considered in connection with every OSJ or branch inspection which are as follows:

(A) Safeguarding of customer funds and securities;
(B) Maintaining books and records;
(C) Supervision of customer accounts serviced by branch office managers;
(D) Transmittal of funds between customers and registered representatives and between customers and third parties;
(E) Validation of customer address changes; and
(F) Validation of changes in customer account information.

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 banker, particularly in small communities, regarding the activities and reputation of the branch 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 holding pages of the account executive. 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 to each associated person may 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.

In a "for cause" inspection, the exam may cover all of the things that would be covered in an annual examination, but there should be a particular focus of the examination on the areas covered by complaints or exception reports developed by the compliance department. In "for cause" examinations, the particular areas of investigation should be more in depth and involve more than just testing.

f. 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 acknowledgment 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.A.2.(f)(2) 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. 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.

g. 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 author has 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.

The handling of customer securities or funds in a remote office presents particular hazards to a firm. In such cases, the inspection of the branch must be particularly enhanced to review the procedures. In most cases, customer funds and securities should be handled away from any remote location or branch to a centralized office where such securities and funds are handled by persons other than the customer representatives or branch managers.

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. *See also* NYSE Rule 401(b) and 410(a)(4).

h. 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. In many cases, a number of complaints should generate an investigation for cause. 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.

i. Review of Transactions. Daily or intra-day review of all securities transactions by 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 suitability, switching, breakpoint sales

or other improprieties. SEC Rule 17a-3 requires that the account name and designation be placed on each order ticket or memorandum, whether electronic or otherwise. Only a designated person is permitted to approve changes in account names or designations on an order. The designated person must be a principal and must document any changes and the reasons for them.

The sale of new products or particularly complex products should receive special scrutiny to be certain that the account executive and the client have a good understanding of the product and it is under these circumstances suitable for the client. As a result of recent amendments to SEC Rule 17a-3 and 17a-4, copies of all correspondence, e-mails and instant messages relating to the business of a broker-dealer must be maintained. This would include any activity at a branch or remote office. Consequently, the broker-dealer's system must maintain such electronic correspondence for the required period of Rule 17a-3 and 17a-4 as well as any other records maintained electronically. In addition, the electronic system of retention must meet the requirements of SEC Rule 17a-3 and 17a-4 which includes that the records be maintained in a form that you write it once and it's maintained permanently and cannot be erased. The electronic system permits for easy retrieval and that the system has back-up off site, among other things. *See* SEC Rule 17a-3 and 17a-4(f).

Computer technology provides for centralized monitoring of trading and handling of funds and remote offices. These programs to create exceptions for unusual trading, flow of funds, delivery of securities are available from many outside vendors and provide an excellent compliance tool that should be used by any firm with remote offices.

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.

j. Implementing Procedures to Detect Financial Misconduct. All firms should have procedures to detect financial misconduct, including embezzlement of customer funds or company funds. The Bulletin No. 17 provides a very nice checklist and includes the following red flags:

1. Receipt of checks payable to the representative or an outside business of the representative;

2. Opening of a bank account in the firm's name or any name similar to the firm's name by a representative or opening an account in a firm name of an entity owned by the account executive;

3. Receipt of cash or securities by the representative;

4. Transfers of funds or securities between customer accounts;

5. Use of post office box or at an address associated with the representative for customer accounts;

6. Transfer of customer funds or securities to employee accounts without supervisory approval.

Bulletin No. 17 also discusses what the author thinks is a very important procedures. Any time a customer's address changes, it should be confirmed directly with the customer by mail to the old address and in addition it should be confirmed orally, if possible. Likewise, any withdrawal of funds from a customer account should be confirmed to the customer at his address at the time of the withdrawal and if there has been a recent change in address a confirmation of withdrawal funds should be sent to both the old and new address. Requests for checks and withdrawals by a customer from an account should be carefully scrutinized because in a number of cases customer withdrawal requests were in fact forged. Changes in the name of an account should be permitted only upon approval of the designated principal and a memorandum of the reasons and documentation for the change requested by the client should be noted and maintained.

k. Review of Incoming and Outgoing Correspondence. All correspondence coming into a branch should be reviewed by someone other than the associated person. This is cumbersome for remote branches with only one associated person. The author's suggestion is that all correspondence go to a central location, such as the OSJ, where it is opened outside the control of the associated persons, examined and then sent to the associated person. This is sometimes cumbersome, but it is the single best procedure to detect misconduct, particularly selling away, sales practice complaints and a variety of other misconduct.

l. Confirmation of New Account Information with Customers. A firm should have procedures to send to customers details concerning their new account information to confirm the information, including investment objectives. Likewise, when there is a change of investment objectives or assets, the same should be confirmed to the customer.

m. Customer Mail. The NASD, in IM-3110, now provides that members may hold customer mail only upon the written instruction of the customer and only for two months if the member is advised that the customer will be on vacation or traveling and only for three months if the customer is going outside the United States. The NASD also amended Rule 3110 to provide that only a qualified designated person could approve and document the basis of any change in a customer account name or designation. Any such changes and the reason for it must be maintained pursuant to Rule 17a-4.

n. Firm Procedures and Direct Communication. The broker-dealer should have on its web site and in connection with the opening of any accounts how a customer may contact the firm other than through the customer account executive. Likewise, it is a good idea to provide customers with a summary of procedures and the legal obligations, particularly for a remote representative. These would include such things as prohibiting representatives from accepting customer checks payable to the representative or any business other than the firm, accepting cash, borrowing money from customers, guaranteeing profits and a variety of other similar prohibited activity. These can be provided in connection with confirming the information for a new account and for established customers on an annual basis.

o. Borrowing From and Lending To Customers. In NTM 04-14 (March 2004), the NASD amended its rules regarding lending between registered persons and customers. Lending or borrowing money to customers is many times a sign of some problem and needs to be carefully monitored by supervisors and compliance department. Generally, under NASD Rule 2370, a registered person is prohibited from borrowing money or lending to a customer unless (1) the member has written procedures allowing such lending arrangements consistent with the rule; (2) the loan falls within one of the permissible types of lending arrangements set forth in the rule; and (3) the member pre-approves the loan in writing. The permitted transactions include the following:

1. Lending between family members;

2. Lending between registered person and financial institutions under specified condition. Prior approval is not needed if the lending arrangement is on commercial terms generally available to the public.

3. Customer and the registered person are both registered persons of the same firm.

4. Lending arrangement is based on personal relationship with a customer such that the loan would not have been made or offered had the customer and associated person not maintained a relationship outside of the broker-customer relationship.

5. Lending arrangement is based on a business relationship outside of the broker-customer relationship.

Notwithstanding the exceptions and permitted borrowing, procedures of a broker-dealer are required to carefully monitor each exception and each exception must be documented. The exceptions provide a host of opportunities for a crooked registered person to attempt to engage in questionable transactions. Consequently, procedures should be precise, diligent and documented in each case.

p. Anti-Money Laundering Customer Identification Programs for Broker-Dealers. As a result of Section 326 of the U.S.A. Patriot Act, the Treasury and SEC have issued a rule that requires broker-dealers to implement reasonable procedures to verify the identity of persons seeking to open an account to an extent reasonable and practical, maintain records of such verification and determine whether a person is on any of the known or suspected terrorist or terrorist organization lists. *See* NTM 3-34 (June 2003). Each broker-dealer is required to establish a customer identification program to verify the identity of customers who open accounts. The full scope of the requirements is beyond this paper. However, firms are required to have procedures regarding the following required customer information:

1. Identity and verification procedures;

2. Customer verification through documents or alternatively through non-documentary methods;

3. Comparison with government lists;

In addition, the rules require notice to customers of the customer identification program and required recordkeeping of the verification and other records specified in the rule. Under certain circumstances, a broker-dealer may rely on another financial institution. *See, also,* NASD Rule 3011, NTMs 02-21, 02-47, 02-78, 02-80 and 03-34. In addition, firms are required to monitor for suspicious activity and file suspicious activity reports. All associated persons and branch supervisors should have a working familiarity with what may be a suspicious circumstance and the AML policies and requirements. Suspicious activity requirements are specified in NTM 02-47. *See, also*, NTM 02-21. It should be noted that the NASD maintains a special section in its Web site dealing with anti-money laundering identification programs and suspicious activity reports. In addition, there is a template for procedures for a small firm. All of the information is quite well done, particularly the procedures for small firms.

q. 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 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 branch offices. 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. 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.

In some firms, the suitability 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 should require 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.

As noted above, the most important red flags in connection with suitability are customer complaints. It is important that complaints be carefully investigated and be reviewed 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. Fee-Based Compensation Versus Transaction-Based Compensation

Recently, fee-based brokerage compensation has become very popular. *See* NTM 03-68 (November 2003). The NASD recently reminded members that members must have a program to

evaluate and disclose to customers the costs of its various fee structures. In the release, the NASD reminds members that they must have reasonable grounds to believe that a fee-based account is appropriate for the particular customer. This includes making efforts to obtain information about the customer's financial status, investment objectives, trading history, securities held and account diversification. The NTM points out that the fee structure and material components of the fee-based program and the fee schedules for services provided separately should be fully disclosed. The supervisory procedures should include periodic review of fee-based accounts to determine whether they remain appropriate for their customers. Likewise, customers with transaction-based accounts should review them periodically to determine if fee-based compensation would be more appropriate for the customer. Upon a finding of what is most reasonable for the customer, the firm should suggest changes in the customer's choice of fees. Of course, it is ultimately up to the customer as to which fee based is used. However, the customer's choice should be documented along with the disclosures made to the customer. Many members create reports to customers on an annual basis that compare asset-based fees to those that would have been generated on a transaction commission basis and vice versa.

D. 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 Insurance 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.

In connection with any non-cash compensation, including promotions and prizes for promotions, a member should review the non-cash compensation rule, NASD Rule 2820.

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.

In any compliance program dealing with mutual funds, attention must be given to non-cash compensation Rule 2830 which regulates the use of non-cash compensation given to firms' account executives as part of programs to promote investment company products.

The NASD and the SEC as a result of problems with respect to mutual fund activities involving timing and also late trading have reminded broker-dealers in NTM 03-50 (September 2003), that broker-dealers must be careful not to violate the investment company Rule 22c-1(a) with respect to close of trading. The NTM points out that member firms or associated persons that knowingly or recklessly effect or facilitate an after-the-close mutual fund purchase or redemption will violate NASD Rule 2110. Likewise, knowingly or recklessly facilitating transactions that are prohibited by a fund would also result in violation of Rule 2110. In addition, such activity may violate other federal securities laws and implicate criminal activity.

4. Hedge Funds

The NASD last year called members' attention to hedge funds in NTM 03-47. In particular, the release reminded members that hedge funds present certain risks. The NASD also pointed out that sales of such products carry suitability and other obligations, including in certain circumstances due diligence obligations. Broker-dealers that introduce clients to hedge funds may be engaged in participating in a private placement transaction if the broker-dealer receives any compensation from the hedge fund. Compensation may be in the form of transaction fees, brokerage commissions or other types of compensation, including clearing fees.

5. 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.

In connection with direct participation programs, the NASD has recently adopted a non-cash compensation rule, Rule 2810, regulating compensation paid by third parties and by the firm to account executives in the form of non-cash compensation such as trips and similar prizes in sales contests. Procedures should carefully consider such non-cash compensation rules.

6. Bonds and Bond Funds

The NASD recently emphasized the requirements of suitability and disclosure in connection with the sales practice obligations of firms in connection with the sale of bonds and bond funds. NASD NTM 4-30 (April 2004). The NASD cautioned that 60% of investors do not understand that bond prices fall when interest rates rise. For that reason, the NASD emphasizes that firms must educate and disclose bonds and bond fund risks to customers. In addition, attention is directed to suitability requirements for bonds and bond funds for individuals. The NASD put particular emphasis on providing a balanced disclosure and adequate training and supervision of employees who sell bonds and bond funds. Importantly, supervisory controls to insure compliance was noted in the NTM.

7. 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. Recently, a number of broker-dealers have been sanctioned by the NASD or NYSE for problems 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.

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. In July 2003, the NASD amended Rule 2110, shortened and simplified the rule. Importantly, the NASD also moved certain of the provisions of the rules into a new interpretive material 2210-1 – Guidelines to Insure that Communications are not Misleading. The amendments also created a new Rule 2211 which is a separate rule for institutional sales material and correspondence. *See* also NYSE Rule 472. Rule 2210 very broadly defines "advertisement," "sales literature," "correspondence," "public appearance" and "Independently Prepared Reports." It is a complex rule with specific provisions for particular types of products. All advertising, sales literature and "Independently Prepared Reports" must be pre-approved by the signature of a registered principal. The rule further requires a separate file of such material which includes names of the person(s) who prepared and/or approved the use of advertisements and sales literature. Within 10 days of first use or publication, a member must file certain advertisements and sales literature with the NASD involving registered investment companies, sales literature concerning direct participation programs and government securities.

Certain material must be filed 10 days prior to use, including sales literature containing bond fund volatility ratings, investment company material that includes or incorporates performance rankings or performance comparisons of the investment company with other companies when the ranking or comparison category is not generally published or is a creation either directly or indirectly of the investment company or an affiliate, advertisements concerning CMOs and concerning security futures. Members that have not previously filed advertisements with the NASD or with a registered securities exchange must file initial advertisements at least 10 days prior to use. For certain products, such as mutual funds, variable contracts, unit investment trusts, direct participation prospectus and government securities, and collateralized mortgage obligations, pre-filing with NASD is required. Rule 2210(c)(8) 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 in subsection (1) for all communications with the public and in subsection (2) standards applicable to advertisements and sales literature. 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 branches, particularly those who have independent contractor representatives or are 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 branch 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. All registered principals do not 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. Security Futures, *see* IM 2210-7.

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

g. Collateralized Mortgage Obligations, *see* IM 2210-8.

h. Institutional Sales Material, *see* IM 2211.

The NASD's complete revision of the advertising and communications rule are very helpful. They modernize a number of things of importance, including ranking guidelines, use of names, form letters and group electronic mail, television and radio advertisements. They deleted the prior options communications provision in IM 2210. Options communications are moved to a new Rule 2220, as set forth above.

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).

The NASD in NTM 03-33 (July 2003), reminded members that instant messaging and all types of other electronic delivery methodology would be considered communication if it is a communication to the public and must meet the requirements for preservation of records and record retention of SEC Rule 17a-3 and 17a-4, as well as NASD Rule 3110.

However, the broker-dealer continues to be responsible for reviewing all communications with customers, whether by written correspondence, e-mail, instant messaging or other. 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 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 prohibit any communication with customers by e-mail or electronic mail except through the company's electronic communication system.

Similar problems arise with personal websites. Most firms prohibit representatives from having their own websites. However, if a firm allows a representative to have a private website, it 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 or maintaining 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 an executive or branch 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 2212 and NYSE Rule 440A specifically regulate telemarketing. In connection with the revision of the advertising and communication rules, the old rule telemarketing rule, NASD Rule 2211, was changed to NASD Rule 2212. 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.

In NTM 04-15 (March 2004), the NASD amended Rule 2212 and its books and records rule to provide that NASD members must comply with the Federal Trade Commission's Do Not Call Registry. This means that solicitations within the permitted hours cannot be made if the person's name is on the Do Not Call Registry unless the member has an established business relationship as defined in the rule, the member has received express written permission to call, or the person called as a broker-dealer. The established business relationship is defined at some length in the revised rule. Firms should have procedures to cover the Do Not Call Registry rule.

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.

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.

V. Branch and Remote Office Books and Records

A. Introduction

The "New Books and Records Requirements for Broker-Dealers" under SEC Rules 17a-3 and 17a-4 became effective May 2, 2003. *See* SEC Rule 17a-3, 17 C.F.R. 240.17a-3; SEC Rule 17a-4, 17 C.F.R. 240.17a04; SEC Release 34-44992, 66 F.R. 55818 (November 2, 2001). The rule amendments to SEC Rules 17a-3 and 17a-4 were very controversial. The state securities commissioners pushed for maintaining substantial records at each office within their respective states so that they could easily access them. Because of the cost, the industry strongly opposed the change. The SEC compromised by providing that only certain records, mostly dealing with customer sales practices, would be maintained at each office or alternatively made available electronically. The purpose of this section is to outline some of the key changes that effect broker-dealer operations, particularly branch offices and sales practices. The key changed areas in SEC Rules 17a-3 and 17a-4 are described below.

B. Order Tickets

Order tickets whether executed or unexecuted must show:

1. The terms and conditions of the order and instructions and any modification or cancellation thereof;
2. The account number;
3. Time of entry;
4. Execution price;
5. Time of execution or cancellation;
6. Discretion;
7. Order receipt time;
8. Identity of associated person, if any, responsible for the account;

9. Identity of person who entered or accepted the order on behalf of the customer (or if the order was entered on an electronic system, a notation regarding such).

C. Memorandum of Each Purchase or Sale

1. Memorandum of each purchase or sale of securities for the broker-dealer's own account showing:

   a. the price; and
   b. time of execution to the extent feasible;

2. Where such purchase or sale is with a customer other than a broker or dealer, the time and receipt, the terms and conditions of the order and the account for which it was entered;

3. The terms and conditions of the order, any modification or cancellation;

4. The identity of each associated person, if any, responsible for the account.

5. The identity of any other person who entered or accepted the order on behalf of the customer or where it is entered by an electronic system, a notation that the customer entered the order by himself or herself.

6. For orders by customer (other than a BD), a designation that the order was entered pursuant to discretionary authority.

It should be noted that the NASD recently amended Rule 2510(d)(1) to provide that time and price discretion on orders for the purchase or sale of a definite amount of a specified security received from retail customers is good only for the day absent written discretionary authorization from the retail customer. With respect to institutional accounts, however, time and price discretion is permitted for good to cancel orders provided they are "not held" orders. *See also* NYSE Rule 408(d) and 410(a).

D. Account Information for Individual Customers or Owners of an Account

Account records must include:

1. Customer or owner's name;
2. Identification number;
3. Address, telephone number and date of birth;
4. Employment status, including occupation and affiliation, if any, with another member, broker-dealer or FCM;
5. Annual income and net worth (excluding primary residence);
6. Account's investment objectives;
7. In the case of a joint account, all of the above information for each joint account owner that is a natural person, provided that financial information may be combined;

8. Signature of associated person, if any, responsible for the account and approval by a principal.

For accounts in existence on May 2, 2003, a broker-dealer must obtain this information within three years of such date. If a customer refuses to provide information, the record must include the refusal.

E. Confirmation of Customer Account Information by Customer

1. Within thirty days of the opening of an account and at intervals of thirty-six months thereafter, the broker-dealer must furnish to each customer or owner a copy of the account record or a similar document containing all of the information set forth above in D. If the account was open on May 2, 2003, the information must be sent within a three year period.

2. The broker-dealer must, in connection with the investment objectives, include an explanation of the meaning of any terms used by the broker-dealer regarding investment objectives.

3. The document furnished to the customer must prominently indicate that the customer should make any corrections and return to the broker-dealer and that the customer should notify the broker-dealer of any future changes to the information in the account record.

F. Change in Name or Address of Customer or Owner or Account Investment Objectives

1. Broker-dealer must furnish notification of the change of the customer's address to the former address and to each joint owner and the associated person, if any, responsible for the account within thirty days notice of receipt of such change.

2. Within thirty days after the date the broker-dealer receives notice of any change of investment objective or other change, the broker-dealer must furnish to each customer or owner and the associated person, if any, responsible for the account, a copy of an updated record of information.

G. Discretionary Accounts

A record containing a signature of customer or owner on each power and the signature of the natural person to whom discretionary authority is granted must be maintained.

H. Customer Agreement

A record for each account that each customer or owner was furnished with a copy of any written agreement entered into on or after May 3, 2003 regarding the account and if requested by the customer evidence that the customer or owner was furnished with a fully executed copy of each agreement.

I. Complaints

A broker-dealer must maintain:

1. A copy of each written customer complaint concerning an associated person and its disposition, or alternatively a record of the complainant's name, address, account number, date the complaint was received, the name of all associated persons identified in the complaint, a brief description of the nature of the complaint and the disposition of the complaint.

2. A record showing that each customer has been provided with notice of the address and telephone number of the department to which complaints may be directed.

J. Account Person Compensation

1. A list of each purchase and sale of a security for which an associated person receives compensation, including monetary or non-monetary compensation. (Alternatively, this information could be produced from the firm's record if it can be produced promptly to a securities regulatory authority.)

2. A record of all agreements pertaining to the associated person, including a summary of each associated person's compensation agreement or plan and to the extent the compensation is based on factors other than remuneration, a description of the method of granting compensation.

K. Unusual Account Activity

Copies of all reports of unusual account activity must be maintained.

L. Advertising, Sales Literature and Communications Compliance

Records indicating broker-dealers have complied with and adopted policies and procedures reasonably designed to establish compliance with the applicable requirements regarding advertising, sales literature or other communications with the public be approved by a principal.

M. Communications

Originals of all communications received and copies of communications sent by the broker-dealer, including interoffice memoranda and communication relating to the broker-dealer's business and to the extent required any approvals thereof.

N. Regulatory Orders, Settlements and Examination Reports

Records must be maintained of all regulatory orders, settlements and examination reports and they all need to be available.

O. Supervisory Procedures and Policies

Copies of all procedures and policies within the last three years must be maintained.

P. Branch Office Listings of Certain Persons

1. Record Explicator

For each office, a listing by name and title of each person who can explain without delay the types of records the firm maintains at a particular office and the information contained in those records.

2. Responsible Compliance Personnel

The rules require a listing of each principal responsible for establishing policies and procedures to ensure compliance with the applicable rules that require acceptance or approval of a record by a principal.

Q. Associated Person CRD Number and Identification

Each office where an associated person conducts business or handles funds or securities is required to maintain copies of the associated person's CRD number and all internal identification numbers or code assigned to each associated person dealing from that office.

R. Organization and Registration Documentation

1. All Form BDs and amendments.

2. All Form BDWs and amendments.

3. All licenses or other documentation showing the broker-dealer's registration with regulatory authorities.

S. Record Retention

Rule 17a-4 provides that certain records must be kept for not less than six years, the first two years in an easily accessible place. This includes certain records required by Rule 17a-3 such as:

1. Blotters of all transactions;
2. All assets, liabilities, income expense in capital accounts;
3. Ledgers;
4. Ledger accounts;
5. Securities record;
6. The records required by Rule 17a-3(a)(21) and (22) (i.e., P above).

In addition, because the SEC made an error in amending SEC Rule 17a-3 (it has two subsection (f)s), all of the records required by the new additions discussed in A though Q above appear to be

required to be maintained for six years at a minimum. Rule 17a-4 also requires that the broker-dealer preserve for a period not less than six years after the closing of any customer's account any account cards or records which relate to the terms and conditions with respect to the opening and maintenance of the account. This means that almost all of the records in the new record provisions described in A through Q above shall be preserved for six years after closing an account.

Rule 17a-4 also requires that other records be maintained for not less than three years, the first two years in a readily accessible place. These other records include a variety of records dealing with accounts, accounting, books and other similar records. The provision for three years includes the new provisions but because of the error noted above it is unclear whether they are subject to the six year period described above or the three year period. However, it appears that order tickets and memorandum of purchase and sale, confirmations, margin documents and option documents would need to only be maintained for the three year period. Other documents, including internal broker-dealer systems of which the broker-dealer is a sponsor (relating primarily to trading systems), complaints, account executive compensation and communications, advertisements and sales literature would appear to be subject to the three year requirement were it not for the SEC error.

Rule 17a-4(e) requires that broker-dealers maintain and preserve in an easily accessible place for at least three years after an associated person's employment and any other connection with the broker-dealer has been terminated, all of the records with respect to such associated person. Also included within the three year requirement is every regulatory authority request and the response pursuant to any order, settlement and regulatory examination. Supervisory, compliance and similar manuals and policies and procedures must be maintained for three years after termination of the manual or the procedure. Unusual activity reports must be maintained for eighteen months.

Rule 17a-4(d) requires that all organizational documents (articles, by-laws, minutes and similar type documents and all registrations and licenses) be maintained for the life of the enterprise. Likewise, all fingerprint cards must be maintained for the life of the enterprise and all records with respect to lost and stolen securities must be maintained indefinitely.

T. Branch and Local Office Availability of Certain Records

Certain records must be maintained at an "office" to which they relate. Rule 17a-3(g) defines "office" to mean "any location where one or more associated person regularly conducts the business of handling funds or securities or effecting any transactions and inducing or attempting to induce the purchase or sale of any security." "Office" includes a private residence. If an "office" is a private residence and is not held out to the public as an office and funds and securities of customers are not received there, broker-dealer need not maintain records at that office but must maintain them at another location with the state as selected by the broker-dealer. Further, where records are required to be maintained at an office, the broker-dealer may choose to produce records promptly at the request of the representative of a securities regulatory authority at the office to which they relate or at another location agreed to by the representative. Records covered by the above include all the records required by 17a-3(f). The records that need to be preserved include order tickets, memorandum of purchase and sale, employment questionnaires, applications and other information regarding associated persons, customer account information and other items

mentioned above in A through Q, and the records required by Rule 17a-3(a)(1) and (12) relating to all transactions (securities or cash) and associated persons at the "office".

U. Electronic Storage and Media Requirements

Rule 17a-4(f) provides that records may be stored in "micrographic media" or "electronic storage media" ("Media") if the strict provisions of those sections are met. The requirements of Rule 17a-4(f) are quite complex but are summarized as follows:

1. The broker-dealer must notify its examining authority ninety days prior to employing such Media.

2. The Media must meet the following requirements:

   a. Be in non-write, non-erasable format;

   b. Verify automatically the quality and accuracy of storage media recording process;

   c. Serialize the original and, if applicable, duplicate units of the storage media and time date for required period of retention the information;

   d. Have capacity to readily download index and records to be preserved to any medium acceptable to the regulators.

3. The broker-dealer must have available at all times for regulators:

   a. Easily readable projection or reproduction media for producing images.

   b. Immediate facsimile enlargement.

4. The broker-dealer must:

   a. Store separately the original and duplicate copy of the record stored on any medium for the times required.

   b. Organize and index accurately all information maintained for both original and duplicate storage media and make them available to the staff.

   c. Copies of the index must be duplicated and must be stored separately from the original and preserved for the required time for the records.

5. The broker-dealer must have an audit system providing for accountability regarding inputting documents and the duplicate records that must be maintained. The audit materials must be available to the regulators and preserved for the times the records are required.

6. The broker-dealer must maintain, keep current and provide to the regulators all information necessary to access records and indices stored on electronic media or place in escrow and keep a copy of the physical and logical file format of the electronic storage media, the field format of all different information, types written on the electronic storage media and the source code, together with appropriate documentation and information necessary to access records and indices.

V. Summary and Commentary

The new rules require a significant amount of additional account documentation and record maintenance by broker-dealers, particularly in "offices". If a broker-dealer has an electronic retrieval system that can readily access all of these documents it will be much easier for the broker-dealer to comply with the rules. The long lead time for effectiveness of the rule changes was required to allow broker-dealers time to prepare their systems for the introduction of the new recordkeeping requirements. The contacts with customers with respect to their information and verification of the same require a number of new procedures, whether it is done manually or in electronic format.

In any event, for all "offices" as defined in Rule 17a3-(g)(1), broker-dealers are required to maintain for the most recent two year period the documents required with respect to items in A through Q above. In addition, originals of all communication received and copies of all communication sent and approvals thereof by the member broker-dealer (including interoffice communications) relating to its business as such must be maintained at the "office" to which they relate. Importantly, the amendment to Rule 17a-4(b)(4) relating to communications presents an enormous problem for retention of e-mail since if it's retained electronically it must meet all of the requirements of the SEC's electronic media requirements in 17a-4(f). These requirements are almost impossible to meet for e-mail, particularly indexing and retrieval. It should be noted that the Securities Industry Association has been working diligently with the SEC to reach some practical solutions regarding communications, particularly those in electronic format. However, as of the present time, the negotiations seem to be stalled. In any event, the new books and records requirements present many challenges to broker-dealers.