



U.S. Securities and Exchange Commission

Division of Market Regulation

Staff Legal Bulletin No. 17: Remote Office Supervision

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Summary: This staff legal bulletin (bulletin) sets forth the views of the Division of Market Regulation (Division), reminding broker-dealers that small, remote offices require vigilant supervision. The bulletin describes certain supervisory tools that, based on Commission staff examinations and recent Commission enforcement cases, are characteristic of good supervisory procedures, including the use of unannounced onsite inspections.

Supplementary Information: The statements in this bulletin represent the views of the Division's staff. This bulletin is not a rule, regulation, or statement of the Securities and Exchange Commission (Commission). Further, the Commission has neither approved nor disapproved its content.

Contact Information: James Brigagliano, Assistant Director, Elizabeth Sandoe, Special Counsel, or Liza Orr, Attorney, of the Division of Market Regulation, at 202-942-0772.

Introduction

Sections 15(b)(4)(E)¹ and 15(b)(6)(A)² of the Securities Exchange Act of 1934 (Exchange Act) authorize the Commission to impose sanctions on a firm or any person that fails to reasonably supervise a person subject to their supervision that commits a violation of the federal securities laws.³ Section 15(b)(4)(E) also provides an affirmative defense against a charge of failure to supervise where reasonable procedures and systems for applying the procedures have been established and effectively implemented without reason to believe such procedures and systems are not being complied with.⁴ The Commission's policy regarding failure to supervise is well established.⁵ The Commission "has long emphasized that the responsibility of broker-dealers to supervise their employees is a critical component of the federal regulatory scheme."⁶ A broker-dealer must develop a system for implementing its procedures that could reasonably be expected to prevent and detect securities law violations.⁷ In addition, a broker-dealer must have an appropriate system of follow-up and review if red flags are detected.⁸ However, establishing policies and procedures alone is not sufficient to discharge supervisory responsibility. It is also necessary to implement measures to monitor compliance with those policies and procedures.⁹

Some broker-dealer firms have geographically dispersed offices staffed by only a few people, and many are not subject to onsite supervision. Their

distance from compliance and supervisory personnel can make it easier for registered representatives (representatives) and other employees in these offices to carry out and conceal violations of the securities laws.¹⁰ The supervision of small, remote offices, therefore, can be especially challenging. The Commission staff has examined branch offices and the Commission has brought numerous enforcement cases involving inadequate supervision of these small, remote offices. These cases address situations in remote offices where supervisory mechanisms failed to detect and prevent misconduct. These cases illustrate gaps in firms' supervisory systems and provide insight into the steps that can help firms achieve effective remote office supervision.

The purpose of this bulletin is to remind broker-dealers that vigilant supervision is a necessary component of a firm's policies and procedures and highlight those practices to improve supervision that have been suggested by recent Commission enforcement cases. This bulletin discusses certain remote office supervisory procedures, but it is not intended to be an exhaustive list. This bulletin does not interpret SRO rules and is not intended to replace existing supervisory obligations under SRO rules or the federal securities laws. While we mention certain SRO rules, we do so only to remind readers that many SRO rules also address supervision. We recognize that each firm is different and that firms need flexibility to adopt procedures to suit their individual structure and business needs. Our suggestions are not meant to be exclusive. Nor do they constitute a safe harbor. Rather, this bulletin may assist firms in crafting effective supervisory procedures to prevent and detect remote office misconduct.

We urge firms to review their policies and procedures for remote office supervision to determine if they are reasonably designed to prevent and detect wrongdoing. We suggest an approach to remote office supervision that includes clearly articulated firm policies and procedures and steps to promote customer awareness. We note that these supervisory suggestions also may be relevant to non-remote offices.¹¹

Policies and Procedures

Clearly articulated and vigorously enforced policies and procedures, with sufficient resources to implement them, are an essential part of a supervisory system for remote offices. Comprehensive policies and procedures address all aspects of a remote office's operations. The following policies and procedures may form part of an effective supervisory system.

1. **Inspections.** Inspections are a vital component of a supervisory system.¹² The Commission has determined that broker-dealers that conduct business through remote offices have not adequately discharged their supervisory obligations where there are no inspections of those offices.¹³ Effective inspections can detect misconduct in its infancy, deter future wrongdoing, and prevent or mitigate investor harm.¹⁴ An effective supervisory system employs a combination of onsite and offsite monitoring, including the use of unannounced inspections and mechanisms for verifying that deficiencies are corrected.
 - a. **Routine or "For Cause" Inspections.** Onsite inspections usually take one of two forms: routine or "for cause." Routine inspections are conducted in the ordinary course of business,

while "for cause" inspections are conducted upon learning about a specific event or potential violation. We suggest that all inspections include at least: (1) a review of a sampling of customer files, including account opening documents and trading records; (2) a review of the signature guarantee log; (3) a review of correspondence, advertisements, and sales literature made available at the remote office; (4) a review of business records, including physical and computer files; (5) in-person questioning of the representative by the supervisor about business activities, including inquiry about any unusual activity; and (6) in-person interview by the supervisor of the representative's assistant or support staff, if any, about the remote office's business and any unusual activity.¹⁵ If during the course of the examinations deficiencies are identified, examiners should consider the need to conduct a more in-depth review.

- b. **Unannounced Inspections.** Routine or "for cause" inspections may be either announced or unannounced. Unannounced inspections are conducted on a random, surprise basis.¹⁶ We encourage firms to use unannounced, onsite inspections of remote offices to enhance supervision.¹⁷ They can deter and detect misconduct because they diminish the opportunity for concealment, removal, or destruction of the evidence of misconduct.¹⁸ The Commission staff's experience in the examination program as well as the Commission's enforcement cases, reinforce our belief that unannounced onsite inspections are among the most effective tools to expose and deter misconduct that might otherwise go undetected.¹⁹

For example, in *Quest Capital Strategies, Inc.*, the Commission sanctioned a firm for failing to supervise. In that case, the representative engaged in repeated misconduct that violated firm policies.²⁰ The firm learned of the misconduct yet failed to institute heightened supervision of the representative and relied on the representative's assurances that he would discontinue the activity. Although the firm was aware of the misconduct, it performed only a much belated, pre-announced inspection of the representative's one-person office. The Commission noted, "a surprise inspection is a compliance tool that is necessarily available to every securities firm in carrying out its supervisory responsibilities."²¹

In addition, a supervisor is more likely to uncover evidence of misconduct in customer files, such as fictitious account statements, during an unannounced inspection than in an announced inspection that gives the representative an opportunity to remove such documents from customer files.²² An unannounced inspection might also reveal marketing materials that describe unapproved products, local billboards with unapproved advertisements, or customer account statements showing purchases of unapproved securities.²³ In many failure to supervise cases, the Commission has observed that unannounced, onsite inspections may well have detected misconduct by enabling the supervisor to review records

evidencing misconduct.²⁴

Unannounced inspections could be employed at random, as well as when triggered by "red flags" warning of potential misconduct. As the Commission emphasized in *Edwin Kantor*, "[r]ed flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review. When indications of impropriety reach the attention of those in authority, they must act decisively to detect and prevent violations of the federal securities laws."²⁵ Red flags that could suggest the existence or occurrence of illegal activity and might prompt an unannounced inspection include:²⁶ (1) customer complaints;²⁷ (2) a large number of elderly customers; (3) a concentration in highly illiquid or risky investments; (4) an increase or change in the types of investments or trading concentration that a representative in a remote office is recommending or trading;²⁸ (5) an unexpected improvement in a representative's production, lifestyle, or wealth; (6) questionable or frequent transfers of cash or securities between customer accounts, or to or from the representative;²⁹ (7) the disciplinary history of the representative;³⁰ (8) substantial customer investments in one or a few securities or class of mutual fund shares that is inconsistent with firm policies related to such investments; (9) churning;³¹ (10) trading that is inconsistent with customer objectives;³² or (11) significant switching activity of mutual funds or variable products held for short time periods. It is equally important that representatives do not obtain advance notice about a particular focus of an inspection. Advance notice of the focus affords representatives an opportunity to "doctor" particular records. For this reason, we suggest that firms avoid "cookie-cutter" inspections in each remote office.

- c. **Offsite Monitoring of Trading, Handling of Funds, and Use of Personal Computers.** Centralized technology to monitor the trading and handling of funds in remote office accounts, as well as the use of personal computers, helps detect misappropriation of customer funds, selling away, and unauthorized trading, among other things.³³ In *SG Cowen and Lehman Brothers*, for example, Frank Gruttaduria had a personal computer that was networked to computers used by other employees of the firm but not to the firm-wide system and used this computer to generate false statements and reports, among other things.³⁴ The Commission found that SG Cowen and Lehman Brothers did not have supervisory procedures reasonably designed to prevent and detect Gruttaduria's generation of falsified account statements on personal computers.³⁵ Thus, if firms permit communications with customers from employees' home computers or personal computers not connected to the firm's network, SRO rules require firms to employ systems to monitor those communications.³⁶ In addition, we believe that effective monitoring to detect these transgressions would include contacting a random sampling of customers to make general inquiries or to inquire about specific account activity.

2. **Designate supervisory responsibility.** Explicit delineation of the supervisory hierarchy, including the designation of a direct supervisor for each representative and the assignment of specific supervisory responsibilities to the supervisor, is a necessary part of a firm's supervisory structure.³⁷ Consideration should be given to the independence of supervision when supervisory responsibility is designated. For example, one factor firms should consider is whether the supervisor stands to benefit from the representative's sales activities.³⁸ No individual can supervise themselves.³⁹ As with all supervisory procedures, the Commission has stated that firms should provide a system of review and follow-up to ensure that supervision (by a branch manager or a producing manager) is diligently exercised.⁴⁰ We also encourage firms to review the number of representatives for whom a supervisor is responsible as well as the number, nature, and extent of remote offices that an office of supervisory jurisdiction oversees. The degree of supervisory effectiveness is likely to decrease if a supervisor does not have adequate resources to oversee all of the representatives for whom he or she is responsible.
3. **Carefully review NASD Forms U-4 and U-5 when hiring representatives.**⁴¹ Firms should be especially cautious about employing personnel with disciplinary histories. Where a representative with a disciplinary history is employed in a remote office, the Commission has repeatedly emphasized the need for heightened supervision of the representative.⁴² For example, the Commission in *Kirkpatrick* noted that had the branch manager responsible for supervising the representatives in a remote office imposed heightened supervision on a representative with a disciplinary history, it is likely that the branch manager could have detected earlier or prevented the representative's fraudulent scheme.⁴³ Where a representative has left a firm for cause or changed firms several times, the hiring firm should try to ascertain the reason for the changes and contact prior firms as necessary. The Commission noted in *Signal Securities, Inc.* that as a result of the firm's failure to adopt and implement such procedures, its supervisory personnel were unaware of some of the relevant information that indicated that a representative needed heightened supervision.⁴⁴
4. **Closely monitor outside business activities and selling away.**⁴⁵ A firm should have adequate procedures for reviewing, analyzing, or following up on the information representatives provide concerning outside activities.⁴⁶ In addition, a firm should be alert to and investigate "red flags" indicating possible undisclosed outside business activities and assess all outside business activities by a representative, whether or not related to the securities business. The Commission has recognized that there is a risk that representatives will use outside business activities to carry out or conceal securities law violations.⁴⁷ A representative appearing to live more lavishly than his business income would allow might be a "red flag" indicating pursuit of improper or outside business activities. Additionally, we suggest that firms be wary of a representative who owns a company with a name similar to the name of the firm. A customer may make a check payable to the firm that could be altered by a representative

and deposited into a bank account in the name of the company he owns.

5. **Implement procedures to detect financial misconduct.** We suggest that firms consider implementing procedures to prevent and detect the following improper activities: (1) the receipt of checks made payable to a representative or any outside business of a representative;⁴⁸ (2) the opening of a bank account in the firm's name or any name similar to the firm's name by a representative; (3) the receipt of cash and securities by a representative; (4) frequent or questionable transfers of funds or securities between customer accounts; (5) use of a post office box or an address associated with the representative for customer accounts; and (6) the transfer of customer funds or securities to employee accounts without supervisory approval.⁴⁹ Inspections and thorough investigations of customer complaints can help detect financial misconduct. For example, the Commission noted in *Signal Securities, Inc.* that had a supervisor pursued a customer's complaint more diligently, he might have discovered that a representative was sending the customer fabricated statements for fictitious accounts and misappropriating customer funds.⁵⁰
6. **Education for representatives.** It is incumbent on firms to provide representatives with training so that the representatives understand the responsibilities under the firm's procedures, as well as under the securities laws and rules applicable to their business.⁵¹ As with all compliance and sales practice matters, firms are more likely to prevent misconduct if they provide training for representatives and periodically reinforce that training.⁵²
7. **Monitor and verify customer address changes.** Commission rules require firms to send notification of a change of address to a customer's old address for each account with a natural person as a customer or owner.⁵³ This verification enhances customer protection, and we encourage firms to send such verifications for all customer address changes. Moreover, a customer address change to a post office box or an address affiliated with a representative warrants additional steps to verify that the change is genuine.⁵⁴ In *SG Cowen*, the Commission found that the firm had inadequate procedures for an independent supervisor to follow up on critical missing account documentation involving Gruttaduria's customers. A branch compliance examiner discovered that a large number of Gruttaduria's accounts were using post office boxes or "care of" addresses as the mailing address for account statements without the necessary letter of authorization from the customer on file authorizing use of such addresses. The firm's inadequate procedures allowed Gruttaduria to appear to resolve the matter himself, which he did by creating falsified and forged letters of authorization on his personal computer and forwarding them on to the compliance department. No one at the firm investigated either the circumstances under which addresses for the customer accounts were changed without a letter of authorization, or the manner in which Gruttaduria obtained and supplied the missing documentation.⁵⁵
8. **Record use of the signature guarantee stamp.**⁵⁶ A firm should

have procedures to deter misuse of the signature guarantee stamp to prevent forgeries. These procedures might include maintaining a log of all uses of the stamp and using a stamp with a counter that records each use of the stamp. In *Royal Alliance*, the Commission found that the firm failed to implement procedures adequate to govern the registered principals' use of the signature guarantee stamp.⁵⁷ While the firm's policy required registered principals to maintain logs indicating which documents had been signature-guaranteed, there was no review or follow-up on "red flags" indicating inconsistencies.

9. **Maintain copies of and review incoming and outgoing correspondence.** The Exchange Act and rules thereunder require firms to maintain copies of incoming and outgoing correspondence,⁵⁸ while SRO rules require firms to review and retain such correspondence,⁵⁹ including all documents, reports, profit and loss statements, e-mails, or other materials sent to customers by a representative or received from customers. Firms can enhance the effectiveness of their inspections by reviewing e-mails between representatives.⁶⁰ One method of monitoring use of facsimile machines in remote offices is to program these machines to automatically send duplicate incoming and outgoing facsimiles to an office of supervisory jurisdiction.⁶¹

Customer Awareness

Customer awareness is also an essential component of an effective supervisory system. There is a greater likelihood that misconduct will be promptly identified and rectified when customers (1) are aware of firm procedures, (2) know how to access educational information from regulators, and (3) know how to contact their representative's supervisor and the firm's compliance department. We encourage firms to incorporate the following customer awareness procedures into their supervisory systems.

1. **Confirm new account information with customers.** Reviewing all new account information and confirming the information, including investment objectives, with customers within 30 days of opening the account may prevent falsification of customer information.⁶² When confirming the account information, firms may wish to prominently instruct customers to promptly notify the firm about any change to their account opening information. We suggest that firms establish procedures so that customers forward information regarding corrections and changes to their account information to the firm's compliance department or other central location, in addition to their representative. To the extent the firm provides online access, firms could also encourage customers to review their account statements online to verify account statement accuracy.
2. **Direct customer correspondence to a central firm location.** Firms must provide customers with the address and telephone number to which complaints may be directed.⁶³ We encourage firms to provide customers with the name, address, e-mail, and telephone number of their representative's supervisor and the firm's compliance department in order to facilitate alerting firms of problems with representatives.

3. **Notify customers of firm procedures.** Customers will be less susceptible to misconduct if they are informed about representatives' legal obligations, as well as firm procedures, including policies prohibiting representatives from (i) accepting customer checks payable to the representative or any business name other than the name of the firm; (ii) accepting cash; (iii) borrowing money from customers; and (iv) guaranteeing profits, or the price or the performance of a security.
4. **Establish procedures for direct communication between the firm and customers.** In appropriate circumstances, direct communication from firms to customers, independent of the representative and his supervisor, is an important supervisory mechanism to prevent and detect wrongdoing. For example, it is a prudent practice for a firm's compliance department to communicate directly with customers about unusual activity in accounts or on a spot-check basis.
5. **Inform customers about information available from regulators.** We believe it is useful for firms to inform customers about information available on the Commission's website published by the Commission's Office of Investor Education and Assistance, as well as the websites of the National Association of Securities Dealers and the New York Stock Exchange.⁶⁴

Conclusion

While this bulletin does not provide an exhaustive list of steps to effectively discharge supervisory responsibilities, we believe it contains helpful information that broker-dealers can use to prevent misconduct in remote offices, or detect it at an early stage.

Endnotes

¹ Section 15(b)(4)(E) provides that the "Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds... that such broker or dealer... has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, [the Securities Exchange Act of 1934], the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision." 15 U.S.C. § 78o(b)(4)(E).

² 15 U.S.C. § 78o(b)(6)(A) (authorizing the Commission to impose sanctions on any associated person of a broker-dealer that violates the federal securities laws).

³ The rules of self-regulatory organizations (SROs) also require member firms to reasonably supervise the activities of their employees and their employees' compliance with securities laws and regulations. See, e.g., NASD Rule 3010; NASD Notice to Members 99-45, *NASD Provides Guidance*

on Supervisory Responsibilities (June 1999); NASD Notice to Members 98-38, *NASD Reminds Members of Supervisory and Inspection Obligations* (May 1998); NASD Notice to Members 86-65, *Compliance with the NASD Rules of Fair Practice* (Sept. 1986). See also, NYSE Rule 342.

⁴ 15 U.S.C. § 78o(b)(4)(E).

⁵ See John H. Gutfreund, et al., 51 S.E.C. 93, 108 (Dec. 3, 1992).

⁶ *Id.* See also, SG Cowen Securities Corp., Release No. 34-48335 (Aug. 14, 2003), citing Smith Barney, Harris Upham & Co., Inc., et al., Release No. 34-21813 (March 5, 1985) (stating that "[t]he Commission has emphasized that the `responsibility of broker-dealers to supervise their employees by means of effective, established procedures is a critical component in the federal investor protection scheme regulating the securities markets."").

⁷ See Kirkpatrick, Pettis, Smith, Polian Inc. ("Kirkpatrick"), et al., Release No. 34-48748 (Nov. 5, 2003).

⁸ See W.J. Nolan & Co., et al., Release No. 34-44833 (Sept. 24, 2001). See also, Edwin Kantor, 51 S.E.C. 440, 447 (May 20, 1993).

⁹ See Signal Securities, Inc., et al., Release No. 34-43350 (Sept. 26, 2000), quoting Thomson & McKinnon, Release No. 34-8310 (May 8, 1968) ("Although it was registrant's stated policy...it failed to establish an adequate system of internal control to insure compliance with such policy.").

¹⁰ The Commission has had a longstanding concern with the supervision of dispersed offices. See Reynolds & Co., 39 S.E.C. 902, 916 (May 25, 1960) (discussing the necessity of particular supervisory attention to broker-dealers with multiple, geographically scattered offices prior to the adoption of the Commission's failure to supervise authority under section 15(b)(4) (E)). See also, Shearson, Hamill & Co., 42 S.E.C. 811, 843 (Nov. 12, 1965) (stating "[t]he need for central control increases, not decreases, as branch offices become more numerous, dispersed and distant."); Smith Barney, Harris Upham & Co., Inc., et al., Release No. 34-21813 (March 5, 1985) (holding that "a small branch office poses the potential for significant problems if subject to inadequate supervision").

¹¹ See, e.g., SG Cowen Securities Corp., Release No. 34-48335 (Aug. 14, 2003). See also, Lehman Brothers, Inc., Release No. 34-48336 (Aug. 14, 2003). These cases highlighted the issue of the independence of inspections, in particular the supervision of a producing branch manager who allegedly defrauded customers. The representative, Frank Gruttaduria, was a producing branch manager in a branch office. The responsibility for supervising Gruttaduria's daily retail brokerage activity was entrusted to one of his subordinates. In effect, Gruttaduria was his supervisor's boss. The New York Stock Exchange and the National Association of Securities Dealers, Inc. have filed with the Commission proposed supervisory rules that among other things address the independence of supervision. See Release No. 34-48298 (Aug. 7, 2003) (SR-NASD-2002-162) (amendments to proposed rule change). See also, Release No. 34-48299 (Aug. 7, 2003) (SR-NYSE-2002-36) (amendments to proposed rule change); Release No. 34-46859 (Nov. 20, 2002) (SR-NASD-2002-162); Release No. 34-46858 (Nov. 20, 2002) (SR-NYSE-2002-36); Prudential Securities, Inc., Release No. 34-33082 (Oct. 21, 1993)

(illustrating sales practices abuses and supervisory deficiencies in branch offices).

[12](#) See Signal Securities, Inc., et al., Release No. 34-43350 (Sept. 26, 2000), *citing* Consolidated Investment Services, Inc., Release No. 34-36687 (Jan. 5, 1996). See also, Royal Alliance Associates, Inc., Release No. 34-38174 (Jan. 15, 1997); NASD Rule 3010(c).

[13](#) See Consolidated Investment Services, Inc., Release No. 34-36687 (Jan. 5, 1996) (broker-dealer's supervision of small office run by a single representative inadequate without inspections).

[14](#) See, e.g., Signal Securities, Inc., et al., Release No. 34-43350 (Sept. 26, 2000) (stating that if broker-dealer firm's procedures had included on-site inspections, the firm might have detected representative's unlawful activities).

[15](#) See Quest Capital Strategies, Inc., Release No. 34-44935 (Oct. 15, 2001).

[16](#) We believe that unannounced inspections do not include inspections where the firm gives the representative advance notice of an onsite inspection, such as giving a representative one or two days notice of the inspection or informing the representative that there will be an inspection in the next month but omitting the specific date. Additionally, we do not believe an inspection can be considered surprise if it occurs at the same time each year or is otherwise predictable by the representative. See, e.g., Kaufman, Bernstein et al., Release No. IA-2194 (Nov. 20, 2003) (finding that "[g]iven the predictable timing of the examinations, Kaufman and Bernstein were effectively put on notice that the examination would begin in the first few days of January each year. The examinations did not take place, therefore, 'without prior notice,' but rather followed a predictable pattern that gave Kaufman and Bernstein at least constructive notice as to when the annual examination would occur.").

[17](#) See Quest Capital Strategies, Inc., Release No. 34-44935 (Oct. 15, 2001). See also, Senatore, *Supervision Challenges Facing Broker-dealers Employing the Independent Contractor Small Branch Office Model: A Call to Action*, 52 Bus. Law. 1359 (1997) (strongly emphasizing the need for unannounced inspections when representatives are in remote locations with no onsite supervisors); Walsh, *Right the First Time: Regulation, Quality, and Preventive Compliance in the Securities Industry*, 1997 Colum. Bus. L. Rev. 165, 200 (highlighting the fact that one can "reasonably question the effectiveness" of pre-announced inspections).

[18](#) We understand from market participants that occasionally a firm might have difficulty effecting unannounced inspections because the representative is out of the office. If this is an issue, we suggest the firm take steps to increase the likelihood that a representative will be present at his remote office. For example, a firm might require submission of representatives' calendars on a monthly or quarterly basis.

[19](#) See SEC Press Release No. 2000-143 (Sept. 27, 2000) (former Director of Enforcement Richard H. Walker commented, "As remote brokerage offices have proliferated in recent years, there have been too many failures in supervision. Investors are well served by effective supervision of these offices, including regular unannounced inspections. Customers of these

offices must be assured the full range of investor protections.").

20 Quest Capital Strategies, Inc., Release No. 34-44935 (Oct. 15, 2001).

21 *Id.* See also, NYLIFE Securities Inc., Release No. 34-40459 (Sept. 23, 1998) (noting that "the Commission has determined that firms with a high number of one or two person offices have not discharged their supervisory obligations where there were no surprise inspections.") See also, Royal Alliance Associates, Inc., Release No. 34-38174 (Jan. 15, 1997) (broker-dealer's practice of conducting a pre-announced compliance examination of its off-site representatives only once a year was inadequate to satisfy its supervisory obligations); Consolidated Investment Services, Inc., Release No. 34-36687 (Jan. 5, 1996) (noting that surprise inspections of a small office run by a single representative would have been a prudent course of action).

22 See Quest Capital Strategies, Inc., Release No. 34-44935 (Oct. 15, 2001).

23 See *Id.*

24 See, e.g., NYLIFE Securities Inc., Release No. 34-40459 (Sept. 23, 1998).

25 Edwin Kantor, 51 S.E.C. 440, 447 (May 20, 1993). See also, Gutfreund, 51 S.E.C. at 108, citing Prudential-Bache Securities, Inc., Release No. 34-22755 (Jan. 2, 1986) (stating that a supervisor must conduct "adequate follow-up and review" whenever he or she detects unusual trading activity or other irregularities).

26 Some of these activities may themselves be violations of the securities laws and rules, or of SRO rules, while others may be evidence of such violations.

27 See, e.g., Signal Securities, Inc., et al., Release No. 34-43350 (Sept. 26, 2000) (finding that supervisor failed adequately to investigate a representative's activities after receiving a call in which a customer expressed concerns about how the representative handled his account).

28 See, e.g., Kirkpatrick, et al., Release No. 34-48748 (Nov. 5, 2003) (firm made inquiries regarding a representative's trading concentration in a particular stock and began imposing restrictions on trading in that stock due to concerns that the representative's activities might be affecting the market price of the stock).

29 See, e.g., SG Cowen Securities Corp., Release No. 34-48335 (Aug. 14, 2003) (finding that "[a] crucial component of Gruttaduria's fraudulent conduct was misappropriating funds and securities out of customer accounts and then transferring them into an intermediary brokerage account or directly to other customers or their designees.").

30 See, e.g., Kirkpatrick, et al., Release No. 34-48748 (Nov. 5, 2003) (firm hired a representative with a disciplinary history, as well as a history of financial insolvency, and failed to increase the level of supervision of the representative's activities).

31 See, e.g., D.E. Frey and Company, Inc., Release No. 34-43354 (Sept. 26, 2000) (firm failed reasonably to supervise representatives that were,

among other things, churning customer accounts).

32 See, e.g., Mark Gilbert Platt, et al., Release No. 34-48968 (Dec. 22, 2003) (branch office manager failed reasonably to supervise representative that was, among other things, recommending "unsuitable speculative small-cap technology stocks for the accounts of three elderly Josephthal customers each of whom had stated more conservative investment objectives.").

33 Review of remote office activity by the firm's Compliance or Surveillance Department is especially important in preventing and detecting misconduct.

34 SG Cowen Securities Corp., Release No. 34-48335 (Aug. 14, 2003); Lehman Brothers, Inc., Release No. 34-48336 (Aug. 14, 2003).

35 *Id.*

36 See, e.g., NASD Rule 3010(d); NASD Notice to Members 98-11, *SEC Approves Rules Regarding Supervision, Review and Record Retention of Correspondence* (Jan. 1998). See generally SG Cowen Securities Corp., Release No. 34-48335 (Aug. 14, 2003); Lehman Brothers, Inc., Release No. 34-48336 (Aug. 14, 2003).

37 See, e.g., SG Cowen Securities Corp., Release No. 34-48335 (Aug. 14, 2003) (stating that "[b]y choosing persons subordinate to Gruttadaria to oversee his daily retail brokerage activity, SGC structured its supervisory and compliance functions in a manner that created an inherent risk that Gruttadaria would not be adequately supervised...This structure may have been a contributing factor in the [firm's] supervisory failures..."). See also, Signal Securities, Inc., et al., Release No. 34-43350 (Sept. 26, 2000) (finding that broker-dealer firm's supervisory procedures were inadequate because they failed clearly to assign supervisory responsibilities among the various supervisors); *Id.*, quoting Mabon, Nugent & Co., Release No. 34-19424 (Jan. 13, 1983) (stating that "broker-dealers must not only adopt effective procedures for supervision, but must also 'provide effective staffing, sufficient resources and a system of follow up and review to determine that any responsibility to supervise delegated to compliance officers, branch managers and other personnel is being diligently exercised.'") (See Mabon, Nugent & Co., Release No. 34-27301 (Sept. 27, 1989), vacating the prior Order issued in Release No. 34-19424 but reiterating the Commission's adherence to this statement); NASD Rule 3010(a)(5) (requiring the assignment of each registered person to a person responsible for supervising their activities).

38 See, e.g., Jeffrey L. Harfst, et al., Release No. 34-42080 (Nov. 1, 1999).

39 NASDR 1997 Regulatory & Compliance Alerts, Volume 11, Number 2 (June 1997), discusses the supervision of off-site Series 8 or 24 qualified salespersons, and points out, among other things, that:

Conduct Rule 3010 requires that each registered person (including registered principals) must be assigned to another appropriately registered person responsible for supervising that person's activities. From a practical standpoint, this means that one or more persons identified by the firm must take direct responsibility for the supervision of all producing salespersons, whether they are Series 8 or 24 qualified or not. This supervision would include, but not be limited to, evidencing the review of transactions on both

a daily as well as a periodic basis.

See also, Stuart K. Patrick, 51 S.E.C. 419, 422 (May 17, 1993) ("Supervision, by its very nature, cannot be performed by the employee himself") (Commission order sustaining application of the New York Stock Exchange's supervisory rule).

40 See Josephthal & Co., Inc., Release No. 34-46039 (June 6, 2002) (broker-dealer found to have failed to reasonably supervise by failing to monitor whether its branch managers were adequately discharging their supervisory duties).

41 See NASD Rule 3010(e) (requiring members to review a copy of the Uniform Termination Notice of Securities Industry Registration (Form U-5) filed by a person's most recent previous NASD member employer).

42 See Prospera Financial Services, Inc., et al., Release No. 34-43352 (Sept. 26, 2000) (stating extraordinary supervision of representatives with disciplinary histories is especially appropriate if the representative works out of a one-person office). *See also*, Dale E. Frey, Release No. 34-44982 (Oct. 25, 2001) (chief executive of a broker-dealer, employing "independent contractor" representatives, found to have failed to reasonably supervise by failing (i) to develop procedures for imposing heightened supervision where appropriate, (ii) to implement firm procedures, and (iii) to commit adequate resources to implement supervisory procedures); Kirkpatrick, et al., Release No. 34-48748 (Nov. 5, 2003) (finding that branch manager of a remote office failed to impose heightened supervision on representative with a disciplinary history); James Harvey Thornton, Release No. 34-41007 (Feb. 1, 1999) (stating that knowledge of past misconduct triggers additional obligation to insure supervisory procedures are in place); Signal Securities, Inc., et al., Release No. 34-43350 (Sept. 26, 2000) (finding that a broker-dealer firm's policies and procedures failed adequately to provide for heightened supervision of representatives with a history of compliance-related concerns); NASD Notice to Members 03-49, *NASD Requests Comment on Proposed Amendments to Rule 3010 to Require Heightened Supervision Plans for Associated Persons with a Specified Threshold of Industry/Regulatory-Related Events* (Sept. 2003); NASD Notice to Members 97-19, *The Joint Regulatory Sales Practice Sweep; Heightened Supervisory Procedures* (April 1997).

43 Kirkpatrick, et al., Release No. 34-48748 (Nov. 5, 2003).

44 Signal Securities, Inc., et al., Release No. 34-43350 (Sept. 26, 2000).

45 See *Id.* (finding that broker-dealer firm's procedures failed to provide adequate review and follow-up of the information it gathered concerning the outside activities of its representatives). *See also*, NASD Rules 3030 and 3040, addressing the issue of outside business activities and selling away; NASD Notice to Members 01-79, *Selling Away and Outside Business Activities* (Dec. 2001).

46 See Signal Securities, Inc., et al., Release No. 34-43350 (Sept. 26, 2000).

47 See Prospera Financial Services, Inc., et al., Release No. 34-43352 (Sept. 26, 2000). *See also*, Signal Securities, Inc., et al., Release No. 34-43350 (Sept. 26, 2000).

48 See *Id.* (representative accepted checks from clients made out to his company (an outside business) that he used to misappropriate funds from his clients while he was associated with the firm). See also, Royal Alliance Associates, Inc., Release No. 34-38174 (Jan. 15, 1997).

49 See Josephthal & Co., Inc., Release No. 34-46039 (June 6, 2002) (The Commission stated that the firm's procedures and systems "were deficient because they did not adequately implement effective wire transfer procedures." The representative transferred customer funds to his personal bank account).

50 Signal Securities, Inc., et al., Release No. 34-43350 (Sept. 26, 2000).

51 See generally 15 U.S.C. §§ 78f(c)(3)(A), 78f(c)(3)(B) (authorizing national securities exchanges to deny membership based on failure to meet exchange's standards of training, experience, or competence). See also, NASD Rule 1120 (continuing education requirements).

52 See, e.g., David D. Grayson, et al., Release No. 34-33298 (Dec. 8, 1993) (broker-dealer firm failed to adopt and maintain uniform standards of sales training, the firm did not train its representatives in a central facility or according to a standard curriculum, and the firm's sales training procedures were not reviewed by the sales, legal, or compliance departments). See also, Sandra Logay, Admin. Proc. File No. 3-8969 (Jan. 28, 2000) (stating that "the NASD requires that members...maintain a continuing education program and evaluate their training needs annually and develop a written training plan.") (The initial administrative law judge decision in Sandra Logay became final by order of the Commission on March 6, 2000 (Release No. 34-42496)); NASD Rule 1120 and NYSE Rule 345A; NASD Notice to Members 01-79, *supra* note 45.

53 17 CFR § 240.17a-3(a)(17)(i)(B)(2).

54 See SG Cowen Securities Corp., Release No. 34-48335 (Aug. 14, 2003). See also, NASD Member Alert, *Customer Address Changes and Use of P.O. Boxes* (Jan. 28, 2002).

55 SG Cowen Securities Corp., Release No. 34-48335 (Aug. 14, 2003).

56 See Royal Alliance Associates, Inc., Release No. 34-38174 (Jan. 15, 1997).

57 *Id.*

58 See generally Exchange Act Section 17(a) and Rules 17a-3 and 17a-4 promulgated thereunder (15 U.S.C. § 78q(a) and 17 CFR §§ 240.17a-3, 240.17a-4).

59 See, e.g., NYSE Rules 342 and 472, and NASD Rules 3010(d) and 3110. See also, Notice to Members 99-03, *SEC Approves Rule Amendments Concerning Review of Incoming, Written Correspondence* (Jan. 1999); NASD Notice to Members 98-11, *supra* note 36.

60 See NASD Notice to Members 03-33, *Instant Messaging* (June 2003) (stating "NASD rules do not specifically require member firms to review or approve internal communications. However, members must be certain that

they have procedures adequate to supervise the activities of each registered representative and associated person, including their use of electronic communications technology.").

[61](#) See, e.g., Lehman Brothers, Inc., Release No. 34-48336 (Aug. 14, 2003); SG Cowen Securities Corp., Release No. 34-48335 (Aug. 14, 2003) (branch office manager used a firm facsimile machine to send and receive falsified correspondence). See also, Kirkpatrick, et al., Release No. 34-48748 (Nov. 5, 2003) (representative formulated a written plan to inflate a stock's price and used a branch office facsimile machine to disseminate a copy of the plan).

[62](#) See generally 17 CFR § 240.17a-3(a)(17)(i)(B) (requiring firms to periodically furnish account record information to certain customers).

[63](#) 17 CFR § 240.17a-3(a)(18)(ii).

[64](#) The respective websites are: www.sec.gov; www.nasd.com; and www.nyse.com.

<http://www.sec.gov/interps/legal/mrslb17.htm>
