



**NASAA
Broker Dealer
Section
COORDINATED
EXAMINATION
REPORT**

September 2018

Introduction

The North American Securities Administrators Association (NASAA) is the voice of 67 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, 10 Canadian provinces, 3 Canadian territories, and Mexico. The role of NASAA members in securities regulation is crucial as they serve as the first line of defense for investors from every walk of life. This role as the “cop on the beat” requires NASAA members to take a proactive approach to issues affecting retail investors. This year, in furtherance of that mission, 30 NASAA member jurisdictions conducted a coordinated examination of broker-dealer firms to survey heightened supervision plans for registered representatives of the broker-dealers (the “Coordinated Exam”).

Broker misconduct is a recurring threat for investors. Registered representatives with prior records of misconduct are three times more likely to be repeat offenders than their peers.¹ Heightened supervision of risk-prone registered representatives is a crucial obligation of broker-dealer firms.

Further, broker-dealer firms occupy a uniquely important place in evaluating their employees for potential heightened supervision. Broker-dealers are required to establish and maintain supervisory systems and written procedures that are reasonably designed to ensure compliance with applicable securities laws.² Because firms are required to both thoroughly vet

¹ Egan, Mark, Gregor Matvos, and Amit Seru. "The Market for Financial Adviser Misconduct." *Journal of Political Economy* (forthcoming).

² See, e.g., FINRA, Rule 3110 (2017).

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potential hires prior to employment³ and to supervise them reasonably once they are hired,⁴ they are ideally situated to determine whether a registered representative poses a potential risk to customers, and enact measures to mitigate that risk.

Highlighting the importance of heightened supervision, FINRA recently introduced additional guidance to its member firms concerning supervisory obligations for registered representatives with a history of misconduct.⁵ Much of the focus centered on firms ensuring their supervisory procedures have measures to assess whether heightened supervision is appropriate and hammering home the need to tailor the constraints of a heightened supervision plan on a case-by-case basis.⁶

In the Coordinated Exam, NASAA's members sought to gain a better understanding of how broker-dealers of varying types and size are addressing the issue of heightened supervision, and highlight these practices—the good and the bad—to provide guidance on what the state securities administrators expect from broker-dealers in this space.

The Coordinated Exam employed a uniform exam module designed to obtain information about each firm's policies and procedures related to heightened supervision and, in the cases where individual registered representatives were on heightened supervision, to assess the effectiveness of those plans.

³ FINRA, Rule 3110(e)(2015).

⁴ See 2002 Uniform Securities Act §412(d)(9).

⁵ FINRA, Notice to Members 18-15 (2018). This notice was issued in conjunction with Notice to Members 18-16, which proposed a number of rules changes designed by FINRA to heighten investor protection related to the issue of high-risk registered representatives.

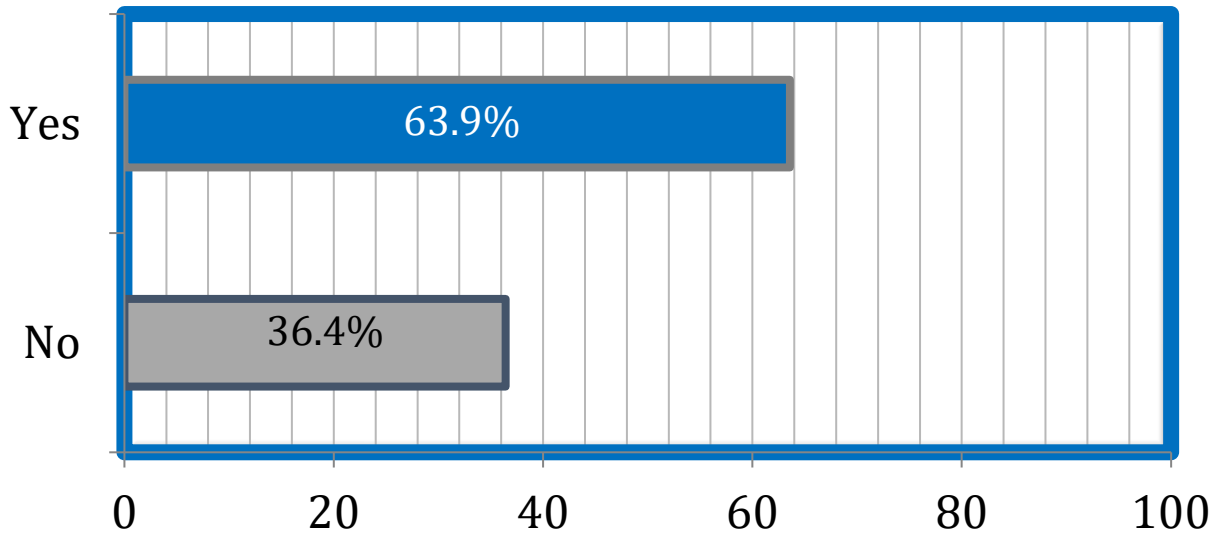
⁶ *Id.*

Coordinated Exam Results:

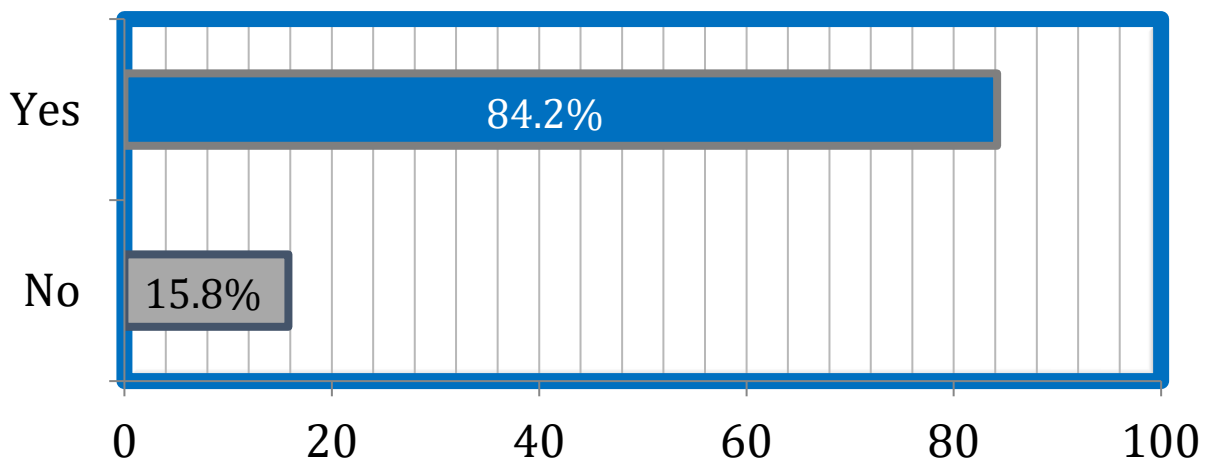
Firm Questions

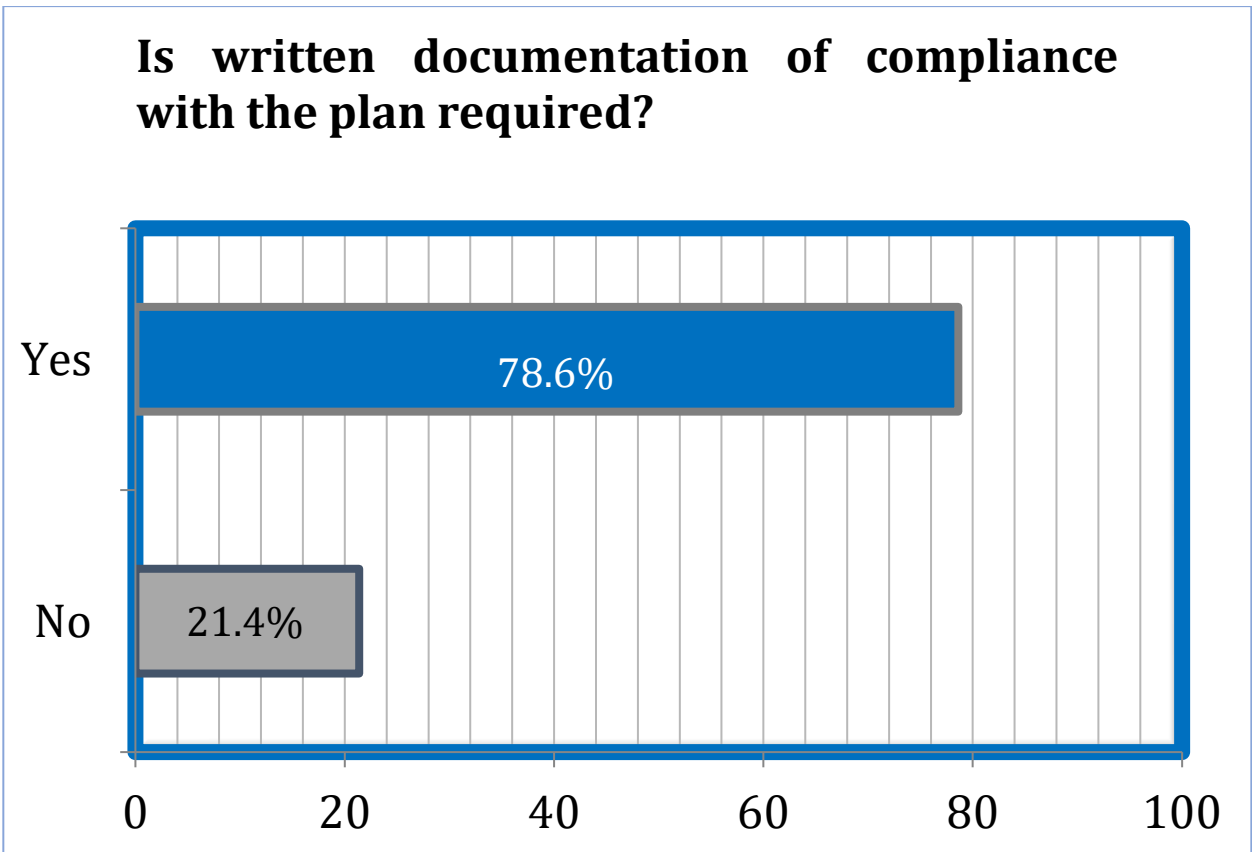
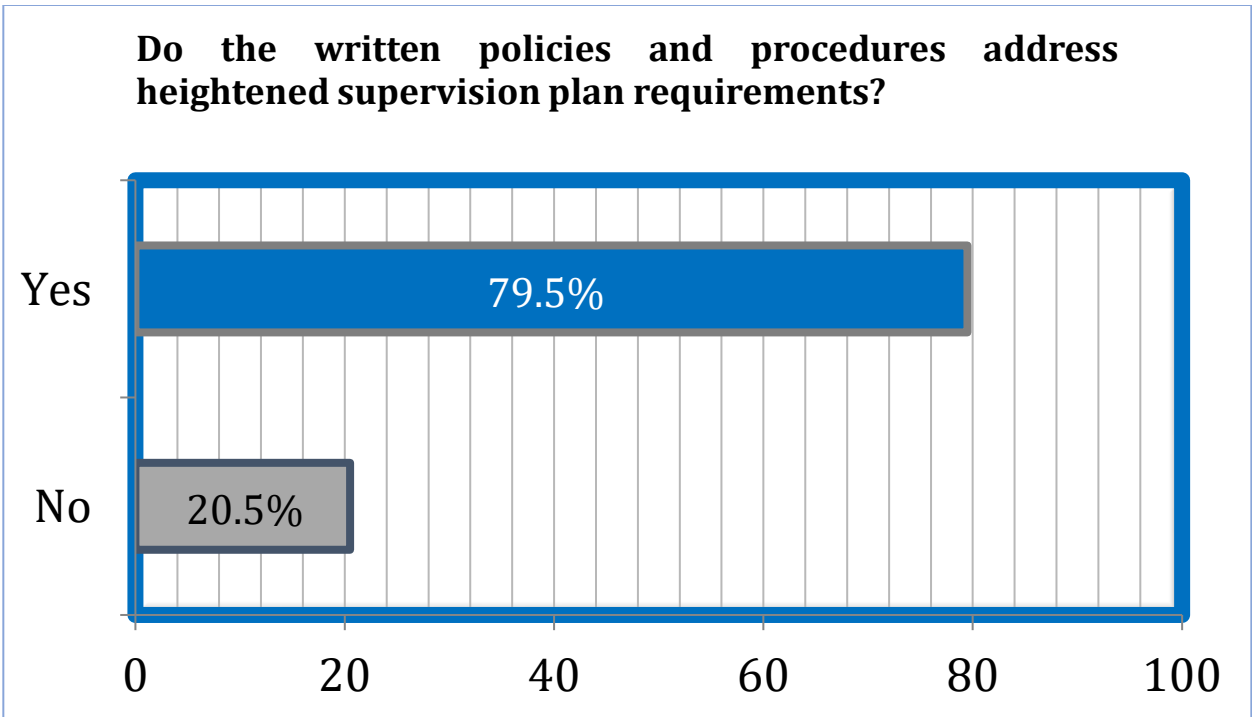
Thirty participating NASAA jurisdictions conducted a total of 165 exams of 121 broker-dealers, a mix that included wirehouse, independent, and introducing firms. The exams were conducted both in the field, at branch offices, and home offices, and as desk exams. The first portion of the exam module related to general questions about the policies and procedures each examined firm has in place to address heightened supervision of its registered representatives. Of the 121 firms examined, nine did not have any policies and procedures related to heightened supervision. Thirty-four firms had no criteria for the assessment of whether heightened supervision would be appropriate for new hires, and an equal number did not have any such criteria for currently associated representatives. Interestingly, 55 (49 percent) of the 112 examined firms that had heightened supervision procedures in place had no policies and procedures related to how a registered representative could be removed from heightened supervision; 14 of these firms had at least one registered representative on heightened supervision, and one firm had 13.

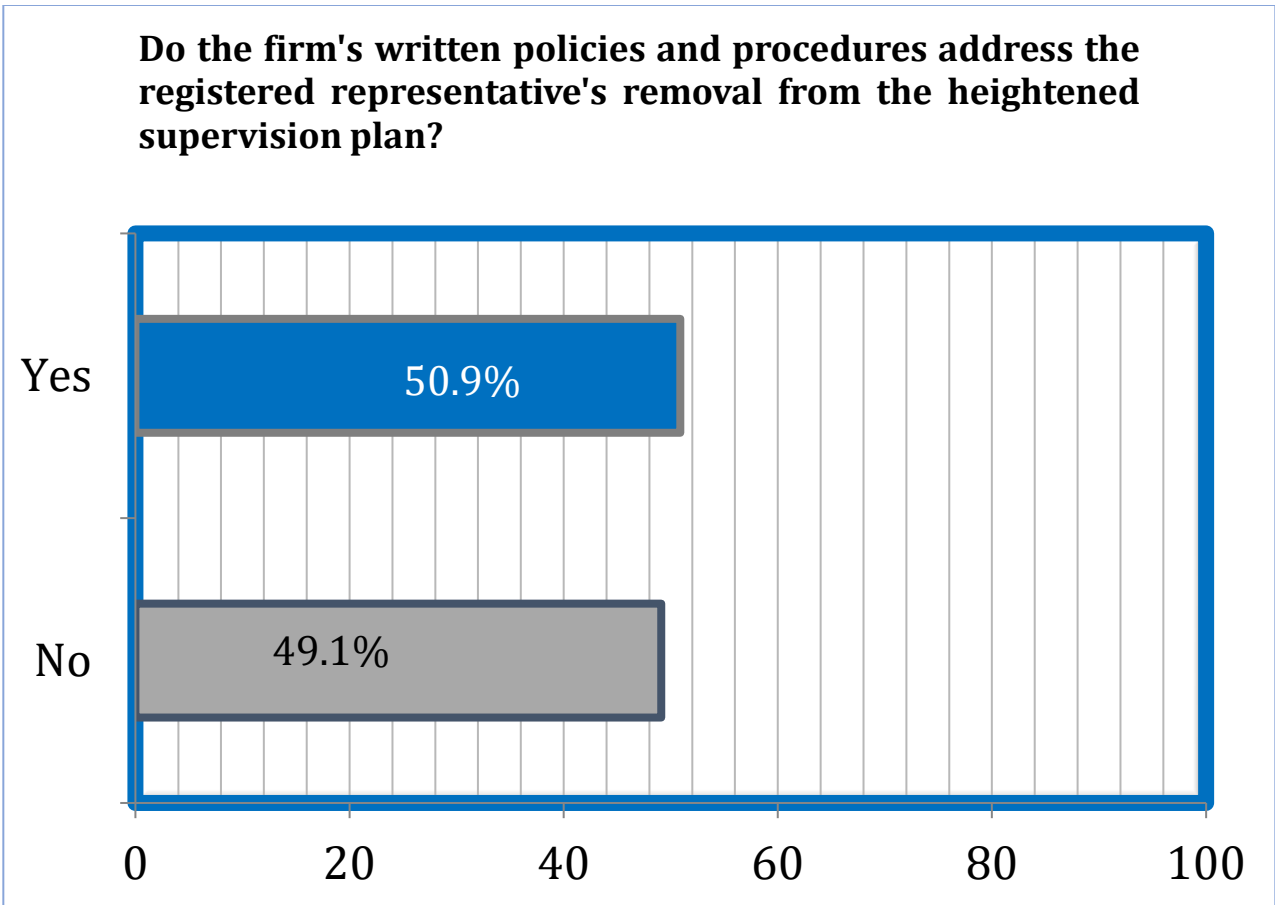
Do the written policies and procedures address criteria for heightened supervision for new hires?



Do the written policies and procedures address criteria for identifying established agents for heightened supervision?







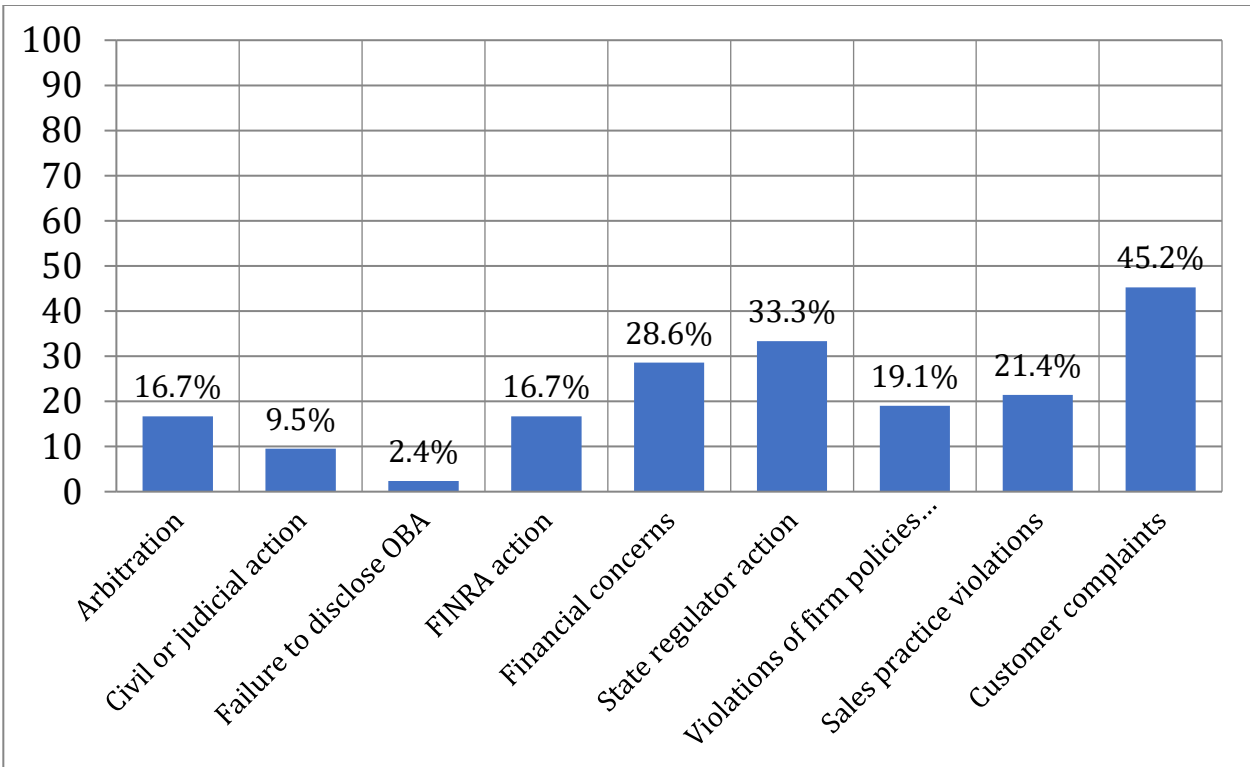
Individual plans

The second portion of the module was reserved for firms with registered representatives on a heightened supervision plan. Of the 121 examined firms, 51 had at least one registered representative on a heightened supervision plan. Among the 51 broker-dealers with registered representatives on a heightened supervision plan, the length of time the firm-imposed heightened supervision varied but ranged from 6 to 24 months. By comparison, most state-imposed heightened supervision plans carry terms of 24 months, which was confirmed through the results of the Coordinated Exam.

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Designating an individual to enforce a heightened supervision plan is a key component of effective supervision. Firms that establish a point person to ensure compliance with the obligations and limitations set forth in a heightened supervision plan reduce the risks of misdeeds going undetected. Further, it provides confidence to regulators that someone at the firm is paying close attention to registered representatives who may pose a greater risk to investors. The results of the Coordinated Exam reinforce the importance of a designated person. It is the title (and location) of that individual where the differences lie. For instance, of the 44 exams that identified a designated individual responsible for heightened supervision of registered representative, 15 were on-site supervisors or branch managers. The balance of the exams identified either OSJs, compliance officers, or the chief compliance staff as the designated individual. We believe that an essential element of an effective enforcement of any heightened supervision plan comes from local supervision (i.e., same branch or close in geographical proximity) as it permits more consistent review of the activities of the registered representative.

The Coordinated Exam also sought information about the circumstances that led to these registered representatives being placed on heightened supervision. Customer complaints against registered representatives dominated this category. State-required heightened supervision and financial disclosures (e.g., disclosed liens and judgments) also significantly factored into the findings. Here, 23 firms had at least one registered representative on a heightened supervision plan because it was required by a state regulator as a condition precedent to registration in that jurisdiction. Additionally, registered representatives were placed on heightened supervision plans for the reasons expressed in the following chart.



Common Issues in the Coordinated Exam Results

In 3 exams, broker-dealers failed to document any sort of review of registered representative conduct under the heightened supervision plans. Additionally, 9 exams found heightened supervision plans which were lacking any elements related to the prior conduct of the registered representative in question. Another 10 firms were found not to be following their own heightened supervision procedures. Chief among the ways they did not follow procedures were (1) withdrawing from states where heightened supervision was required (but allowing the registered agent to still practice in other states), and (2) failing to document compliance with heightened supervision.

Conclusion

It is essential that all firms take this compliance responsibility seriously. As the Coordinated Exam revealed, heightened supervision plans are effective; 90% of the examined firms with a registered representative on a heightened supervision plan reported no complaints against that representative.

In crafting policies and procedures for heightened supervision plans, broker-dealer firms should ensure that the plans call for:

- designated individual(s) with the necessary experience and authority to enforce the plan;
- appropriate and meaningful written documentation evidencing the registered representative's awareness of the conditions of the plan and the supervisor's awareness of his responsibilities;
- periodic review to determine the plan's effectiveness; and
- procedures for removing registered representatives from plans once all of the necessary criteria are met.

Common sense should dictate how heightened supervision plans are tailored; no plan that is one-size-fits-all is reasonable. Heightened supervision plans should be designed to ensure that misconduct is prevented in the future and, at a minimum, should address:

- the conduct for which the registered representative had received scrutiny;
- the records (commission runs, trade blotters, employee trading accounts, e-mails, etc.) related to the registered representative's business that will be part of the review; and

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- the frequency of the review.

NASAA and its member jurisdictions are committed to the protection of investors. While it appears some firms are implementing heightened supervision procedures, less than 25% of the firms maintained supervisors on site who were actually in charge of enforcing heightened supervision plans. Additionally, some 20% of firms (both large and small), failed to enforce the procedures the firms themselves had developed. Finally, the fact that the majority of firms have no plans in place to life heightened supervision is unfortunate.

Cumulatively, these numbers indicate that there is much work to be done both in regard to the new FINRA rules and state requirements regarding supervision. NASAA encourages all firms to review their procedures to ensure they are acting in compliance therewith, and to develop procedures (including the removal of individuals from heightened supervision), where they may be lacking. Finally, NASAA's Broker-Dealer Section will begin looking into complaints regarding individuals who are on heightened supervision to determine what can be done to ensure investor protection responsibilities are met.