Regulatory Interpretations on the Heightened Supervision
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The following is one of the more key NASD NTM’s on Heightened Supervision.

NASD Notice To Members 97-19, NASD Regulation And New York Stock Exchange Memorandum Discusses Sweep Report And Provides Guidance On Heightened Supervision Recommendations.

"C. Developing and Implementing Heightened Supervisory Procedures"

Some factors that might be considered for guidance in devising tailored supervisory programs are described in detail below. Firms are cautioned that these factors and suggestions are neither exhaustive nor will they constitute a safe harbor. The adequacy of a supervisory program can be determined only with reference to the profile of the specific firm, situation, and individuals.

Registered Representative Activities

One of the first things to consider when establishing heightened supervisory procedures is the nature of the conduct that resulted in the registered representative's history of customer complaints, disciplinary actions, or arbitrations, and whether the conduct involved a particular securities product, customer type, or activity. In any of these instances, the product, customer, or activity type should be examined to identify the level and type of risk it presents. The firm should then determine what type of supervision might best control and limit this type of risk. This may range from providing the ordinary level of supervision, to restricting a registered representative's activities for a period of time in a manner that is based on the firm's assessment of the registered representative's prior problems, to assigning a mentor or partner in whom the firm has confidence to work with the registered representative. A firm also may determine that its standard procedures will be adequate, and operate on the understanding that if there is any sign of a problem detected during some stated period, heightened procedures or sanctions will follow. Additionally, such actions may be positively reinforced if associated with training or education involving the product or activity in question.

Training

SRO rules require each member firm, as part of the Firm Element of its Continuing Education Program, to conduct a needs analysis and establish a training plan that includes certain minimum standards. See NASD Rule 3070 and NYSE Rule 345A. For example, such programs, when dealing with investment products and services, must identify their
investment features and associated risk factors, their suitability in various situations, and applicable regulatory requirements that affect the products or services, and present these themes in an understandable format. When analyzing needs and developing Firm Element programs, a determination should be made as to whether specialized training should be provided to a registered representative who has a history of customer complaints, disciplinary actions, or arbitrations involving a particular securities product or a particular activity. Firms could make certain that such training focuses upon the areas in which the registered representative has had problems and is tailored to any special needs in these areas. Additionally, firms should track customer complaints and, if specific trends are identified, programs should be established to train registered representatives to avoid future complaints.

New Account Procedures

If warranted after a review of all circumstances, firms should consider whether a supervisor should exercise closer than normal control over the establishment of new customer accounts by a registered representative. For example, if a registered representative has a history of complaints involving initial transactions in accounts, closer scrutiny of his or her account opening practices may be warranted. In addition to the normal requirements for opening a new account set out in NASD Rule 3110 and NYSE Rule 405, the manager might choose to speak with all or selected new account holders or to independently verify the customer information on the account form on a random or consistent basis, depending on the situation. If the firm deemed it prudent in view of prior activities, it might prohibit any trading until the account information or the order information could be independently verified with the customer. Of course, the optional practice of sending notices to all new customers to verify and ask for comment on the new account information on file at the firm upon the opening of the account might be sufficient in a specific set of circumstances, as might a decision to instead monitor subsequent transactions. Many firms currently encourage their registered representatives to revise and resubmit customer account information forms each time the customer’s investment objectives change. This practice, when in use, can also be an aid in monitoring registered representatives under special supervision. Finally, while not prohibited by rule, firms should be particularly cautious about allowing individuals who warrant special supervision to handle certain types of accounts, including: discretionary accounts; margin, futures, and options accounts; employee, employee-related, and retirement-plan accounts; accounts that contain low- priced, speculative securities; other accounts engaged in high-risk strategies; or any accounts where any of the conduct leading to the previous regulatory problems might be an issue.
Specific Transactions

SRO rules require firms to establish procedures for the review of all transactions by a supervisor. See NASD Rule 3010 and NYSE Rule 342. When reviewing conduct to determine whether heightened supervision is warranted, firms should focus on whether a specific type of transaction was involved in prior problems, and should consider prohibiting like transactions, or requiring supervisory approval of all such transactions in advance of execution, as is routinely required at many firms in the case of low-priced securities, options, and discretionary trades. Examples of orders that may pose potential harm, and as to which many firms may as a matter of practice already require prior supervisory approval, are: orders in discretionary accounts; orders in low-priced, speculative securities; orders of an unusual size or frequency considering the particular account's trading pattern; deep out-of-the-money and uncovered options orders; or mutual fund switches. Firms without such procedures as a normal part of their supervisory programs should give careful consideration to making them a part of any heightened supervision program.

Customer Account Activity Monitoring

SRO rules require members to periodically examine customer accounts to detect and prevent irregularities or abuses. See NASD Rule 3010 and NYSE Rule 342. Many firms meet this requirement by generating special exception or activity reports that enable supervisors to detect unusual trading activity in the account. For example, firms could consider developing exception reports that are designed to detect: transactions that are uncharacteristic in size or volume; any unusual increases or decreases in a broker's commissions; transactions between accounts; or excessive or suspicious corrections. Firms also could consider reviewing the registered representative's customer contacts by, for example, monitoring selected telephone conversations between the registered representative and both existing and potential customers or attending meetings between the representative and his or her clients. Firms also could consider requiring supervisors to have more frequent and closer contact with customers of registered representatives who are subject to heightened supervision to determine whether potential problems exist and further inquiry is warranted. Contacting customers who choose to transfer their accounts to another firm also may be helpful in certain circumstances. See NASD Notice to Members 97-19, Page 163.

The next four are SEC releases related to "Heightened Supervision"

In re Druz, 58 S.E.C. 1526, 1528 (1995).
A "salesman who has previously evidenced misconduct can be retained only if he subsequently is subjected to a commensurately higher level of supervision. In relying on regular firm procedures to supervise [the registered representative] the branch office manager acted unreasonably." See Druz at 1528.

**In re Consolidated Investment Services, Inc.**, 6 S.E.C. Docket 19 (1996).

"[The broker-dealer] chose to hire McCormick knowing that there was a pending NASD complaint against him. One year later, [the broker-dealer] was notified by the NASD that a decision was made in the aforementioned complaint and McCormick was censured and fined $5000. Having undertaken to hire and retain such a registered representative, [the broker-dealer] had an obligation to insure that procedures were in place to supervise him properly."(Footnoted omitted). See **Consolidated Investment Services, Inc.** Page 23.


i) "The Commission has repeatedly emphasized the need for heightened supervision when a firm employs a broker with known regulatory problems or customer complaints."

ii) "The Commission also requires that broker-dealers have adequate procedures to advise supervisory personnel of disciplinary issues and financial problems concerning its representatives. As a result of Signal's failure to adopt and implement such procedures, its supervisory personnel were unaware of some of the information that indicated that Cammarano required heightened supervision."

iii) "The Commission has determined that broker-dealers that conduct business through off-site offices have not adequately discharged their supervisory obligations where there are no inspections of those offices"...If Signal's procedures had included such inspections the Firm might have detected Cammarano's violations."

iv) "The Commission has made it clear that responsibility for the supervisory function of a registered broker-dealer is incumbent upon the most senior members of management. Senior management has a duty not only to provide a meaningful supervisory structure, but also to actively monitor and enforce it. It is incumbent upon management to ensure that branch managers, registered representatives, or any other firm employees do not ignore procedures.

v) "It is critical for investor protection that a broker establish and enforce effective procedures to supervise its employees. Establishment of policies and procedures is not
sufficient to discharge supervisory responsibility. It also is necessary to implement measures to monitor compliance with those policies and procedures."


Held: Notwithstanding supervisor's policy of heightened review of a broker with a disciplinary history, Commission held him responsible for failure to properly enforce those policies. See _Clarence Z. Wurtz_, Page 7.