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EFFECTIVE SUPERVISION, INVESTOR CONFIDENCE AND CAPITAL FORMATION

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I. THE LINK BETWEEN HEALTHY SECURITIES MARKETS AND ECONOMIC PROSPERITY

In the wake of the 1929 market crash, Congress developed the Securities Act of 1933 ("Securities Act").[1] Congress assembled this body of law "to restore the confidence of the prospective investor . . . [and] bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power." *United States v. Naftalin,* 441 U.S. 768, 775-76 (1978). Once the Securities Act went into effect, Congress found little time for rest. It followed up on this accomplishment by enacting a collection of companion statutory compilations, including the Securities Exchange Act of 1934 ("Exchange Act"),[2] the Investment Company Act of 1940,[3] and the Investment Advisors Act of 1940.[4] These broad federal statutory mandates were implemented so as "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry."[5]

Congress charted the ambitious course of action sketched above while embracing the belief that federal oversight of this area would strengthen investor confidence and cause those standing on the sidelines to conclude that they would be treated fairly if they ventured into the capital markets.[6] Once investors came to the conclusion that they would receive a "fair shake" in the financial markets, young companies that were deemed to possess stellar prospects would be in a position to attract the capital necessary to expand their payrolls.[7]

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1. 15 U.S.C. §§ 77 a *et seq.*
2. 15 U.S.C. §§ 78 a *et seq*. Among other things, the Exchange Act created the Securities and Exchange Commission ("SEC") itself. In creating the SEC, Congress recognized the need to steer clear of rigidity, which would hobble the agency's mission. As a means of empowering the SEC, Congress made certain that it was endowed with "an arsenal of flexible enforcement powers." 425 U.S. 185 (1976).
3. 15 U.S.C. §§ 80a – 1 *et seq.*
4. 15 U.S.C. §§ 80b – 1 *et seq.*
5. *SEC v. Capital Gains Research Bureau,* 375 U.S. 180, 186 (1963). After embracing the notion of full disclosure, the Supreme Court went on to expound upon this fundamental paradigm shift by observing as follows: "'It requires but little appreciation . . . of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail' in every facet of the securities industry." *Capital Gains Research Bureau, at 186-87*, *quoting Silver v. New York Stock Exchange*, 373 U.S. 341 (1963).

II. INVESTOR PROTECTION

State and federal regulators play a large role in the oversight of the securities industry. Government authorities, however, do not stand alone with respect to their duty to promote investor confidence.[8] Self-Regulatory Organizations ("SROs"), such as the NASD and the NYSE, are similarly charged with overseeing the actions of those who work in the securities industry.[9] While embracing basic notions of pragmatism, Congress has implored governmental authorities and SROs to coordinate their actions while working in conjunction with one another.[10] Collectively, these entities have sought to achieve their objectives, at least in part, by compelling registered securities firms operating under their jurisdiction to shoulder significant supervisory obligations.[11] The duties and responsibilities which have been placed upon securities firms serve as a means of leverag-

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6. Between 1911 and 1933, 47 states had enacted securities regulation statutes, commonly referred to as "blue sky" laws. Joel Seligman, *The Reformation of Federal Securities Law Concerning Nonpublic Information*, 73 Geo. L. J. 1083, 1091 (1985). "Nonetheless, it was apparent by 1933 that state blue sky enforcement alone could have only limited success in stopping securities fraud, primarily because no state law could reach by direct action or extradition a seller of fraudulent securities located in a second state." *Id.* "Moreover, large classes of securities, such as those listed on recognized exchanges, [were] . . . exempted from the requirements of these laws." Harry Shulman, *Civil Liability And The Securities Act,* 43 Yale L. J. 227, 241 n. 51 (1933).
7. See Roy A. Schotland, *Unsafe at any Price: A Reply To Manne, Insider Trading and the Stock Market*, 53 Va. L. Rev. 1425, 1441 (1967) (presuming that a lesser level of participation in the stock market by investors "will tend to reduce the health of that market and have a negative impact on corporations already held publicity, on smaller corporations which may need more capital to grow and on the economy as a whole"). See also Hsiu-Kwang Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 Colum. L. Rev. 260, 264 (1968) (noting that "[a] liquid stock market presupposes public confidence which creates willingness to purchase shares. Much of the difficulty in organizing capital markets in the less developed countries arises from public distrust and reluctance to invest funds in such markets"); Victor Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws,* 93 Harv. L. Rev. 322, 335 (1979) (arguing that a benefit which flows from an increase in "investor faith in the market would be a reduction in the cost of capital by reason of eliminating the higher risk premiums required by investors to compensate for their fear of overreaching"); Joel Seligman, *Reformulation of Federal Securities Law Concerning Nonpublic Information,* 73 Geo. L. J. 1083, 1095 (asserting that the disclosures mandated by the federal securities laws were designed to reduce the perceived risks associated with the purchase of securities, which "would tend to reduce the risk premiums that issuers selling new securities would have to pay, thus increasing the funds available for economic growth").

ing the resources of these regulators while further heightening investor confidence in the capital markets.[12]

8. When analyzing the benefits flowing from heightened levels of investor confidence, it is important to keep in mind that members of the investing public may experience the same devastating financial consequences regardless of whether those losses stem from willful conduct characterized by intentional deceit – on the one hand, or mere mistake, oversight and incompetence, on the other hand. Regardless of the precise mindset harbored those who brought about the underlying losses, it seems certain that large scale financial carnage will typically lead to lower levels of trust and confidence. With this in mind, the SEC has stressed the need to guard against the evils of fraud, as well as harm which may be occasioned through mere carelessness. In espousing this observation, the Commission noted that "[r]egulators must protect the public not only from professionals in the business who practice deliberate deception, but also from those whose credulity and failure to investigate inflict equal harm on investors and undermine public confidence in the securities market to the same extent." *In re Nassar & Co.,* 47 SEC 20, 22 (1978). *See also Aaron v. SEC,* 446 U.S. 680 (1980) (J. Blackmun) (concurring in part and dissenting in part) (noting that "when misinformation causes loss, it is small comfort to the investor to know that he has been bilked by negligent mistake rather than by fraudulent design").
9. William O. Douglas, who served as Chairman of the SEC before being elevated to the U.S. Supreme Court, previously characterized the thought process underlying enactment of the federal securities laws by noting that Congress' intent was "one of 'letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.'" *Silver v. New York Stock Exchange*, 373 U.S. 341, 352 (quoting statement articulated by Justice Douglas during the period in which he presided over the SEC).
10. Through the implementation of coordinated regulatory efforts, the interests of the investing public are furthered, with efficiencies being achieved within the securities firms that are the subject of the underlying examinations and general oversight initiatives. *See Department of Enforcements v. Quattrone, NASD No. CAF 030008 (November 22, 2004), reversed on other grounds, In the matter of Frank P. Quattrone*, Exchange Act Rel. No. 53547 (March 24, 2006). *See also Speech by Steven Cutler, Director, SEC Div. Of Enforcement, (December 20, 2002)* (discussing agreement in principle calling for payment of over $1.4 billion pursuant to resolution of research analysts investigation while recognizing joint efforts of SEC, NYSE, NASD, New York Attorney General's Office, North American Securities Administrators Association and individual states); Written Statement of Richard Walker Concerning Securities Fraud on the Internet, U.S. Senate Permanent Subcommittee on Investigations, at 23 (stressing that the SEC, Division of Enforcement, "works closely with self-regulatory organizations . . . as well as state regulatory authorities and the North American Securities Administrators Association").

III. CORNERSTONE PRINCIPLE

The essential role of effective supervision cannot be overstated.[13] From the NASD's perspective, "[e]stablishing, maintaining and enforcing written supervisory procedures is a cornerstone of self-regulation within the securities industry."[14]

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11. Arguably, SROs are better positioned to instill and promote an environment that fully embraces investor protection considerations because they are afforded far greater latitude when implementing and enforcing applicable standards and prohibitions. Pursuant to well-established precedent, "[t]he NASD has authority to impose sanctions for violations of 'moral standards' even if there was no 'unlawful' conduct." *Department of Enforcement v. Shvartz*, 2000 NASD Discip. LEXIS 6 at 13 (NAC June 2, 2000). Indeed, NASD disciplinary proceedings may result in the assessment of sanctions based upon the transgression of "ethical requirements where no legally cognizable wrong occurred." *DBCC v. Respondent 1*, NASD No. C05960041, at 9 (NBCC October 10, 1997). Reduced to its essence, the sweeping language of NASD Rule 2110, which compels NASD members to "observe high standards of commercial honor and just and equitable principles of trade," dramatically alters the equation. On account of the extraordinary breadth of Rule 2110, the NASD is empowered "to regulate broker/dealers under ethical standards, as well as legal standards. The principal consideration is whether the misconduct 'reflects on an associated person's ability to comply with regulatory requirements necessary to the proper functioning of the securities industry and protection of the public.'" *Department of Enforcement v. Tad Enrique Mihalopoulos, Sr.,* NASD No. C01030004, at 13-14 (April 26, 2004). The broad principles and standards emanating from Rule 2110 are contravened whenever there is a violation of the duty of "fair dealing." *See Department of Enforcement v. VTR Capital* , NASD No. CAF980005 (August 18, 1999).
12. See *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) (recognizing "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'"). See also *Donald T. Sheldon,* Exchange Act Release No. 31475, 52 SEC Docket 3826, 3855 (November 18, 1992), aff'd. 45 F.3rd 1515 (11th Cir. 1995) (finding that "[i]t is critical for investor protection that a broker establish and enforce effective procedures to supervise its employees")
13. It is axiomatic that an effective supervisory system must necessarily be grounded upon the establishment of thorough, detailed written supervisory procedures that pass muster on all fronts. In evaluating the adequacy of supervisory procedures, securities industry personnel may not take comfort in any blessing that may be expressly or impliedly conveyed by examiners or other regulatory personnel. As the SEC has repeatedly observed, registered securities firms must take it upon themselves to make certain they adhere to their obligations; "responsibility for compliance with applicable requirements cannot be shifted to regulatory authorities." *James L. Owsley, Exchange Act* Rel. No. 32491 (June 18, 1993).
14. NASD NTM 98-96.

Further, "[t]he Commission has long emphasized that the responsibility of broker-dealers to supervise their employees is a critical component of the federal regulatory scheme." *John H. Gutfreund*, 51 S.E.C. 93, Release No. 31554 (1992). See also *Connecticut Capital Markets*, Exchange Act Release No. 50034, at 4 (July 16, 2004). Succinctly put, supervision is a first line of defense for investor protection. *In the matter of Paul C. Kettler*, 52 S.E.C. Docket No. 2150, Rel. No. 34-31354 (Oct. 26, 1992). See also NASD NTM 99-45 (observing 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.'"); *Department of Enforcement v. Investment Management Corp.*, at 10 n. 22 (NAC December 15, 2003) (finding that NASD Rule 3010 promotes greater levels of self-regulation within the firm itself and thereby "serves to protect investors from fraudulent trading practices").

Through the effective implementation of supervisory obligations, those charged with such responsibilities are empowered to prevent the effects of employee misconduct from ever reaching members of the investing public. On the other hand, supervisory lapses may readily result in an array of acts, the effects of which victimize customers. Coming at it from another direction, supervisory deficiencies and customer harm are no strangers to one another.

To the contrary, they go hand-in-hand with each other. See *Goldman Sachs & Co.*, Securities Act Release No. 8434, at 11 (July 1, 2004) (finding that firm's inadequate supervisory system engendered violation of registration requirements while recognizing that "'[w]here there has been an underlying violation of the federal securities laws, the failure to have or follow compliance procedures has frequently been found to evidence a failure reasonably to supervise the primary violator'" (citation omitted)).

Although the precise formulation may vary, depending upon the circumstances, elements of a failure to supervise case which may be brought in the federal securities law context are as follows:

(1) An associated person violated at least one provision of the federal securities laws;

(2) The supervisor at issue was directly responsible for oversight of the individual or function at issue; and

(3) The supervisor failed to 'reasonably supervise' the associated person or the underlying area with a view to preventing the violations.

See *Sandra Logay*, 71 S.E.C. Docket 1398, Admin. Pro. File No. 3-8969 (Jan. 28, 2000), 2000 WL 95098.[15]

IV. RESPONSIBILITY OF TOP EXECUTIVES

Those at the highest level within a brokerage firm are ultimately responsible for the firm's compliance with the supervisory provisions under which the firm operates. "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." *Signal Securities*, Exchange Act Release No. 43350, at 8 (Sept. 26, 2000), *citing Frederick H. Joseph,* Exchange Act Release No. SEC Docket 283, 290 (May 20, 1993).[16]

During the early 1990s, the SEC stressed these principles while explaining its rationale in the *Gutfreund* case, where it held John Gutfreund and other high-ranking officers of Salomon Bros. responsible for abuses within the U.S. treasury securities market. While doing so, the SEC emphasized the following:

> As Chairman and Chief Executive Officer of Salomon, Gutfreund bore ultimate responsibility for ensuring that a prompt and thorough inquiry was undertaken and that [the employee in question] was appropriately disciplined. A chief executive officer has ultimate affirmative responsibility, upon learning of serious wrongdoing within the firm as to any segment of the securities market, to ensure that steps are taken to prevent further violations of the securities laws and to determine the scope of the wrongdoing. He failed to ensure that this was done.

SEC Release No. 34-31554, at 16 (Dec. 3, 1992).

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15. In *Logay*, the Commission elaborated on firm and branch manager supervisory duties. In doing so, the SEC made it clear that in a situation where a firm's compliance procedures require substantive client contact, the mailing of a general, routine "happy supervisory letter" is inadequate. Since "red flags" suggested the possibility of, among other things, unsuitable trades and churning, the supervisor was obligated to contact the customers at issue and make an inquiry as to the specific species of troubling conduct. While discussing the parameters of adequate supervision, the Commission also noted that a supervisor may defend against allegations which have been brought by showing that: 1) a proper system of established procedures was in place; and 2) he reasonably discharged the duties imposed by those procedures. *Logay* at 23-24. See also *Consolidated Investment Services, Inc*., 61 S.E.C. Docket No. 19, Release No. 36687 (Jan. 9, 1996) (discussing "reasonable discharge" of supervisory obligations).
16. See also *Kirkpatrick, Pettis, Smith et al*., Exchange Act Release No. 48748, at 6 (noting that "[a] broker-dealer's president is responsible for compliance with all requirements imposed on his firm unless he reasonably delegates particular functions to others and neither knows, nor has reason to know, that such person's performance is deficient.")

As specified by the SEC only six months later, these principles are unwavering. Complete compliance with the spirit and letter of the teachings in this area is mandatory regardless of the revenue generating capacity enjoyed by the registered person. More specifically, while addressing the supervisory shortcomings surrounding the oversight of Michael Milken, the SEC articulated the following remarks:

> In this case, the violations were committed by a very senior and powerful person within Drexel, Milken. He was, however, like all other persons, equally bound by the federal securities laws and should have been subject to greater supervision within the firm.

Kantor, 51 S.E.C. 440, Exchange Act Rel. No. 32341 (May 20, 1993).

While stressing the need for effective supervision without regard to the revenue generating capacity of a particular individual, the Commission also noted that reasonable supervision requires "strict adherence" to internal company procedures. *Kantor*, Exchange Act Release No. 32341. Propelled by a lust for riches, the supervisor at issue had cast a blind eye toward the machinations in which Milken engaged and failed to implement the supervisory procedures which were then in place. See also *Nicholas A. Boccella*, Exchange Act Rel. No. 26574, 42 S.E.C. Docket No. 1808, 1810 (Feb. 27, 1989).[17]

V. ASSIGNMENT OF SPECIFIC RESPONSIBILITIES TO SPECIFIC SUPERVISORS

Pursuant to NASD Rule 3010(b)(3), NASD member firms must maintain procedures which "shall include the titles, registration status and locations of the required supervisory personnel and the responsibilities of each supervisory person . . . ."[18] A supervisory system which fails to assign specific responsibilities to particular individuals is inherently deficient.[19] See *Signal Securities*, at 8 (concluding that Signal's supervisory proce-

17. Based on well established principles which have consistently been espoused by the SEC, "[i]t is not sufficient for a broker dealer to establish a system of supervisory procedures which rely solely on supervision by branch managers." *Prudential-Bache Securities, Inc.,* Exchange Act Release No. 22755, 48 S.E.C. 372, 400 (1986). Moreover, to the extent supervisory responsibilities are placed upon front line personnel, sufficient funds must be budgeted for these tasks, with efforts also being made to insure that these responsibilities are being properly discharged. See *Mabon, Nugent & Co.*, Exchange Act Release No. 19424, 26 SEC Docket 1846, 1852 (Jan. 13, 1983) (noting that securities firms must "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.").

dures . . . were inadequate because they failed clearly to assign supervisory responsibilities among the various supervisors). See also *Steven E. Muth et al.,* Initial Decision Release No. 262, at 37-38 (finding that conflicting statements by two supervisors with respect to their respective supervisory responsibilities over a broker supported the "conclusion that no system was in place to monitor whether [the broker's] . . . supervisors were executing their supervisory responsibilities.").

"The written procedures also must include the business line and applicable securities laws for which each supervisor is responsible." NASD Notice To Members 99-45, at 294 (June 1999). "[T]he purpose of this rule is to allow for personnel at the firm, as well as regulators, to easily determine who is responsible for supervising a particular area and the time period for which the person was assigned the supervisory responsibility." *Id.*, at 295.[20]

When considering the principle that specific responsibilities must be assigned to particular supervisors, NASD Rules 3012 and 3013, which were recently promulgated, must also be taken into account. While further ratcheting up the supervisory pressures on registered securities firms, NASD Rules 3012 and 3013 articulate new directives and place additional

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18. The full text of NASD Rule 3010 (b)(3) provides as follows:

> The member's written supervisory procedures shall set forth the supervisory system established by the member pursuant to paragraph (a) above, and shall include the titles, registration status and locations of the required supervisory personnel and the responsibilities of each supervisory person as these relate to the types of business engaged in, applicable securities laws and regulations, and the Rules of this Association. The member shall maintain on an internal record the names of all persons who are designated as supervisory personnel and the dates for which such designation is or was effective. Such record shall be preserved by the member for a period of not less than three years, the first two years in an easily accessible place.

19. If the specific supervisor charged with conducting a particular review or procedure is not identified by name, he must be identified by title. See NASD NTM 98-96, at 735 (December 1998). Merely stating that the 'Compliance Department,' 'Trading Department,' or a 'principal' will conduct the review is not sufficient." *Id.*

20. On a related note, it is well-established that registered persons are not allowed to supervise themselves. *DBCC v. Gliksman*, at 16, (NAC March 31, 1999), *citing, In re John Bradford Titus*, Exchange Act Rel. No. 38029 (Dec. 9, 1996) (holding that registered person could not act as his own supervisor). This rule remains constant even if the individual in question is a principal. As stated by the National Adjudicatory Council of the NASD, "'Series 8 or 24 qualified persons are no more capable to supervise themselves [sic] than a Series 7 qualified representative." *DBCC v. Corporate Securities Group*, at 10 (June 10, 1998) (citation omitted).

burdens on specific supervisory personnel. Rule 3012(a)(1) requires members to name one or more principals "who shall establish, maintain and enforce a system of supervisory control policies and procedures . . . ."

This person is to ensure that the supervisory systems are adequate. The specific supervisors who are enumerated under Rule 3012(a)(1) must provide an annual report to senior management and ensure the adequacy of the firm's supervisory system.[21]

VI. FAILURE TO RESPOND TO RED FLAGS

Notwithstanding the absence of bright line standards, it is of critical importance to fashion a proper interpretation and construction of "red flags." In a nutshell, "red flags" may be viewed as indicators that should alert a person familiar with the operations of a brokerage firm that further investigation of specific conduct is necessary to protect against the transgression of established standards.

"Red flags" have routinely been described as "indications of violations" or "suggestions of irregularities". Once such an indication or suggestion manifests itself, the need for prompt action arises. As stated by the Commission in *Kantor*:

> Red 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.

21. Rule 3012(a)(2)(A) requires that the firms maintain adequate controls in the supervisory system to detect securities violations in customer accounts. A person senior to the producing manager must perform the supervisory review. If the operations of the company consist of small offices, limited in size or resources, a principal knowledgeable about the firm's supervisory control procedures may conduct the review.
Rule 3012(a)(2)(B) addresses the scope of activities which are to be reviewed and monitored. These include customer changes of investment objectives, the validation of such changes and day to day activities in the customer's account.
Rule 3012(a)(2)(C) defines conditions that require "heightened supervision". Pursuant to this provision, heightened supervision is required when a producing manager generates 20% or more of the revenue of the business unit supervised. It is also required for other circumstances to avoid conflicts of interest that undermine complete and effective supervision because of an economic, commercial or financial interest the supervisor holds in the associated persons or type of business which is to be supervised. See NTM 04-71 for additional information concerning these new provisions.

Kantor, 51 S.E.C. 440, Rel. No. 32341 (May 20, 1993). Viewed from a common sense perspective, it is clear that when suggestions of potential substantive improprieties surface, the need for a meaningful inquiry arises.[22] Once the offensive conduct is tracked down and analyzed, proper supervisory measures must be implemented. See *Kernweis,* NASD Disciplinary Proceeding No. C02980024 (Feb. 16, 2000).

In *Kernweis*, The National Adjudicatory Council ("NAC") of the NASD found that there had been a "failure to supervise an account based on the size, frequency, and number of transactions." Although the firm had committed to monitor the brokers at issue in four specific areas, there was no evidence that any meaningful actions had been taken in this regard. After assessing the situation in its entirety, the NAC did not hesitate to conclude that the oversight measures that had been implemented fell short of the mark. The NAC supported its determination by highlighting a failure to vigorously investigate red flags, while also stressing the principle that supervisory personnel must not simply rely upon the unverified representations of employees.[23]

Given the extent to which supervisory vitality and activism has been repeatedly stressed, it's readily apparent that supervisors may not embrace a passive mindset through the point at which they are confronted by unmistakable evidence of improprieties. To the contrary, supervisory personnel are obligated to pursue events which may raise eyebrows even though there may be only subtle indications of an improper scheme which is still in its infancy. As stated by the SEC in *Gutfreund*:

> The supervisory obligations imposed by the federal securities laws require a vigorous response even to indications of wrongdoing. Many of the Commission's cases involving a failure to supervise arise from situations where supervisors were aware only of "red flags" or "suggestions" of irregularity, rather than situations where, as here, supervisors were explicitly informed of an illegal act.

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22. In a routine case dealing with failure to supervise issues, a failure to supervise finding is layered upon an attending substantive violation. However, that need not be the case. A violation of NASD Rule 3010(a), which necessitates a proper supervisory system, or Rule 3010(b), which relates to proper written supervisory procedures, may "occur in the absence of an underlying rule violation." *Department of Enforcement v. Respondent 1*, NASD No. C9B040036, at 22 (March 15, 2005).
23. The facts which gave rise to the *Kernweis* opinion are noteworthy. There was an undue concentration of speculative securities, with an annual turnover rate of 26.1. However, the customer had executed an activity letter wherein he affirmed his speculative objectives and was arguably willing to "bet the ranch".

Exchange Act Release No. 34-31554, at 14. See also *Quest Capital Strategies*, at 6 (emphasizing principle that "supervisors must act decisively to detect and prevent violations of the securities laws when an indication of irregularity is brought to their attention.") If no investigatory efforts are initiated as a result of "red flags" being overlooked, a failure to supervise finding may be appropriate.[24]

As an additional matter, a supervisor, as opposed to a compliance officer, is required to investigate activities which serve as "red flags". See *Dan Druz*, Exchange Act Rel. No. 35203, 58 S.E.C. Docket No. 1526 (Jan. 9, 1995).

VII. HEIGHTENED SUPERVISION

The principle of heightened supervision serves as a significant source of concern among securities industry personnel.[25] The enhanced liability which is linked to this dengenders considerable anxiety. However, the uncertain parameters of this area may serve as the basis for even greater worries within the securities industry. The ambiguities attending the breadth of the net cast by this principle are illustrated by the inconsistent

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24. See *Bradford Titus*, 63 S.E.C. Docket No. 926, Rel. No. 38029, (December 9, 1996) articulating failure to supervise findings where registered representative purchased index options on behalf of a relatively inexperienced customer and opened a new account absent supervisory approval while rejecting defense claims that the registered representative had camouflaged the improprieties. Moreover, an inquiry into the surrounding circumstances, standing alone, is not sufficient. Effective supervision also requires effective follow-up and review. See *Department Of Market Regulation v. Yankee Financial Group, Inc.*, at 38 (Dec. 10, 2004). See also *Kirkpatrick Pettis, Smith et al.*, Exchange Act Release No. 48748 at 7 (stating that "[r]ed flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review.")

25. The concept of heightened supervision, in its current form, is of recent vintage. As a means of calling attention to this issue, the NASD published NTM 97-19 in early 1997. That Notice To Members carried the results of a study which focused upon operations maintained within 179 offices of various registered brokerage firms. Among other things, NTM 97-19 outlined general supervisory responsibilities under both NASD Rule 3010 and NYSE Rule 342. It then went on to provide guidance concerning the potential need for heightened supervision under various circumstances. According to NTM 97-19, conduct which may give rise to a need for heightened supervision includes: a disciplinary history, customer complaints, frequent changes of employment and sales or regulatory violations. As a means of further illuminating pertinent considerations in this area, NTM 97-19 also sets forth guidance for developing and implementing heightened supervisory procedures. Through NTM 97-19, management is advised to consider whether the underlying conduct stems from innate (and less retractable) traits such as greed, incompetence etc., as compared to factors which may be remedied through additional training.

standards reflected in the teachings articulated in *Prospera Financial Services,* Exchange Act Release No. 43352, at 6-7 (September 26, 2000), with the relevant clauses being underscored, as set forth below:

> The Commission has repeatedly emphasized the need for heightened supervision when a firm employs a broker with known regulatory problems or customer complaints. *See James Thornton,* Exchange Act Release No. 41007, 69 SEC Docket 49, 55 (February 1, 1999) (firm failed reasonably to supervise when (supervisory policies made no provision for heightened supervision of a registered representative with a disciplinary history)); *Consolidated Investment Services*, Exchange Act Release No. 36687, 61 SEC Docket 20, 30 (Jan. 5, 1996) (registered representative who has previously evidenced misconduct can be retained only if he subsequently is subjected to a commensurately higher level of supervision) (citing *Dan A. Druz*, Exchange Act Release No. 35203, 58 SEC Docket 1627 (January 9, 1995)); *Frank J. Custable, Jr.,* Exchange Act Release No. 51 SEC Docket at 82. Extraordinary supervision of a registered representative with a disciplinary past is particularly appropriate when that representative operates out of a one-person office, a substantial distance away from supervisory or compliance personnel. *Houston A. Goddard*, Exchange Act Release No. 32839, 54 SEC Docket 2431, 2439 (September 2, 1993).[26]

See also Quest Capital Strategies, at 6 (noting that once a supervisor learns that a registered representative has engaged in misconduct, the representative cannot be retained unless he or she is subjected to enhanced supervision); *Steven E. Muth*, Initial Decision Release No. 262 (collecting cases finding that the hiring of a broker "subject to NASD complaint required heightened supervision" and "prior history of customer complaints against representative required increased supervision and monitoring.")

26. *Goddard* involved a collection of factors which necessitated heightened supervision. The broker, who had been the subject of two customer complaints, conducted his business within a one-person office. After arriving to perform an audit, supervisory personnel found that the broker "reeked" of alcohol. Moreover, the broker had made efforts to transform all customer accounts into margin accounts and was generally abusive toward other firm employees. In formulating failure to supervise findings, the Commission concluded that the supervisors could not merely look to the firm's written supervisory procedures which were then in existence. Given the outrageous nature of the attending circumstances, there was an undeniable need for heightened supervision, regardless of the precise details reflected in the written supervisory procedures.

A. Heightened Supervision Requirements Predicated On Violation of Rule 2110

The breadth of the net cast by NASD Rule 2110 is undoubtedly of immense proportions; Rule 2110 has, on occasion, been described as the mother of all catch-all provisions.[27] Financial industry professionals falling under the NASD's jurisdiction must not take solace after reviewing the plain text of the rule.

The actual verbiage of Rule 2110 refrains from highlighting the obligations of brokers and other individuals, and instead places the onus on registered entities by declaring that "[a] *member*, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade" (emphasis added).

Any comfort that may be derived from the precise language utilized within the rule will necessarily be fleeting in nature. Viewed in its proper context, Rule 2110 governs the acts and omissions of professionals working within the financial services industry to the same extent it controls and restrains the conduct of NASD member firms. This construction necessarily follows from an analysis of Rule 2110 under the light cast by NASD Rule 0115 (a), which provides as follows: "These Rules shall apply to all members and persons associated with a member. Persons associated with a member shall have the same duties and obligations as a member under these Rules."

It is commonly understood that violations of substantive NASD rules, such as those enumerated below, bring about a companion violation of NASD Rule 2110: NASD Rule 2120[28] (manipulation, deception or fraud);[29] Rule 2210[30] (communications with the public);[31] Rule

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27. Rule 2110 is easily the most widely cited of all NASD Conduct Rules. As for the rules enforced by the NYSE, Rule 405 appears to be the provision that is most often cited. Pursuant to NYSE Rule 405(1), "[e]very member organization is required. . . to:

    (1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.

    As previously indicated by the NASD, "the know-your-customer requirement [is] embedded in Article III, Section 1 of the Rules of Fair Practice" (which has been renumbered as Rule 2110). NASD Special Notice To Members 96-32, at 233 (May 9, 1996). Pursuant to these teachings, NYSE Rule 405(1) may fairly be deemed to have been incorporated by reference within NASD Rule 2110.

28. NASD Rule 2120 provides as follows: "No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance."

2310[32] (suitable recommendations);[33] Rule 3010[34] (supervision);[35] Rule 3030[36] (outside business),[37] and Rule 3040[38] (selling away).[39]

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29. *See Market Surveillance Committee v. Markowski,* NASD No. CMS920091, at 19 (NAC July 13, 1998)*; Department of Enforcement v. Charles K. Waddell,* No. C05000021, 2001 NASD Discip. LEXIS 28 (OHO May 14, 2001)
30. NASD Rule 2210 is broad in scope and lengthy in nature. Rule 2210(a) defines various terms and phrases appearing within the entirety of Rule 2210. Subpart (b) itemizes approval and record-keeping requirements associated with pertinent materials. As for subpart (c), it generally focuses upon circumstances surrounding the filing of promotional and informational materials with the NASD's Advertising Regulation Department. NASD Rule 2210(d), titled "Content Standards", serves as the provision that governs the tone and character of the messages that are conveyed to investors. Rule 2210(d) prohibits the employment of outright falsities, as well as mere hyperbole. Rule 2210(d) provides, in pertinent part, as follows:

    (A) All member communications with the public shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. No member may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communication to be misleading.

    (B) No member may make any false, exaggerated, unwarranted or misleading statement or claim in any communication with the public. No member may publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.
31. *See Department of Enforcement v. Rogala*, NASD No. C8A030089, at 12 (October 11, 2004).
32. Pertinent provisions appearing within NASD Rule 2310 provide that:

    (A) 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 upon 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.

    (B) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

        a. the customer's financial status;

        b. the customer's tax status;

        c. the customer's investment objectives; and

        d. such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.
33. *See Department of Enforcement v. Brookes McIntosh Bendetsen*, NASD No. C01020025, at 11 (July 8, 2003)

Similarly, it is well known that someone who engages in conduct which is prohibited under Section 10(b) of the Exchange Act likewise vio-

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34. Pursuant to NASD Rule 3010(a), NASD member firms must have an appropriate supervisory system in place. The introductory verbiage of Rule 3010(a) states as follows:

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

    In accordance with the mandate of NASD Rule 3010(b), member firms generally devote considerable resources toward their written supervisory procedures. The specific mandates of Rule 3010(b) articulate, among other things, the following requirements:

    > (1) Each member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of this Association.

35. A violation of either Rule 3010(a) or Rule 3010(b) gives rise to a violation of Rule 2110. *See Department of Enforcement v. Hennion & Walsh*, NASD No. C9B040013, at 24 (January 10, 2005); *Department of Enforcement v. J. Alexander Securities*, NASD No. CAF010021, at 22 (August 16, 2004).
36. NASD Rule 3030 places limitations on the ability of an associated person who is registered to engage in outside business. The text of Rule 3030 specifically states that:

    > No person associated with a member in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member. Such notice shall be in the form required by the member. Activities subject to the requirements of Rule 3040 shall be exempted from this requirement.

37. *See Department of Enforcement v. Samuel J. Trigillo*, NASD No. C8A040082, at 15 (June 8, 2005); *Market Regulation Committee v. Shaughnessy*, NASD No. CMS950087, at 11-12 (May 27, 1997).
38. NASD Rule 3040 has served as a focal point of high stakes litigation on a perennial basis. Conduct undertaken in violation of that rule has brought about the demise of untold promising careers within the securities industry and resulted in enormous investor losses. Rule 3040, which reflects a series of crucial subparts, caveats and qualifications, begins with the language set forth below:

    > **(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.

39. *See Department of Enforcement v. Hanson*, NASD Disc. Proceeding No. C9A00027, at 1 (NAC December 13, 2001) (finding that Respondent's violation of Rule 3040 was also a violation of Rule 2110).

lates NASD Rule 2110. See e.g., *Department of Enforcement v. Albino*, NASD Disc. Proceeding No. CAF970002, at 25 (Feb. 17, 1999) (summing up finding by noting that baseless price prediction made in violation of Section 10(b) of the Exchange Act also gave rise to a violation of NASD Rule 2110).[40]

Given the importance Congress attached to recordkeeping obligations while developing and refining the federal securities laws, it should not come as a surprise that a violation of Rule 17a-3, promulgated pursuant to Section 17 of the Exchange Act, may likewise engender a violation of NASD Rule 2110. *See Department of Enforcement v. Baker, NASD Disc. Proceeding No. C8A010048, at 14-15 (August 5, 2002)* (finding that employee caused her employer to violate Rule 17a-3 by failing to report the receipt of cash, with NASD Rules 2110 and 3110 thereby being violated). *See also Department of Enforcement v. Investment Management Corp., at 8-9 (NAC December 15, 2003).* So broad is the net cast by Rule 2110 that a violation of its strictures may be found even if a registered representative merely directs obscenities toward a customer. See NASD NTM 96-44 (July, 1996) (recognizing that "abusive communications between members and their associated persons with customers . . . is considered conduct that is inconsistent with the requirement that members shall observe high standards of commercial honor and just and equitable principles of trade . . .").[41]

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40. Not surprisingly, a violation of NASD Rule 2110 may also be found under circumstances where Section 17(a) of the Securities Act is violated. *See Department of Enforcement v. L.H. Ross & Company*, NASD No. CAF040056 at 30-31 (August 30, 2004) (finding that the employment of material misrepresentations and omissions of fact in private placement offerings violated, among other things, Section 17(a) and, thus, Rule 2110.

41. Undoubtedly, the NASD recognizes the need to exercise restraint when assembling Notices To Members that may be deemed expansive and far-reaching, such as NTM 96-44. If a Notice To Members goes too far and ventures into uncharted territory when construing or interpreting an existing rule, successful assaults may be launched upon the discussion reflected therein. Pursuant to Section 19(b)(1) of the Exchange Act, an SRO such as the NASD cannot implement a "proposed rule or any proposed change in, addition to, or deletion from" its rules absent a filing with the SEC which is "accompanied by a concise general statement of the basis and purposed rule change." The issuance of a Notice To Members which establishes a new standard of conduct may readily be characterized as a "change in or addition to" NASD rules, thus necessitating compliance with the rule making process delineated within Section 19(b)(1) of the Exchange Act. See *General Bond & Share Co. v. SEC*, 39 F. 3d 1451, (10th Cir. 1995) (striking down NASD NTM 75-16 after concluding that it established a new standard and thus amounted to a "rule change").

Due to the broad reach of Rule 2110, it may come as no surprise that its provisions apply in a wide range of circumstances that involve the violation of a substantive NASD rule or results in customer harm. Less well known, however, is the principle that the conduct of a registered representative which is far removed from the securities markets may also result in a violation of Rule 2110.

By way of example, a broker who presents a misleading reimbursement claim to his employing firm violates Rule 2110. See *DBCC v. Brunn*, at 5 (January 23. 1998). Likewise, a broker who falsely portrays his daughter's tuition as a donation in order to take advantage of the firm's matching gift program commits a violation of Rule 2110. See *James A. Goetz*, Exchange Act Release No. 39796, at 4 (March 25, 1998).[42]

The rationale associated with the application of Rule 2110 in situations which are removed from the financial markets rests upon the notion that such improprieties "reflect[] directly on [the broker's] . . . ability both to comply with regulatory requirements fundamental to the securities business and to fulfill his fiduciary responsibilities in handling other people's money." *Goetz*, Exchange Act Release No. 39796, at 4.

VIII. SPECIAL CONSIDERATIONS ASSOCIATED WITH REMOTE OFFICE SUPERVISION

Early in 1996, the SEC telegraphed its concern over the loose practices which then governed the oversight and supervision of small, satellite offices housing one or two registered representatives. Specifically, with an eye toward raising the bar in this area, the Commission cast doubt upon the adequacy of supervisory systems which did not provide for surprise inspections of satellite offices on a mandatory basis. See *Consolidated Investment Services*, Exchange Act Release No. 36687 (Jan. 5, 1996).

With the passage of time, the SEC took steps to raise the bar even higher. In 1997, the Commission issued its opinion in *Royal Alliance Associates*, Exchange Act Release No. 38174 (January 15, 1997). In that opinion, the SEC directed pointed criticism toward Royal Alliance's supervisory methods, while noting that the firm's "practice of conducting

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42. As a means of enhancing the accuracy of official regulatory filings associated with registered persons, Rule 2110 violations have also been found in situations where a securities industry professional causes a misleading Form U-4 to be filed on his or her behalf. *See Department of Enforcement v. Howard*, at 13 (NAC November 16, 2000), *aff'd, In the Matter of Daniel Richard Howard,* Exchange Act Rel. No. 46269 (July 26, 2002).

a pre-announced compliance examination only once a year was inadequate to satisfy its supervisory obligations." *Id.*, at 7. At that point, the Commissioners went on to fire a shot across the bow of this segment of the securities industry by making it clear that they "harbor grave doubts that this practice would necessarily discharge the supervisory obligations of any firm that incorporates a structure in which smaller branch offices are operated by only one or two representatives." *Id.*

1998 ushered in more of the same. During the fall of that year, the SEC reiterated its recent teachings in this area through the issuance of its opinion in *NYLife Securities*, Exchange Act Release No. 34-40459 (Sept. 23, 1998). In *NYLife*, the SEC reminded observers of the principles it had articulated in *Royal Alliance* while noting that "firms with a high number of one or two person offices have not discharged their supervisory obligations where there were no surprise inspections." *Id.*, at 6. The SEC, however, then took matters one step further by layering on an additional level of critique. In doing so, the Commission deemed the supervisory procedures of NYLIFE Securities to be inadequate because they did not provide for a "system of follow up and review" to determine that the front line supervisor was diligently exercising the oversight responsibilities which had been placed upon him. *Id.*[43]

With these SEC opinions serving as a backdrop, SEC staff members recently synthesized the essence of these holdings, and combined them with numerous other principles while addressing supervisory responsibilities in this area. This report, which was issued by the Division of Market Regulation, was released on March 19, 2004. It is titled, "Staff Legal Bulletin No. 17: Remote Office Supervision." Some of the enlightening observations raised by the Division of Market Regulation in that report are as follows:

- Inspections should include "a review of business records, including physical and computer files." *Id.*, at 3.
- "Unannounced onsite inspections are among the most effective tools to expose and deter misconduct that might otherwise go undetected." *Id.*

43. See also *Signal Securities*, SEC Release No. 34-43350 (Sept. 26, 2000) (finding that firm's failure to mandate inspections of its "remote offices" was particularly unreasonable as the firm employed most of its registered representatives in these offices, with those deficiencies being even more troubling on account of deficient follow up and review practices.

- Unannounced inspections are to be narrowly construed so as to exclude situations where a registered representative is given one or two days notice of the inspection, or the registered representative is not provided with a specific date but is advised that "there will be an inspection in the next month." *Id.*, at 10 n. 16.
- A customer "address change to a post office box . . . warrants additional steps to verify that the change is genuine." *Id.*, at 6.
- Firms may enhance their oversight of incoming and outgoing correspondence by programming facsimile machines in remote offices "to automatically send duplicate incoming and outgoing facsimiles to an office of supervisory jurisdiction." *Id.*, at 7.

CONCLUSION

The ashes and the rubble emanating from the 1929 market crash prompted Congress to enact expansive legislation in the securities area, with the expectation that these measures would heighten investor confidence and invigorate the capital formation process.

Governmental authorities, along with SROs, have utilized their resources so as to directly promote investor confidence, while at the same time pressing registered securities firms to be more vigilant from an oversight perspective. Given the tone of numerous disciplinary actions associated with supervisory shortcomings, taken together with the potential for private actions, it is of utmost importance that supervisory systems receive the emphasis they deserve.

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