

Chapter Two

General Supervision & Customer Recommendations

Introduction

The foundation of a firm's supervisory system is its written supervisory manual, also known as the firm's policy and procedures manual. All members are required to have a policy and procedures manual that outlines the supervisory structure of the firm and that designates a principal to be responsible for each business area of supervision. The policy and procedures manual must include the title, location, and registration status of all supervisors and a copy of the manual must be kept in each office of the firm where supervised activities are conducted. The purpose of the written policy and procedures manual is to ensure compliance with the firm's rules, as well as the rules of the industry. The manual must be updated to reflect the adoption of new policies, a change in personnel, or new industry regulations. The manual must also clearly outline the way the periodic compliance examinations are conducted and documented. The NYSE, the SEC and the NASD can take action against a firm or principal for failing to supervise its operations and agents.

The Role of the Principal

Prior to any firm being admitted as a member of the NASD, they must have a least two principals to supervise the activities of the firm. At a minimum, one must be a principal to supervise employees and the other must be a financial operations principal, or FINOP, to supervise the financial and operational activities of the firm. It is the principal's responsibility to ensure that all rules in the policy and procedures manual are followed by the firm's employees. It is also the responsibility of the principal to review and approve all of the following:

- ✓ New accounts
- ✓ Advertising
- ✓ Sales literature
- ✓ Transactions
- ✓ Correspondence

The principal reviews and approves the above listed items in writing by signing or initialing the item. In the case of transactions, a principal may initial each ticket or initial a daily trade run. This supervisor's initials will evidence the fact that the trades have been reviewed and approved. There is no requirement that a principal approve a trade prior to its execution, but the trade must be reviewed and approved promptly. Each registered representative must be assigned to a specific supervisor. A principal of a member firm who fails to supervise the actions of the agents under their control may be subject to action by the NYSE, the NASD and the SEC. A principal will not be subject to action if there are written procedures in place that are designed to detect and prevent violations. These procedures must have been enacted and the supervisor must not have reason to

believe the system is not operating properly. Additionally, the principal will not be found to have failed to supervise if an agent has employed extreme measures to conceal their actions. Each member firm must designate a principal to review the firm's supervisory system. This person is responsible for recommending changes in the system to the firm's senior management and this person must be identified to the NASD as the principal in charge of reviewing the firm's compliance systems.

Supervisor Qualifications and Prerequisites

People who supervise or train agents generally must register as a principal with the NASD and qualify by training or experience. Prior to taking a principal exam, the individual must have successfully completed the appropriate registered representative examination. Once appointed as a principal of a firm an individual has 90 days to pass the appropriate principal exam. A principal of an NASD member firm will usually take the General Securities Principal exam known as the series 24 while a principal of an NYSE member firm will take the General Securities Sales Supervisor exams known as the series 9 and 10 exams. Series 9/10 General Securities Sales Supervisors and Series 24 general securities principals may manage or supervise the firm's corporate securities business, including investment banking, direct participation programs, investment company products, and variable contracts. A Series 9 and 10 or Series 24 does not qualify an individual as a:

- ✓ Registered Options Principal
- ✓ Municipal Securities Principal
- ✓ Financial and Operations Principal
- ✓ Introducing Broker/Dealer Financial and Operations Principal

All portions of NASD administered exams are proprietary and to be held in the strictest of confidence. The NASD considers it a violation of its rules for any individual to:

- ✓ Disclose exam questions or content to anyone
- ✓ Reproduce exam questions
- ✓ Receive exam questions or content from anyone
- ✓ Compromise the content of any exam
- ✓ Remove any portion of an exam from the exam location

TAKE NOTE!

A series 9/10 General Securities Sales Supervisor is not qualified to supervise a member firm's trading or investment banking operations

Continuing Education

Most registered agents and principals are required to participate in industry mandated continuing education programs. The continuing education program consists of a firm element, which is administered by the broker dealer, and a regulatory element, which is administered by the regulators.

Firm Element Continuing Education

Every NASD member firm at least annually must identify the training needs of its covered employees and develop a written training plan based on their employees' needs. A covered employee is a registered person who engages in sales of securities to customers, trading, investment banking and their immediate supervisors. The firm, at a minimum, should institute a plan that increases the covered employees' securities knowledge and should focus on the products offered by the firm. The plan should also highlight the risks and suitability requirements associated with the firm's investment products and strategies. The firm is not required to file their continuing education plan with the NASD unless it is specifically requested to do so. However, firms who fail to adequately document their continuing education program, including their covered agents' compliance with the program, may be subject to disciplinary action.

Regulatory Element

All registered agents who were not registered on or before July 1, 1988 must participate in the regulatory element of the continuing education requirement. Agents subject to the requirement must complete the computer based training at an approved facility on the second anniversary of their initial registration and every three years thereafter. The content of the exam is developed by The Securities Industry Regulatory Council on Continuing Education and is not the responsibility of the broker dealer. The NASD will notify the agent 30 days prior to their anniversary date. This notification provides the agent with 120-day window to complete the regulatory continuing education requirement. An Agent who fails to complete the requirement within that period will have their registration become inactive. Agents whose registrations have become inactive may not engage in any securities business that requires a license and may not receive commissions until their registration is reactivated. Registered representatives are subject to series 101 of the regulatory element, while registered principals are subject to series 201 of the requirement. Agents, who were exempt from the regulatory element as a result of having been registered for 10 years or more with a clean disciplinary history on July 1, 1998, who become the subject of a significant disciplinary action, will now be required to participate in the regulatory element of the continuing education requirement. Additionally, if an agent who was exempt from the regulatory element subsequently becomes registered as a principal, they will become subject to the series 201 requirement. The one-time exemption is only for the regulatory element; there is no exemption from the firm element of the continuing education program.

Tape Recording Employees

Certain firms may be subject to special supervision requirements if a significant amount of its registered agents came from a firm or firms that have been disciplined by regulators. Firms that are subject to the taping rule must implement special written procedures and begin taping the conversation of its registered personnel and customers within 60 days of being notified by the NASD that the firm has become subject to the taping rule. The firm also must implement written procedures to retain, review, and

classify the recordings. Firms that fall into the following categories must tape their employees:

- ✓ Has more than five but less than 10 registered representatives and 40% or more have come from disciplinary firms within the last three years
- ✓ Has at least 10 but less than 20 registered representatives and four or more have come from disciplinary firms within the last three years
- ✓ Has 20 or more employees and at least 20% have come from disciplinary firms within the last three years

A broker dealer who has been notified by the NASD that they are subject to the taping rule has a one-time option to reduce their number of registered representatives. If the firm elects to reduce a portion of the subject agents to eliminate the taping requirement, for 180 days, the firm may not rehire the subject agents who were eliminated.

Information Obtained From an Issuer

If a broker dealer obtains information during the performance of duties to an issuer of securities it may not use that information to solicit business. A broker dealer may obtain information from an issuer while acting as:

- ✓ An underwriter
- ✓ A transfer agent
- ✓ A paying agent
- ✓ An investment banker

Customer Complaints

All written complaints received from a customer or from an individual acting on behalf of the customer must be reported promptly to the principal of the firm. The firm is required to:

- ✓ Maintain a copy of the complaint at a supervising office of supervisory jurisdiction
- ✓ Electronically report all complaints to the NASD within 15 days of the end of each calendar quarter. If no complaints were received, no report is due
- ✓ Report complaints within 10 days to the NASD, if the complaint alleges misappropriation of funds or securities or forgery

The firm must maintain a separate customer complaint folder, even if it has not received any written customer complaints. If the firm's file contains complaints, the file must state what action was taken by the firm, if any, and it must disclose the location of the file containing any correspondence relating to the complaint. NYSE rules require member firms to acknowledge all customer complaints within 15 days of receipt and must respond to the compliant within a reasonable time. Complaints received by the member via email may be responded to by replying to the email address that originated the compliant or by sending a letter to the customer's address of record. If a member firm receives a verbal complaint it may respond verbally and must record the verbal complaint in a call log.

TAKE NOTE! A principal is required to review all written customer complaints but there is no required time frame to respond or take action.

Mediation

Mediation is an informal attempt by two parties to try to resolve a dispute, prior to entering into the formal arbitration process. During the mediation process the two parties meet to discuss the contested issue, and the dialog is monitored by a mediator. The mediator is a neutral person with industry knowledge suggested by the NASD, who tries to help the parties reach an agreement. If the mediator is not acceptable, the parties may select another mediator from a list of approved mediators or their own independent mediator. Prior to entering into the mediation process, both parties must agree to try to resolve the issue in mediation and must split the mediator's fee. The mediation process begins with an initial joint meeting where both parties lay out their claims for the mediator and the other party. During the second phase of the process, each side meets with the mediator individually in meetings known as caucuses. The mediator is a neutral party and will not disclose information provided during the caucus sessions to the opposing side. The mediation process will continue until an agreement is reached, the mediator declares an impasse with no possible resolution, or one of the parties or the mediator withdraws from the process in writing. The mediation process may provide a resolution for all or some of the contested issues. Issues that are not resolved in mediation may be resolved through formal arbitration.

Code of Arbitration

The NASD's Code of Arbitration Procedure provides parties with a forum to resolve disputes. Most claims submitted to arbitration are financial in nature, although other claims may be submitted. Arbitration provides a cost-effective alternative to dispute resolution and many disputes will be resolved much sooner than they otherwise may have been in court. All industry members are required to settle all disputes through arbitration. A public customer, however, must agree in writing to settle any dispute through arbitration. When a customer opens an account with a broker dealer, the broker dealer will often have the customer sign a customer agreement, although not required by industry standards. The customer agreement usually contains a pre-dispute arbitration cause where the customer agrees to settle any dispute that may arise in arbitration rather than in court.

The Arbitration Process

Arbitration begins when an aggrieved party, known as the claimant, files a statement of claim, along with a submission agreement with the NASD. The party alleged to have caused the claimant harm must respond to the statement of claim and is known as the respondent. Dispute resolution through arbitration is available for matters involving:

- ✓ Member vs. member
- ✓ Bank vs. member
- ✓ Member vs. bank
- ✓ Member vs. registered representative
- ✓ Registered representative vs. member
- ✓ Customer vs. member
- ✓ Member vs. customer

Simplified Arbitration

Simplified arbitration is available for disputes involving amounts in dispute of \$25,000 or less. Simplified arbitration provides no opportunity for a hearing. Parties submit their case in writing only. One arbitrator reviews the case and renders a decision. For amounts that exceed \$25,000, a hearing must be held.

Larger Disputes

Larger disputes will be submitted to a panel of up to five arbitrators to render a decision on the matter. A hearing will take place and evidence and testimony will be presented to the panel. The number of arbitrators must always be odd, so the panel will be made up of one, three or five arbitrators from both the public and the industry.

Awards Under Arbitration

Awards under arbitration are final and binding; there is no appeal. If a monetary payment has been awarded, the party required to pay has 30 days to comply with the decision. A member or a registered representative, who fails to pay an award under arbitration, is subject to suspension. All pending arbitrations and arbitrations settled where the award was \$10,000 in favor of the customer are all disclosed to the public through the NASD's Public Disclosure Program.

NYSE Notification

The NYSE requires that it be notified of any award against an employee in excess of \$15,000 and requires that it be notified of any award against a firm in excess of \$25,000. The NYSE also requires members to notify the exchange on form RE-3 in the event of any of the following:

- ✓ Any written complaint received alleging forgery, misappropriation or theft of customer funds or securities
- ✓ Any action brought by another regulator naming the member or an employee as a defendant

- ✓ Any charge, arrest or conviction of any associated person of any criminal offense including shoplifting and DUI
- ✓ Any action taken by a member against one of its employees that results in a penalty of exceeding \$2,500, a suspension or termination an employee
- ✓ Any violation of securities laws or SRO regulation